

SABINE ROYALTY TRUST

Form 10-Q

November 07, 2006

Table of Contents

**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 Number: 1-8424

SABINE ROYALTY TRUST

(Exact name of registrant as specified in its charter)

Texas
(State or other jurisdiction
of incorporation or
organization)

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

Trust Division
Bank of America, N.A.
Bank of America Plaza
901 Main Street
17th Floor
Dallas, Texas 75202
(Address of principal executive offices)
(Zip Code)

(214) 209-2400
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one): Large accelerated filer Accelerated filer Non-accelerated filer

Edgar Filing: SABINE ROYALTY TRUST - Form 10-Q

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

Number of units of beneficial interest outstanding at November 6, 2006: 14,579,345

TABLE OF CONTENTS

PART I FINANCIAL INFORMATION

Item 1. Financial Statements.

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

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

Item 4. Controls and Procedures.

PART II OTHER INFORMATION

Item 1. Legal Proceedings.

Item 1A. Risk Factor

Item 6. Exhibits.

SIGNATURES

Trustee Certification Pursuant to Section 302

Trustee Certification Pursuant to 18 U.S.C. Section 1350

Table of Contents

SABINE ROYALTY TRUST

PART I FINANCIAL INFORMATION

Item 1. Financial Statements.

The condensed financial statements included herein have been prepared by Bank of America, N.A. (as successor to NationsBank, N.A.), as Trustee (the "Trustee") of Sabine Royalty Trust (the "Trust"), pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in annual financial statements have been condensed or omitted pursuant to such rules and regulations, although the Trustee believes that the disclosures are adequate to make the information presented not misleading. The condensed financial statements of the Trust presented herein are unaudited except for the balances as of December 31, 2005, and, therefore are subject to year-end adjustments. It is suggested that these condensed financial statements be read in conjunction with the financial statements and notes thereto included in the Trust's latest annual report on Form 10-K. The December 31, 2005 balance sheet is derived from the audited balance sheet as of that date. In the opinion of the Trustee, all adjustments necessary to present fairly the assets, liabilities and trust corpus of the Trust as of September 30, 2006, the distributable income for the three-month and nine-month periods ended September 30, 2006 and 2005 and the changes in trust corpus for the nine-month periods ended September 30, 2006 and 2005, have been included. The distributable income for such interim periods is not necessarily indicative of the distributable income for the full year.

The condensed financial statements as of September 30, 2006 and for the three-month and nine-month periods ended September 30, 2006 and 2005, included herein, have been reviewed by Deloitte & Touche LLP, an independent registered public accounting firm, as stated in their report appearing herein.

Table of Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Unit Holders of Sabine Royalty Trust and
Bank of America, N.A., Trustee

We have reviewed the accompanying condensed statement of assets, liabilities and trust corpus of Sabine Royalty Trust as of September 30, 2006, and the related condensed statements of distributable income for the three-month and nine-month periods ended September 30, 2006 and 2005 and changes in trust corpus for the nine-month periods ended September 30, 2006 and 2005. These condensed financial statements are the responsibility of the Trustee.

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

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

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

We have previously audited, in accordance with standards of the Public Company Accounting Oversight Board (United States), the statement of assets, liabilities and trust corpus of Sabine Royalty Trust as of December 31, 2005, and the related statements of distributable income and changes in trust corpus for the year then ended (not presented herein); and in our report dated March 10, 2006, we expressed an unqualified opinion on those financial statements. In our opinion, the information set forth in the accompanying condensed statement of assets, liabilities and trust corpus as of December 31, 2005, is fairly stated, in all material respects, in relation to the statement of assets, liabilities and trust corpus from which it has been derived.

/s/ Deloitte & Touche LLP

Dallas, Texas
November 6, 2006

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

	Notes	September 30, 2006	December 31, 2005
	<u> </u>	<u> </u>	<u> </u>
Assets			
Cash and short-term investments		\$ 4,597,667	\$ 6,335,822
Royalty interests in oil and gas properties (less accumulated amortization of \$21,448,186 and \$21,359,883 at September 30, 2006 and December 31, 2005)		946,999	1,035,302
		<u> </u>	<u> </u>
TOTAL		\$ 5,544,666	\$ 7,371,124
		<u> </u>	<u> </u>
Liabilities and Trust Corpus			
Trust expenses payable		\$ 155,508	\$ 148,696
Other payables	4	433,301	176,176
		<u> </u>	<u> </u>
		588,809	324,872
Contingencies	6		
Trust corpus - 14,579,345 units of beneficial interest authorized, issued and outstanding		4,955,857	7,046,252
		<u> </u>	<u> </u>
TOTAL		\$ 5,544,666	\$ 7,371,124
		<u> </u>	<u> </u>

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

Table of Contents**SABINE ROYALTY TRUST****CONDENSED STATEMENTS OF DISTRIBUTABLE INCOME (UNAUDITED)**

	<u>Notes</u>	Three Months Ended September 30,	
		<u>2006</u>	<u>2005</u>
Royalty income		\$15,133,235	\$13,695,105
Interest income		94,796	48,075
Total		15,228,031	13,743,180
General and administrative expenses		(508,067)	(440,626)
Distributable income		<u>\$14,719,964</u>	<u>\$13,302,554</u>
Distributable income per unit (basic and assuming dilution) (14,579,345 units)	1,3,5	<u>\$ 1.01</u>	<u>\$.91</u>

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

Table of Contents**SABINE ROYALTY TRUST****CONDENSED STATEMENTS OF DISTRIBUTABLE INCOME (UNAUDITED)**

	Notes	Nine Months Ended September 30,	
		2006	2005
Royalty income		\$47,592,022	\$37,817,463
Interest income		262,989	112,643
Total		47,855,011	37,930,106
General and administrative expenses	3	(1,667,701)	(1,644,950)
Distributable income		\$46,187,310	\$36,285,156
Distributable income per unit (14,579,345 units)	1,3,5	\$ 3.17	\$ 2.49

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

Table of Contents**SABINE ROYALTY TRUST****CONDENSED STATEMENTS OF CHANGES IN TRUST CORPUS (UNAUDITED)**

	Note	Nine Months Ended September 30,	
		2006	2005
Trust corpus, beginning of period		\$ 7,046,252	\$ 4,523,075
Amortization of royalty interests		(88,303)	(107,709)
Distributable income		46,187,310	36,285,156
Distributions	3	(48,189,402)	(35,522,143)
Trust corpus, end of period		\$ 4,955,857	\$ 5,178,379
Distributions per unit (14,579,345 units)	3	\$ 3.31	\$ 2.44

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

Table of Contents

SABINE ROYALTY TRUST

NOTES TO CONDENSED FINANCIAL STATEMENTS (UNAUDITED)

1. TRUST ORGANIZATION AND PROVISIONS

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

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

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

Bank of America, N.A. (the Trustee), acts as trustee of the Trust. The terms of the Trust Agreement provide, among other things, that:

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

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

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

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

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

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

Table of Contents

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

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

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

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

Table of Contents

2. ACCOUNTING POLICIES

Basis of Accounting

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

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

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

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

Distributions to Unit holders are recognized when declared by the Trustee (see Note 3).

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

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

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

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

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

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

Use of Estimates

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

Impairment

The Trustee routinely reviews the Trust's royalty interests in oil and gas properties for impairment whenever events or circumstances indicate that the carrying amount of an asset may not be recoverable. If an impairment event occurs and it is determined that the carrying value of the Trust's royalty interests may not be recoverable, an impairment will be recognized as measured by the amount by which the carrying amount of the royalty interests exceeds the fair value of these assets, which would likely be measured by discounting projected cash flows.

Table of Contents

New Accounting Standards

In February 2006, the FASB issued SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments* an amendment of FASB Statements No. 133 *Accounting for Derivative Instruments* and No. 140 *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. This statement resolves issues address in Statement 133 Implementation Issue No. D1, Application of Statement 133 to Beneficial Interests in Securitized Financial Assets. This statement is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. The Trust has no financial instruments and accordingly, this new Standard will not impact the financial statements of the Trust.

In March 2006, the FASB issued SFAS No. 156, *Accounting for Servicing of Financial Assets* an amendment of FASB Statements No. 140 *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. This statement requires an entity to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract in certain situations. This statement is effective as of the beginning of an entity's first fiscal year that begins after September 15, 2006. The Trustee does not believe that the adoption of this statement will have a material effect on the Trust's financial statements.

In July 2006, the FASB issued FASB Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes*, which clarifies the accounting for uncertainty in income taxes recognized in the financial statements in accordance with SFAS No. 109, *Accounting for Income Taxes*. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Trustee does not believe that the adoption of this statement will have a material effect on the Trust's financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. This statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007. The Trustee does not believe that the adoption of this statement will have a material effect on the Trust's financial statements.

In September 2006, the FASB issued SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans* an amendment of FASB Statements No. 87, 88, 106 and 132(R). This statement improves financial reporting by requiring an employer to recognize the over funded or underfunded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income of a business entity or changes in unrestricted net assets of a not-for-profit organization. This statement is effective as of the end of the fiscal year ending after December 15, 2006. The Trustee does not believe that the adoption of this statement will have a material effect on the Trust's financial statements.

Distributable Income per Unit

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

Federal Tax Considerations

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

Table of Contents

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

State Tax Considerations

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

Unit holders should be advised that New Mexico imposes a withholding tax on payments of oil and gas proceeds derived from royalty interests and, to reduce the administrative burden imposed by these rules, the Trustee has opted to allow the payors of oil and gas proceeds to withhold on royalty payments made to the Trust. The Trust will then file a New Mexico tax return, obtain a refund, and distribute that refund to Unit holders. Unit holders who transfer their Units before the New Mexico tax refund is received by the Trust or after the refund is received but before the next Monthly Record Date will not receive any portion of the refund. As a result, such Unit holders may incur a double tax first through the reduced distribution received from the Trust as withholding at the Trust level reduces the amount of cash available for distribution and second by the tax payment made directly to New Mexico with the filing of their New Mexico income tax returns.

In May 2006, the State of Texas passed legislation to implement a new margin tax at a rate of 1% to be imposed on revenues less certain costs, as specifically set forth in the new legislation. The effective date of the new legislation is January 1, 2008, but the tax generally will be imposed on revenues generated in 2007 and thereafter. Entities subject to tax generally include trusts unless otherwise exempt, and most other types of entities. Trusts that meet certain statutory requirements are generally exempt from the margin tax as passive entities. Although the income of the Trust is passive as it consists primarily of royalty income from the sale of crude oil and natural gas, there is no clear authority that the Trust satisfies all the margin tax statutory requirements for the exemption for passive entities to apply. Therefore, pending additional legislative action or the issuance of applicable administrative rules promulgated by the Texas Comptroller, it is uncertain whether the Trust would be exempt from the margin tax as a passive entity or subject to the margin tax at the Trust level. Approximately 65% of the Trust's royalty income is generated in Texas.

If the Trust is exempt from the margin tax at the Trust level as a passive entity, each Unit holder that is a taxable entity would generally include its share of the Trust's revenue in its margin tax computation. If, however, the margin tax is imposed on the Trust at the Trust level, each Unit holder would generally exclude its share of the Trust's net income from its margin tax calculation.

Each Unit holder is urged to consult his own tax advisor regarding the requirements for filing state tax returns.

3. DISTRIBUTION TO UNIT HOLDERS

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

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

4. PAYABLES

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

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

Table of Contents**5. SUBSEQUENT EVENTS**

Subsequent to September 30, 2006, the Trust declared the following distributions:

Monthly Record Date	Payment Date	Distribution per Unit
October 16	October 30	\$.27953
November 15	November 29	\$.46741

Subsequent to September 30, 2006, the Trust received 2005 tax refunds from the states of Oklahoma and New Mexico for approximately \$720,000 and \$267,000, respectively. These refunds pertained to the respective states income tax levied on non-resident recipients of royalty income. There is no income tax at the Trust level, but individual Unit holders who do not reside in these states should consult their tax advisor as to what their tax liability might be in these particular states.

Also the Trust received a cash settlement of approximately \$595,000 subsequent to September 30, 2006. This settlement resulted from two separate class action civil actions filed in the Second District Court in Washita County, Oklahoma in 1997 and subsequently consolidated in 1999. The lawsuits alleged that EI Paso Natural Gas Company and Burlington Resources Oil and Gas Company failed to pay or significantly underpaid royalties for various reasons including, but not limited to, failure to pay for certain periods, underreporting natural gas volumes, using artificial pool or index prices, and improper and undisclosed deductions on certain wells in various counties in Oklahoma.

6. CONTINGENCIES

Contingencies related to the royalty properties that are unfavorably resolved would generally be reflected by the Trust as reductions to future royalty income payments to the Trust with corresponding reductions to cash distributions to Unit holders. The Trustee is aware of no such items as of November 6, 2006.

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

Liquidity and Capital Resources

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

Results of Operations

Distributable income consists of royalty income plus interest income plus any decrease in cash reserves established by the Trustee less general and administrative expenses of the Trust less any increase in cash reserves established by the Trustee. Distributable income for the three months ended September 30, 2006 was \$14,719,964 or \$1.01 per Unit. Royalty income amounted to \$15,133,235 while interest income was \$94,796. General and administrative expenses totaled \$508,067.

Edgar Filing: SABINE ROYALTY TRUST - Form 10-Q

Distributions during the period \$.37996, \$.34502, and \$.38496 per Unit payable to Unit holders of record on July 17, August 15, and September 15, 2006, respectively.

Table of Contents

Royalty income for the quarter ended September 30, 2006 increased approximately \$1,438,000, or 11%, compared with the third quarter of 2005 due to an increase in the price of oil and the production of gas. These increases were offset somewhat by decreases in the production of oil and the price of gas. Compared to the preceding quarter ended June 30, 2006, royalty income increased approximately \$610,000, or 4%, due to an increase in the price of oil as well as an increase in the production of gas. These increases were tempered by a decrease in the price of gas. Oil production was relatively unchanged. Royalty income for the nine months ended September 30, 2006 increased approximately \$9,775,000 or 26% compared with the same time period of 2005 due mainly to increases in the price of both oil and gas as well as an increase in the production of gas. These increases were offset somewhat by a decrease in the production of oil.

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

	Quarter Ended		
	September 30, 2006	September 30, 2005	June 30, 2006
Production			
Oil (Bbls)	123,879	166,571	122,325
Gas (Mcfs)	1,463,287	1,322,984	1,252,720
Average Price			
Oil (per Bbl)	\$ 58.51	\$ 37.67	\$ 55.57
Gas (per Mcf)	\$ 6.28	\$ 6.50	\$ 7.06
	Nine-Months Ended		
	September 30, 2006	September 30, 2005	
Production			
Oil (Bbls)	373,894	449,528	
Gas (Mcfs)	4,069,059	3,964,600	
Average Price			
Oil (per Bbl)	\$ 55.48	\$ 37.58	
Gas (per Mcf)	\$ 7.59	\$ 6.13	

Gas revenues received for the three months ended September 30, 2006, related primarily to production for April 2006 through June 2006. The average price of gas as reported by the Henry Hub for the same time period was \$5.85 per Mcf. The average price of gas for the Henry Hub was \$6.11 per Mcf for January 2006 through September 2006. Oil revenues for the three months ended September 30, 2006 related primarily to production for May 2006 through July 2006. The average price of oil as reported by Nymex for that time period was \$72.00 per barrel. The average price of oil was \$68.17 per barrel for January 2006 through September 2006. As of October 24, 2006, the average price of gas for the Henry Hub was \$6.52 per Mcf and the average price of oil reported by Nymex was \$57.02 per barrel. It is difficult to accurately estimate future prices of oil and gas, and any assumptions concerning future prices may prove to be incorrect.

Interest income for the quarter ended September 30, 2006 increased approximately \$46,700 compared with the third quarter of 2005. Compared to the preceding quarter ended June 30, 2006, interest income increased approximately \$8,900. Interest income for the nine-month period ended September 30, 2006 increased approximately \$150,300 compared to the same time period. Changes in interest income are the result of changes in interest rates and funds available for investment.

General and administrative expenses for the quarter ended September 30, 2006 increased by approximately \$67,000 compared to the same quarter of 2005 primarily due to increases in printing fees of approximately \$55,600 and escrow agent/trustee fees of approximately \$37,000. These increases were offset somewhat by a decrease in costs of approximately \$24,100 associated with the upgrading of financial reporting. Compared to the previous quarter ended June 30, 2006, general and administrative expenses decreased approximately \$57,400. This decrease was mainly due to the timing of payment in the second quarter of engineering expenses related to the reserve report and unitholder services of \$84,700 and \$13,300, respectively. These decreases were offset somewhat by increases in the escrow agent/trustee fees of \$21,600 and in the timing of payments of expenses for printing the annual report. General and administrative expenses for the nine months ended September 30, 2006 increased approximately \$22,800 compared to the first nine months of 2005. This increase can be attributed mainly to the increase in escrow agent/trustee fees and engineering fees related to the reserve information of approximately \$65,200 and \$47,600, respectively. In addition to the timing of payment of unitholder services and legal services of \$15,100 and \$13,500, respectively, added to the increased expenses. These increases were tempered somewhat by decreases in professional services associated with Sarbanes- Oxley compliance of approximately \$49,000 and upgrading the financial reporting of about \$22,700.

Table of Contents

Proxy Solicitation

On January 4, 2006, proxy solicitation materials were mailed to Unit holders of record and Unit holders who hold the Units through brokerage accounts. The solicitation received by Unit holders concerns an initiative created by Sabine Production Partners, LP.

Despite the similarity of the name of Sabine Production Partners, LP (SPP), it is not an entity that is affiliated with the Trust.

In the proposals SPP sets forth in its proxy solicitation, SPP seeks to gain control of the assets of the Trust by liquidating the Trust in a manner whereby the assets of the Trust are sold to SPP in exchange for partnership interests in SPP that would be distributed to Unit holders of the Trust upon its liquidation.

On January 31, 2006, SPP announced that it is suspending indefinitely its previously-announced solicitation of proxies from Unit holders of the Trust. SPP is not withdrawing or abandoning its Registration Statement or Proxy Statement/Prospectus. SPP has stated that no recommencement of the solicitation will occur without a public announcement to that effect by SPP and the making of appropriate filings with SEC. Until such announcement and filings, SPP has stated that it will not attempt to call a meeting of the Trust's Unit holders using any proxies that have been submitted prior to recommencement.

Subsequent Events

Subsequent to September 30, 2006, the Trust received 2005 tax refunds from the states of Oklahoma and New Mexico for approximately \$720,000 and \$267,000, respectively. These refunds pertained to the respective states income tax levied on non-resident recipients of royalty income. There is no income tax at the Trust level, but individual Unit holders who do not reside in these states should consult their tax advisor as to what their tax liability might be in these particular states.

Also, the Trust received a cash settlement of approximately \$595,000 subsequent to September 30, 2006. This settlement resulted from two separate class action civil actions filed in the Second District Court in Washita County, Oklahoma in 1997 and subsequently consolidated in 1999. The lawsuits alleged that EI Paso Natural Gas Company and Burlington Resources Oil and Gas Company failed to pay or significantly underpaid royalties for various reasons including, but not limited to, failure to pay for certain periods, underreporting natural gas volumes, using artificial pool or index prices, and improper and undisclosed deductions on certain wells in various counties in Oklahoma.

Critical Accounting Policies and Estimates

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

Basis of Accounting

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

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

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

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

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

Table of Contents

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

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

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

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

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

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

Revenue Recognition

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

Reserve Disclosure

Independent petroleum engineers estimate the net proved reserves attributable to the royalty interests. In accordance with Statement of Financial Standards No. 69, Disclosures About Oil and Gas Producing Activities, estimates of future net revenues from proved reserves have been prepared using year-end contractual gas prices and related costs. Numerous uncertainties are inherent in estimating volumes and the value of proved reserves and in projecting future production rates and the timing of development of non-producing reserves. Such reserve estimates are subject to change as additional information becomes available. The reserves actually recovered and the timing of production may be substantially different from the reserve estimates. Other than those filed with the SEC, our estimated reserves have not been filed with or included in any reports to any Federal agency.

Contingencies

Contingencies related to the royalty properties that are unfavorably resolved would generally be reflected by the Trust as reductions to future royalty income payments to the Trust with corresponding reductions to cash distributions to Unit holders. The Trustee is aware of no such items as of November 6, 2006.

Use of Estimates

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

Impairment

The Trustee routinely reviews the Trust's royalty interests in oil and gas properties for impairment whenever events or circumstances indicate that the carrying amount of an asset may not be recoverable. If an impairment event occurs and it is determined that the carrying value of the Trust's royalty interests may not be recoverable, an impairment will

be recognized as measured by the amount by which the carrying amount of the royalty interests exceeds the fair value of these assets, which would likely be measured by discounting projected cash flows.

Table of Contents

New Accounting Standards

In February 2006, the FASB issued SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments* an amendment of FASB Statements No. 133 *Accounting for Derivative Instruments* and No. 140 *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. This statement resolves issues address in Statement 133 Implementation Issue No. D1, Application of Statement 133 to Beneficial Interests in Securitized Financial Assets. This statement is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. The Trust has no financial instruments and accordingly, this new Standard will not impact the financial statements of the Trust.

In March 2006, the FASB issued SFAS No. 156, *Accounting for Servicing of Financial Assets* an amendment of FASB Statements No. 140 *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. This statement requires an entity to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract in certain situation. This statement is effective as of the beginning of an entity's first fiscal year that begins after September 15, 2006. The Trustee does not believe that the adoption of this statement will have a material effect on the Trust's financial statements.

In July 2006, the FASB issued FASB Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes*, which clarifies the accounting for uncertainty in income taxes recognized in the financial statements in accordance with SFAS No. 109, *Accounting for Income Taxes*. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Trustee does not believe that the adoption of this statement will have a material effect on the Trust's financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. This statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007. The Trustee does not believe that the adoption of this statement will have a material effect on the Trust's financial statements.

In September 2006, the FASB issued SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans* an amendment of FASB Statements No. 87, 88, 106 and 132(R). This statement improves financial reporting by requiring an employer to recognize the over funded or underfunded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income of a business entity or changes in unrestricted net assets of a not-for-profit organization. This statement is effective as of the end of the fiscal year ending after December 15, 2006. The Trustee does not believe that the adoption of this statement will have a material effect on the Trust's financial statements.

Table of Contents

State Tax Considerations

In May 2006, the State of Texas passed legislation to implement a new margin tax at a rate of 1% to be imposed on revenues less certain costs, as specifically set forth in the new legislation. The effective date of the new legislation is January 1, 2008, but the tax generally will be imposed on revenues generated in 2007 and thereafter. Entities subject to tax generally include trusts unless otherwise exempt, and most other types of entities. Trusts that meet certain statutory requirements are generally exempt from the margin tax as passive entities. Although the income of the Trust is passive as it consists primarily of royalty income from the sale of crude oil and natural gas, there is no clear authority that the Trust satisfies all the margin tax statutory requirements for the exemption for passive entities to apply. Therefore, pending additional legislative action or the issuance of applicable administrative rules promulgated by the Texas Comptroller, it is uncertain whether the Trust would be exempt from the margin tax as a passive entity or subject to the margin tax at the Trust level. Approximately 65% of the Trust's royalty income is generated in Texas.

If the Trust is exempt from the margin tax at the Trust level as a passive entity, each Unit holder that is a taxable entity would generally include its share of the Trust's revenue in its margin tax computation. If, however, the margin tax is imposed on the Trust at the Trust level, each Unit holder would generally exclude its share of the Trust's net income from its margin tax calculation.

Each Unit holder is urged to consult his own tax advisor regarding the requirements for filing state tax returns.

Forward Looking Statements

This Report includes forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, which are intended to be covered by the safe harbor created thereby. All statements other than statements of historical fact included in this Report are forward-looking statements. Although the Trustee believes that the expectations reflected in such forward-looking statements are reasonable, such expectations are subject to numerous risks and uncertainties and the Trustee can give no assurance that they will prove correct. There are many factors, none of which is within the Trustee's control, that may cause such expectations not to be realized, including, among other things, factors identified in the Trust's most recent Annual Report on Form 10-K affecting oil and gas prices and the recoverability of reserves, general economic conditions, actions and policies of petroleum-producing nations and other changes in the domestic and international energy markets.

The Trust has an Internet website and has made available its annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to such reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act at <http://www.sbr-sabineroyalty.com> as soon as reasonably practicable after such information is electronically filed with or furnished to the SEC.

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. Other than the Trust's ability to periodically borrow money as necessary to pay expenses, liabilities and obligations of the Trust that cannot be paid out of cash held by the Trust, the Trust is prohibited from engaging in borrowing transactions. The amount of any such borrowings is unlikely to be material to the Trust. The Trust periodically holds 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 does not engage in transactions in foreign currencies which could expose the Trust or Unit holders to any foreign currency related market

risk.

Item 4. Controls and Procedures.

As of the end of the period covered by this report, the Trustee carried out an evaluation of the effectiveness of the design and operation of the Trust's disclosure controls and procedures pursuant to Exchange Act Rules 13a-15 and 15d-15. Based upon that evaluation, the Trustee concluded that the Trust's disclosure controls and procedures are effective in timely alerting the Trustee to material information relating to the Trust required to be included in the Trust's periodic filings with the Securities and Exchange Commission. There has not been any change in the Trust's internal control over financial reporting during the period covered by this report that has materially affected, or is reasonably likely to materially affect, the Trust's internal control over financial reporting.

Table of Contents

PART II OTHER INFORMATION

Item 1. Legal Proceedings.

The Trust received a cash settlement from two separate class action civil actions, as detailed under Part I, Item 2. *Trustee's Discussion and Analysis of Financial Condition and Results of Operations - Subsequent Events.*

Item 1A. Risk Factors.

There have been no material changes in the risk factors disclosed under Part I, Item 1A of the Trust's Annual Report on Form 10-K for the year ended December 31, 2005.

Items 2-5 not applicable.

Item 6. Exhibits.

Exhibit Number
and Description

(31) Trustee Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

(32) Trustee Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Table of Contents

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.

SABINE ROYALTY TRUST

By: Bank of America, N.A.
Trustee

By: /s/ Ron E. Hooper
Ron E. Hooper
Senior Vice President and Trust
Administrator

Date: November 7, 2006

(The Trust has no directors or executive officers.)