

SAN JUAN BASIN ROYALTY TRUST  
Form 10-K  
March 18, 2019

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**Form 10-K**

**Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

**For the Fiscal Year Ended December 31, 2018**

**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. 001-08032**

**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)*

**Compass Bank**

**300 W. 7<sup>th</sup> Street, Suite B**

**Fort Worth, Texas**

*(Address of principal executive offices)*

**75-6279898**

*(I.R.S. Employer  
Identification No.)*

**76102**

*(Zip Code)*

**(866) 809-4553**

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(Registrant's telephone number, including area code)

**Securities registered pursuant to Section 12(b) of the Act:**

Title of Each Class	Name of Each Exchange on Which Registered
Units of Beneficial Interest	New York Stock Exchange

**Securities registered pursuant to Section 12(g) of the Act:**

None

(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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 website, 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company, or an emerging growth company. See the definitions of large accelerated filer, accelerated filer, smaller reporting company, and emerging growth company in Rule 12b-2 of the Exchange Act.

Large accelerated filer	Accelerated filer	Non-accelerated filer	Smaller reporting company
Emerging growth company			

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

Aggregate market value of the Units of Beneficial Interest held by non-affiliates of the registrant as of June 30, 2018: \$269,720,179

At March 18, 2019 there were 46,608,796 Units of Beneficial Interest of the registrant outstanding.

**DOCUMENTS INCORPORATED BY REFERENCE**

None.



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### Information Regarding Forward-Looking Statements

Certain information included in this Annual Report on Form 10-K contains, and other materials filed or to be filed by the San Juan Basin Royalty Trust (the Trust) with the Securities and Exchange Commission (the SEC) (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, as amended (the Exchange Act) and Section 27A of the Securities Act of 1933, as amended (the Securities Act). 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, should, assume, believe, plan, intend, or other words that convey the uncertainty of future events or outcomes. Such statements are based on certain assumptions of Compass Bank, the trustee of the trust (the Trustee), and certain assumptions of information provided to the Trust by Hilcorp San Juan L.P. (Hilcorp), the owner of the Subject Interests (as defined herein). Such statements also are based on an assessment of, and are subject to, a variety of factors deemed relevant by the Trustee and Hilcorp that involve risks and uncertainties. However, whether actual results and developments will conform with such expectations and predictions is subject to a number of risks and uncertainties that could affect the future results of the energy industry in general, and the Trust and Hilcorp in particular, and could cause those results to differ materially from those expressed in such forward-looking statements. The actual results or developments anticipated may not be realized or, even if substantially realized, they may not have the expected consequences to or effects on Hilcorp's business and the Trust. Such statements are not guarantees of future performance and actual results or developments may differ materially from those projected in such forward-looking statements. The Trust undertakes no obligation to publicly update or revise any forward-looking statements, except as required by applicable law.

### Hilcorp Information

As a holder of a net overriding royalty interest, the Trust relies on Hilcorp for information regarding Hilcorp and its affiliates, the Subject Interests, including the operations, acreage, well and completion count, working interests, production volumes, sales revenues, capital expenditures, operating expenses, reserves, drilling plans, drilling results and leasehold terms related to the Subject Interests, and factors and circumstances that have or may affect the foregoing. See Part II, Item 9A Controls and Procedures.

Hilcorp's reporting of natural gas volumes differs from the reporting of gas volumes from Burlington Resources Oil & Gas Company LP (Burlington), an indirect wholly-owned subsidiary of ConocoPhillips, from which Hilcorp acquired the Subject Interests on July 31, 2017. The natural gas volumes reported to the Trust by Hilcorp are based on plant residue gas volumes plus equivalent volumes for natural gas liquids. Hilcorp converts one barrel of natural gas liquids to six Mcf of natural gas using industry standards. Historically, ConocoPhillips reported natural gas production to the Trust based on wellhead volumes. Such differences in reporting methodology could significantly affect the comparison of reported natural gas volumes and average pricing in 2018 to those from prior periods.

## GLOSSARY OF OIL AND NATURAL GAS TERMS

The following defined terms, certain of which have been adopted by the SEC and the Financial Accounting Standards Board are used within this Annual Report on Form 10-K:

**Bbl:** Barrel, generally 42 U.S. gallons measured at 60 degrees Fahrenheit.

**Btu:** British thermal unit; the amount of heat necessary to raise the temperature of one pound of water one degree Fahrenheit.

**Coal Seam Well:** A well completed to a coal deposit found to contain and emit natural gas.

**Conventional Well:** A well completed to a formation historically found to contain deposits of oil or natural gas (for example, in the San Juan Basin, the Pictured Cliffs, Dakota and Mesaverde formations) and operated in the conventional manner.

**Developed Oil and Natural Gas Reserves:** Reserves of any category that can be expected to be recovered (i) through existing wells with existing equipment and operating methods or in which the cost of the required equipment is relatively minor compared to the cost of a new well; and (ii) through installed extraction equipment and infrastructure operational at the time of the reserves estimate if the extraction is by means not involving a well. See 17 CFR 210.4-10(a)(6).

**Distributable Income:** An amount paid to Unit Holders equal to the Royalty Income received by the Trustee during a given period plus interest, less the expenses and payment of liabilities of the Trust, adjusted by any changes in cash reserves.

**Estimated future net revenues:** Computed by applying current oil and natural gas prices (with consideration of price changes only to the extent provided by contractual arrangements and allowed by federal regulation) to estimated future production of proved oil and natural gas reserves as of the date of the latest balance sheet presented, less estimated future expenditures (based on current costs) to be incurred in developing and producing the proved reserves and assuming continuation of existing economic conditions. See 17 CFR 210.4-10(c)(4)(A). Estimated future net revenues are sometimes referred to in this Annual Report on Form 10-K as estimated future net cash flows.

**GAAP:** United States generally accepted accounting principles.

**Grantor Trust:** A trust (or portion thereof) with respect to which the grantor or an assignee of the grantor, rather than the trust, is treated as the owner of the trust properties and is taxed directly on the trust income for federal income tax purposes under Sections 671 through 679 of the Internal Revenue Code of 1986, as amended.

**Henry Hub:** Henry Hub index.

**Lease Operating Expenses:** Expenses incurred in the operation of a producing property as apportioned among the several parties in interest.

**Mcf:** Thousand cubic feet.

**MMBtu:** Million British thermal units.

**MMcf:** Million cubic feet.

**Multiple Completion Well:** A well which produces simultaneously, with or without separate tubing strings, from two or more producing horizons or alternatively from each.

**Net Overriding Royalty Interest:** A share of gross production from a property, measured by net profits from operation of the property and carved out of the working interest, i.e., a net profits interest.

**Natural Gas Liquids (NGL):** Those hydrocarbons that are separated from the gas as liquids through the process of absorption, condensation, adsorption or other methods in gas processing or cycling plants.

**Proved developed reserves:** Proved natural gas and oil reserves that can be expected to be recovered through existing wells with existing equipment and operating methods or in which the cost of the required equipment is relatively minor compared to the cost of a new well.

**Proved natural gas and oil reserves:** Those quantities of oil and natural gas, which, by analysis of geoscience and engineering data, can be estimated with reasonable certainty to be economically producible from a given date forward, from known reservoirs, and under existing economic conditions, operating methods, and government regulations prior to the time at which contracts providing the right to operate expire, unless evidence indicates that renewal is reasonably certain, regardless of whether deterministic or probabilistic methods are used for the estimation. The project to extract the hydrocarbons must have commenced or the operator must be reasonably certain that it will commence the project within a reasonable time. See 17 CFR 210.4-10(a)(22).

**Proved undeveloped reserves (PUDs):** Proved reserves that are expected to be recovered from new wells on undrilled acreage, or from existing wells where a relatively major expenditure is required for well recompletion. Reserves on undrilled acreage shall be limited to those directly offsetting development spacing areas that are reasonably certain of production when drilled, unless evidence using reliable technology exists that establishes reasonable certainty of economic producibility at greater distances. Undrilled locations can be classified as having undeveloped reserves only if a development plan has been adopted indicating that they are schedule to be drilled within five years, unless specific circumstances justify a longer time. Under no circumstances shall estimates for proved undeveloped reserves be attributable to any acreage for which an application of fluid injection or other improved recovery technique is contemplated, unless such techniques have been proved effective by actual projects in the same reservoir or an analogous reservoir, or by other evidence using reliable technology establishing reasonable certainty.

**Reasonable certainty:** (i) If deterministic methods are used, reasonable certainty means a high degree of confidence that the quantities will be recovered or (ii) if probabilistic methods are used, there should be at least a 90% probability that the quantities actually recovered will equal or exceed the estimate. A high degree of confidence exists if the quantity is much more likely to be achieved than not, and, as changes due to increased availability of geoscience (geological, geophysical, and geochemical), engineering, and economic data are made to estimated ultimate recovery (EUR) with time, reasonably certain EUR is much more likely to increase or remain constant than to decrease. See 17 CFR 210.4-10(a)(24).

**Recompleted Well:** A well completed by drilling a separate well bore from an existing casing in order to reach the same reservoir, or redrilling the same well bore to reach a new reservoir.

**Reserves:** Estimated remaining quantities of oil and natural gas and related substances anticipated to be economically producible, as of a given date, by application of development projects to known accumulations. In addition, there must exist, or there must be a reasonable expectation that there will exist, the legal right to produce or a revenue interest in the production, installed means of delivering oil and natural gas or related substances to market, and all permits and financing required to implement the project. See 17 CFR 210.4-10(a)(26).

**Undeveloped oil and natural gas reserves:** Reserves of any category that are expected to be recovered from new wells on undrilled acreage, or from existing wells where a relatively major expenditure is required for well recompletion. See 17 CFR 210.4-10(a)(31).

**Working Interest:** The operating interest under an oil and natural gas lease.

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**PART I**

**ITEM 1. BUSINESS**

The Trust is an express trust created under the laws of the State of Texas by the San Juan Basin Royalty Trust Indenture entered into on November 1, 1980, between Southland Royalty Company ( *Southland* ) and The Fort Worth National Bank. Effective as of September 30, 2002, the original indenture was amended and restated and, effective as of December 12, 2007, the restated indenture was amended and restated, which we refer to as the *Indenture*. As a result of a series of mergers and other transactions, the current Trustee of the Trust is Compass Bank (the *Trustee* ), which is a wholly-owned subsidiary of Banco Bilbao Vizcaya Argentaria, S.A.

**The Conveyance and the Royalty**

Pursuant to the Net Overriding Royalty Conveyance (the *Conveyance* ) effective November 1, 1980, Southland conveyed to the Trust a 75% net overriding royalty interest (the *Royalty* ) that burdens certain of Southland's oil and natural gas interests (the *Subject Interests* ) in properties located in the San Juan Basin of northwestern New Mexico (the *San Juan Basin* ). Subsequent to the Conveyance of the Royalty, through a series of sales, assignments and mergers, Southland's successor became Hilcorp San Juan L.P. ( *Hilcorp* ), which acquired the Subject Interests from Burlington Resources Oil & Gas Company LP ( *Burlington* ), an indirect wholly-owned subsidiary of ConocoPhillips on July 31, 2017. The Royalty functions generally as a net profits interest. Under the terms of the Conveyance, the Trust receives 75% of net proceeds from the Subject Interests. The term *net proceeds*, as used in the Conveyance, means the excess of gross proceeds received by Hilcorp during a particular period over production costs for such period. *Gross proceeds* means the amount received by Hilcorp (or any subsequent owner of the Subject Interests) from the sale of the production attributable to the Subject Interests, subject to certain adjustments. *Production costs* generally means costs incurred on an accrual basis by Hilcorp in operating the Subject Interests, including both capital and non-capital costs. For example, these costs include development drilling, production and processing costs, applicable taxes and operating charges. However, Hilcorp informed the Trust that, for wells operated by Hilcorp, it generally did not intend to accrue lease operating expenses to the Trust. If production costs exceed gross proceeds in any month, the excess is recovered out of future gross proceeds prior to the making of further payment to the Trust, but the Trust is not otherwise liable for any production costs or other costs or liabilities attributable to the Subject Interests or the minerals produced therefrom. If at any time the Trust receives more than the amount due under the Royalty, it is not obligated to return such overpayment, but the amounts payable to it for any subsequent period are reduced by such amount, plus interest, at a rate specified in the Conveyance.

The Royalty constitutes the principal asset of the Trust. The Trust's beneficial interest in the Royalty is divided into 46,608,796 units (the *Units* ) representing undivided fractional interests in the beneficial interest of the Trust equal to the number of shares of the common stock of Southland outstanding as of the close of business on November 3, 1980. Each stockholder of Southland of record at the close of business on November 3, 1980 received one freely tradable Unit for each share of the common stock of Southland then held. Holders of Units are referred to herein as *Unit Holders*.

As of December 31, 2018, 98% of the Trust's estimated proved reserves consisted of natural gas reserves, and 96% of the gross proceeds from the Subject Interests in 2018 were attributable to the production and sale of natural gas by Hilcorp as well as other proceeds. Accordingly, the market price for natural gas produced and sold from the San Juan Basin heavily influences the amount of Trust income available for distribution to the Unit Holders by the Trust and, by extension, the price of the Units. Normally there is greater demand for natural gas used for heating or air conditioning purposes in the summer and winter months than during the rest of the year.

**The Trustee**

The primary function of the Trustee is to collect the net proceeds attributable to the Royalty ( *Royalty Income* ), to pay all expenses and charges of the Trust and to distribute the remaining available income to the

Unit Holders. The Trust received approximately \$19.4 million and \$33.2 million in Royalty Income from Hilcorp and Burlington in each of the fiscal years ended December 31, 2018 and 2017, respectively. After deducting administrative expenses and accounting for interest income and any change in cash reserves, the Trust distributed approximately \$18.0 million and \$39.1 million to Unit Holders in each of the fiscal years ended December 31, 2018 and 2017, respectively. The Trust's corpus was approximately \$5.8 million and \$6.6 million as of December 31, 2018 and 2017, respectively.

Proceeds from production in the first month are generally received by Hilcorp in the second month, the net proceeds attributable to the Royalty are paid by Hilcorp to the Trustee in the third month, and distribution by the Trustee to the Unit Holders is made in the fourth month. Unit Holders of record as of the last business day of each month (the monthly record date) will be entitled to receive the calculated monthly distribution amount for such month on or before ten business days after the monthly record date. The amount of each monthly distribution will generally be determined and announced ten days before the monthly record date. The aggregate monthly distribution amount is the excess of (i) the net proceeds attributable to the Royalty paid to the Trustee, plus any decrease in cash reserves previously established for liabilities and contingencies of the Trust, over (ii) the expenses and payments of liabilities of the Trust, plus any net increase in cash reserves.

The Trustee may, in its sole discretion, establish a cash reserve for payment of Trust liabilities that are contingent or uncertain or otherwise not currently due and payable. As of December 31, 2018, the Trustee had established cash reserves of \$1.0 million. In September 2018 the Trust utilized cash reserves of \$97,909 to pay Trust administrative expenses, and the Trust replenished its cash reserves by \$97,909 in October 2018. The Trustee does not anticipate any increase to the cash reserves in 2019.

Cash being held by the Trustee as cash reserves or pending distribution may be placed, in the Trustee's discretion, in obligations issued by (or unconditionally guaranteed by) the United States or any agency thereof, repurchase agreements secured by obligations issued by the United States or any agency thereof, certificates of deposit of banks having capital, surplus and undivided profits in excess of \$50 million or money market funds that have been rated at least AAm by Standard & Poor's and at least Aa by Moody's, subject, in each case, to certain other qualifying conditions. Currently, such funds are placed in interest-bearing negotiable order of withdrawal accounts whose funds are either insured by the Federal Deposit Insurance Corporation or secured by other assets of the Trustee.

The other powers and duties of the Trustee are set forth in the Indenture and include the prosecution and defense of claims by and against the Trust, the engagement of consultants and professionals and the payment of Trust liabilities. If the Trustee determines that the Trust does not have sufficient funds to pay its liabilities, the Trustee may borrow funds on behalf of the Trust, in which case no distributions will be made to Unit Holders until such borrowings are repaid in full. The Trustee may not sell or dispose of any part of the assets of the trust without the affirmative vote from the Unit Holders of 75% of all of the Units outstanding; however, the Trustee may sell up to 1% of the value of the Royalty (as determined pursuant to the Indenture) during any 12-month period without the consent of the Unit Holders if it determines such a sale is in the best interest of the Unit Holders. The Trust does not operate the Subject Interests and is not empowered to carry on any business activity. The Trust has no employees, officers or directors. All administrative functions of the Trust are performed by the Trustee.

Under the Indenture, the Trustee may act in its discretion in carrying out its powers and performing its duties and is liable only for fraud or for acts and omissions in bad faith. The Trustee is not liable for any act or omission of its agents or employees unless the Trustee acted in bad faith in its selection and retention of such agents or employees. The Indenture provides that the Trustee and its officers, agents and employees must be indemnified and receive reimbursement of expenses from the assets of the Trust for liabilities and claims incurred in the administration of the Trust, except for liabilities and claims arising from the Trustee's fraud or bad faith.

### **Duration of the Trust**

The Trust will terminate if (a) its gross revenue for each of two successive years is less than \$1 million per year or, if earlier, (b) the Unit Holders of at least 75% of all of the Units outstanding vote in favor of termination. Upon termination of the Trust, the Trustee must sell the Royalty and distribute the proceeds to Unit Holders after satisfying or establishing reserves to satisfy the liabilities of the Trust.

### **Hilcorp**

The sale of San Juan Basin assets from Burlington to Hilcorp closed on July 31, 2017. Hilcorp is the operator of the majority of the Subject Interests, and as a result, Hilcorp's actions could have a material impact on the results of operations and could have interests that conflict with the interests of the Trust and the Unit Holders. The Subject Interests that are not operated by Hilcorp are operated by other operators, some of which may be affiliated with Hilcorp. As an operator, Hilcorp has the obligation under the Conveyance to conduct its operations in accordance with reasonable and prudent business judgment and good oil and natural gas field practices. The development of the Subject Interests is conducted pursuant to operating and similar agreements to which the Trust is not a party and under which the Trust has no control or other rights to determine the location, timing and other key aspects of development and maintenance that may materially impact results of operations. Neither the Trustee nor the Unit Holders can influence or control the operation or future development of the Subject Interests.

Hilcorp's interests may conflict with those of the Trust and the Unit Holders in situations involving the development, maintenance, operation or abandonment of the Subject Interests. Hilcorp has the right to abandon any well when, in its opinion, such well ceases to produce or is not capable of producing oil and natural gas in paying quantities, even though such well is still generating revenue for the Unit Holders. Hilcorp reserves the right to not participate in operations on the Subject Interests when it has a right to do so under the applicable operating or similar agreement. Hilcorp may make decisions with respect to expenditures and decisions to allocate resources to projects in other areas that adversely affect the Subject Interests, including reducing expenditures on these properties, which could cause oil and natural gas production to decline at a faster rate and thereby result in lower cash distributions by the Trust in the future. In addition, Hilcorp is not obligated to the Trust to maintain any particular types or amounts of insurance, and insurance may not be commercially available at adequate levels to cover its operational hazards at all times during the life of the Trust. If a well is damaged, Hilcorp would have no obligation to drill a replacement well or otherwise compensate the Trust for the loss. The Trust does not have insurance or indemnification to protect against losses or delays in receiving proceeds from such events.

Hilcorp also is responsible, subject to the terms of an agreement with the Trust, for marketing the production from such properties, either under existing sales contracts or under future arrangements, at the best prices and on the best terms it shall deem reasonably obtainable in the circumstances. Additionally, Hilcorp is obligated under the Conveyance to maintain books and records sufficient to determine the amounts payable to the Trustee.

### **Additional Information**

The principal office of the Trust is located at 300 West 7<sup>th</sup> Street, Suite B, Fort Worth, Texas 76102 (toll-free telephone number (866) 809-4553). The Trust makes available (free of charge) its annual, quarterly and current reports (and any amendments thereto) filed with the SEC through its website at [www.sjbrt.com](http://www.sjbrt.com) as soon as reasonably practicable after electronically filing or furnishing such material with or to the SEC. The Trust's materials filed with the SEC are available at the SEC's internet site, [www.sec.gov](http://www.sec.gov). This site contains reports and, as applicable, proxy and information statements, and other information regarding the Trust and other issuers that file electronically with the SEC.

The Trust is a widely held fixed investment trust ( WHFIT ) classified as a non-mortgage widely held fixed investment trust ( NMWHFIT ) for federal income tax purposes. The Trustee, 300 West 7<sup>th</sup> Street, Suite B, Fort

Worth, Texas 76102 (toll-free telephone number (866) 809-4553, email address: [slt.us@bbva.com](mailto:slt.us@bbva.com)), is the representative of the Trust that will provide tax information in accordance with the applicable U.S. Treasury Regulations governing the information reporting requirements of the Trust as a WHFIT and a NMWHFIT. The tax information is generally posted by the Trustee on the Trust's website: [www.sjbtr.com](http://www.sjbtr.com).

**ITEM 1A. RISK FACTORS**

Not required.

**ITEM 1B. UNRESOLVED STAFF COMMENTS**

None.

**ITEM 2. PROPERTIES**

The Royalty conveyed to the Trust was carved out of Southland's (now Hilcorp's) working interests and royalty interests in certain properties situated in the San Juan Basin. See Item 1. Business, for information on the conveyance of the Royalty to the Trust. References below to gross wells and acres are to the interests of all persons owning interests therein, while references to net are to the interests of Hilcorp (from which the Royalty was carved) in such wells and acres.

Unless otherwise indicated, the following information in this Item 2 is based upon data and information furnished to the Trustee by Burlington and Hilcorp.

**The Subject Interests**

The Subject Interests consist of working interests, royalty interests, overriding royalty interests and other contractual rights in 151,900 gross (119,000 net) producing acres in San Juan, Rio Arriba and Sandoval Counties of northwestern New Mexico. According to the information provided by Hilcorp, there were, as of December 31, 2018, 4,322 gross (828.1 net) wells on the properties underlying the Subject Interests, calculated on a well bore basis and not including multiple completions as separate wells, of which approximately 988 gross (274.7 net) wells were Multiple Completion Wells, resulting in a total of 5,382 gross (1,134.7 net) completions.

Hilcorp has informed the Trust that all of the subject acreage is held by production, and even though it has not been fully developed in every formation, Hilcorp has classified all of such acreage as developed. Production from conventional natural gas wells is primarily from the Pictured Cliffs, Mesaverde and Dakota formations, ranging in depth from 1,500 to 8,000 feet. Additional production is attributable to coal seam reserves in the Fruitland Coal formation.

Coal seam natural gas constituted approximately 15% of our proved natural gas reserves as of December 31, 2018. The process of removing coal seam natural gas is often referred to as degasification or desorption. Millions of years ago, natural gas was generated in the process of coal formation and absorbed into the coal. Water later filled the natural fracture system. When the water is removed from the natural fracture system, reservoir pressure is lowered and the natural gas desorbs from the coal. The desorbed natural gas then flows through the fracture system and is produced at the well bore. The volume of formation water production typically declines with time and the natural gas production may increase for a period of time before starting to decline. Typically, the volumes of natural gas produced from a Coal Seam Well decline more rapidly than those of Conventional Wells. In order to dispose of the formation water, surface facilities including pumping units are required. The price of coal seam natural gas is typically lower than the price of conventional natural gas. This is because the heating value of coal seam natural gas is much lower than that of conventional natural gas due to (a) ever increasing percentages of carbon dioxide in coal seam natural gas (carbon dioxide has no heating value), and (b) the absence of heavier hydrocarbons such as ethanes, propanes, and butanes, which are present in conventional natural gas. Furthermore, the production costs and processing fees for coal seam natural gas are typically higher than the processing fees for conventional natural gas due to the cost of extracting the carbon dioxide.

The Royalty conveyed to the Trust is limited to the base of the Dakota formation, which is currently the deepest significant producing formation under acreage affected by the Royalty. Rights to production, if any, from deeper formations are retained by Hilcorp.

**2019 Capital Expenditure Budget**

On March 1, 2019, Hilcorp has informed the Trust that for 2019, it currently has budgeted approximately \$2.6 million in capital expenditures, which includes approximately \$0.7 million towards five well recompletions and approximately \$1.9 million towards drilling one new horizontal well.

**Oil and Natural Gas Production**

Hilcorp's reporting of natural gas volumes differs from the reporting of gas volumes by Burlington and ConocoPhillips. The natural gas volumes reported to the Trust by Hilcorp are based on plant residue gas volumes plus equivalent volumes for natural gas liquids. Hilcorp converts one barrel of natural gas liquids to six Mcf of natural gas using industry standards. Historically, ConocoPhillips reported natural gas production to the Trust based on wellhead volumes. Such differences in reporting methodology could significantly affect the comparison of reported natural gas volumes and average pricing in 2018 to those from prior periods.

Production of oil and natural gas and related average sales prices attributable to each of the Subject Interests and the Royalty for the two years ended December 31, 2018, were as follows:

	For the year ended December 31,			
	2018		2017	
	Natural Gas (Mcf)	Oil and Condensate (Bbls)	Natural Gas (Mcf)	Oil and Condensate (Bbls)
Production				
Subject Interests	32,501,962	52,944	25,779,802	55,225
Royalty	10,406,632	32,191	12,122,810	25,128
Average Price (per Mcf/Bbl)	\$ 1.89	\$ 52.23	\$ 2.68	\$ 35.75

Production costs for natural gas and oil attributable to the Subject Interests for the two years ended December 31, 2018 were as follows:

	2018	2017
Total Production Costs (including capital expenses)	\$ 38,488,437	\$ 29,682,492
Average Production Costs per unit of Production	\$ 1.1842	\$ 1.1514
Lease Operating Expenses	\$ 27,757,091	\$ 22,691,965
Average Lifting Cost per unit of Production	\$ 0.8540	\$ 0.8802

The Trust recognizes production during the month in which the related net proceeds attributable to the Royalty are paid to the Trust. Royalty Income for a calendar year is based on the actual natural gas and oil production during the period beginning with November of the preceding calendar year through October of the current calendar year. Sales volumes attributable to the Royalty are determined by dividing the net profits by the Trust from the sale of oil and natural gas, respectively, by the prices received for sales of such volumes from the Subject Interests, taking into consideration production taxes attributable to the Subject Interests. Because the oil and natural gas sales attributable to the Royalty are based upon an allocation formula dependent on such factors as price and cost, including capital expenditures, the aggregate sales amounts from the Subject Interests may not provide a meaningful comparison to sales attributable to the Royalty.

The fluctuations in annual natural gas production that have occurred during these two years generally resulted from changes in the demand for natural gas during that time, market conditions, and variances in capital

spending to generate production from new and existing wells, as offset by the natural production decline curve. Also, production from the Subject Interests is influenced by the line pressure of the natural gas gathering systems in the San Juan Basin. As noted above, oil and natural gas sales attributable to the Royalty are based on an allocation formula dependent on many factors, including oil and natural gas prices and capital expenditures.

### **Marketing**

Natural gas produced in the San Juan Basin is sold in both interstate and intrastate commerce. Please refer to the discussion contained herein under Regulation for information as to federal regulation of prices of oil and natural gas. As part of the transition from Burlington to Hilcorp, Hilcorp has assumed, or been assigned, all the natural gas purchase, gathering and processing contracts affecting the Subject Interests. Natural gas produced from the Subject Interests is processed at the following sites: Chaco, Val Verde, Milagro, Ignacio or Kutz plants, all located in the San Juan Basin. Hilcorp sells natural gas produced from the Subject Interests under various contracts.

Hilcorp's sales contracts with Chevron Natural Gas (Chevron) and EDF Trading North America LLC (EDF) automatically renewed for an additional one-year term and now expire on March 31, 2020. Each of Hilcorp's sales contracts with EDF and Chevron provides for (i) the delivery of such natural gas at various delivery points through their respective termination dates and (ii) the sale of such natural gas at prices that fluctuate in accordance with published indices for natural gas sold in the San Juan Basin. Hilcorp's natural gas sales contract with New Mexico Gas Company, Inc. automatically renewed for an additional one-year term and now expires on March 31, 2020. The contract provides for the sale of certain winter-only natural gas supplies processed at the Kutz plant at prices that fluctuate in accordance with published indices for natural gas sold in the San Juan Basin.

Hilcorp contracts with Enterprise Field Services, LLC (EFS) for the gathering and processing of certain natural gas produced from the Subject Interests. Hilcorp's predecessor signed an agreement with EFS which was effective November 1, 2011 for a term of 15 years. Hilcorp's predecessor has disclosed to the Trust a summary of that agreement which the Trust has reviewed with its consultants, subject to conditions of confidentiality.

Hilcorp's predecessor entered into four contracts with Williams Four Corners, LLC (WFC), each of which is effective for a term of 15 years commencing April 1, 2010. The EFS and WFC contracts covered the gathering and processing of virtually all of the natural gas produced from the Subject Interests. On October 1, 2018, Harvest Midstream I, L.P., an affiliated midstream company of Hilcorp, completed the acquisition of WFC's gas pipeline and processing facilities in the San Juan Basin. The Conveyance sets forth the processing costs that Hilcorp can charge for both non-affiliates and affiliates.

The Trust is not a party to any of the purchase, gathering or processing contracts. As part of the 1996 settlement of litigation filed by the Trustee in 1992 against Burlington and Southland, the Trustee and Burlington established a formal protocol pursuant to which compliance auditors retained by the Trustee have access to Burlington and its successors' books and records, which protocol has been adopted by Hilcorp.

**Oil and Natural Gas Reserves**

***Proved Reserves***

All of the Trust's reserves are located in the San Juan Basin. Total proved Developed and Undeveloped Oil and Natural Gas Reserves attributable to the Royalty as of December 31, 2018 were as follows:

Reserves Category	Proved Reserves <sup>(1)(2)</sup>	
	Natural Gas (MMcf)	Crude Oil and Condensate (MBbls)
Developed	75,844	203
Undeveloped	-	-
<b>Total Proved</b>	<b>75,844</b>	<b>203</b>

- (1) Proved reserves were calculated using prices equal to the twelve-month unweighted arithmetic average of the first-day-of-the-month commodity prices for each of the preceding twelve months, which were \$3.10 per MMBtu (Henry Hub) of natural gas and \$65.56 per Bbl (West Texas Intermediate) of oil. The adjusted volume-weighted average prices over the life of the properties were \$2.55 per Mcf of gas and \$54.06 per Bbl of oil.
- (2) The Trust does not own a specific percentage of the oil and gas reserves because the Conveyance has defined the Trust's interest as a net overriding royalty interest. Because the Trust's reserve quantities are determined using an allocation formula, any fluctuations in actual or assumed prices or costs will result in revisions to the estim