

PROSPECTUS

SOUTHLAND ROYALTY COMPANY

**46,616,496 UNITS OF BENEFICIAL INTEREST IN
PERMIAN BASIN ROYALTY TRUST**

— AND —

**46,616,496 UNITS OF BENEFICIAL INTEREST IN
SAN JUAN BASIN ROYALTY TRUST**

Southland Royalty Company ("Southland") proposes to transfer net overriding royalty interests (equivalent to net profits interests) in certain producing oil and gas properties to two trusts ("Trusts") and to distribute all the units of beneficial interest ("Units") in the Trusts to the holders of its Common Stock. This Prospectus describes the issuance and distribution of Units in these two Trusts, the Permian Basin Royalty Trust and the San Juan Basin Royalty Trust, and related matters. The Units offered hereby are to be issued to the stockholders of Southland as described in the Proxy Statement included in this Prospectus.

Units in the Trusts will be freely transferable independently of each other and independently of the Common Stock. Application will be made to list the Units of each Trust on the New York Stock Exchange, Inc.

The principal executive offices of Southland are located at 1000 Fort Worth Club Tower, Fort Worth, Texas 76102, and its telephone number is (817) 390-9200.

**THESE SECURITIES HAVE NOT BEEN APPROVED OR DISAPPROVED BY THE
SECURITIES AND EXCHANGE COMMISSION NOR HAS THE COMMISSION
PASSED UPON THE ACCURACY OR ADEQUACY OF THIS PROSPECTUS.
ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.**

The date of this Prospectus is September 26, 1980

NO PERSON HAS BEEN AUTHORIZED TO GIVE ANY INFORMATION OR TO MAKE ANY REPRESENTATIONS NOT CONTAINED IN THIS PROSPECTUS IN CONNECTION WITH THE TRANSACTION DESCRIBED HEREIN, AND IF GIVEN OR MADE SUCH INFORMATION OR REPRESENTATIONS MUST NOT BE RELIED UPON AS HAVING BEEN AUTHORIZED. THIS PROSPECTUS DOES NOT CONSTITUTE AN OFFER OF ANY SECURITIES OTHER THAN THE REGISTERED SECURITIES TO WHICH IT RELATES OR AN OFFER TO ANY PERSON IN ANY STATE WHERE SUCH OFFER WOULD BE UNLAWFUL. THE DELIVERY OF THIS PROSPECTUS AT ANY TIME DOES NOT IMPLY THAT INFORMATION HEREIN IS CORRECT AS OF ANY TIME SUBSEQUENT TO ITS DATE.



Southland Royalty Company

September 30, 1980

To the Stockholders of
Southland Royalty Company:

As previously announced, the board of directors of Southland Royalty Company has approved the transfer of net overriding royalty interests (equivalent to net profits interests) in certain of the Company's producing oil and gas properties to two separate Trusts. One of these Trusts, the Permian Basin Royalty Trust, would own interests in principally oil producing properties located primarily in the Permian Basin in Texas. The assets of the other Trust, the San Juan Basin Royalty Trust, would be interests in principally gas producing properties in the San Juan Basin in New Mexico. Units of beneficial interest in both of the Trusts would be distributed on a one-for-one basis to Southland's stockholders. Thereafter Units of each Trust would be traded separately from each other and from the Common Stock of Southland.

The proposed transfer of assets to the Trusts will involve a significant portion of Southland's total assets. Therefore, it will be undertaken only if it is approved by the holders of not less than a majority of the outstanding shares of Common Stock. For the reasons stated in the attached Proxy Statement, the board of directors believes that the proposed transaction is in the best interests of Southland and its stockholders.

After the distribution of the Units, Southland will continue its business of oil and gas exploration, development and production. It is to be expected that the reduced assets, revenues and income of the Company will be reflected in a reduced market price for the Common Stock.

Under Southland's Executive Stock Incentive Plan, which was approved by the stockholders in 1978, Common Stock purchase options and related stock appreciation rights have been granted to key employees. However, only a portion of the previously granted options and rights may be exercised at this time. In order to prevent employees from being unfairly penalized by the proposed creation of the Trusts and the distribution of the Units, the board of directors has recommended amendments which would make all outstanding options and rights under the plan exercisable before the record date for determining stockholders entitled to receive Units and, with respect to any option not exercised at such time, make adjustments in the exercise price and certain other terms. These amendments will be adopted only if they are approved by the holders of not less than a majority of the outstanding shares of Common Stock, and shares owned by persons who hold options under the plan will not be entitled to vote. For the reasons stated in the Proxy Statement the board of directors recommends that stockholders vote in favor of these amendments.

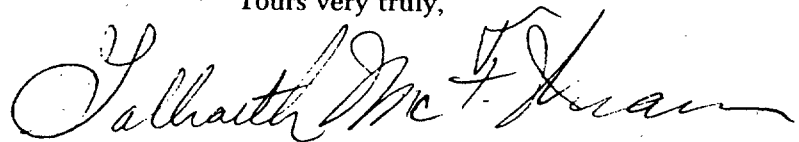
Finally, the board of directors has adopted, subject to stockholder approval, the Southland Royalty Company 1980 Stock Incentive Plan. This plan, if approved, will be effective after the distribution of the Units of the Trusts. The board of directors believes that this new plan will aid the Company in attracting and retaining qualified personnel and, as stated in the Proxy Statement, recommends that it be approved.

You are very cordially invited to attend the special meeting of stockholders to be held at the time and place stated in the Proxy Statement. Regardless of whether you plan to attend the meeting, and regardless of the manner in which you intend to vote, you are urged to complete, sign and return the enclosed proxy. Your proxy may be revoked in the manner stated in the Proxy Statement and will be revoked if you attend the meeting and vote in person.

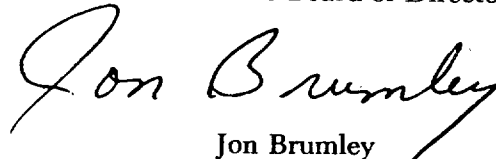
The tax consequences of the proposed transaction may be very important to individual stockholders and should be considered in tax planning for 1980. Each stockholder should carefully read the information under "Income Tax Consequences" in the attached Proxy Statement and, in addition, consider consulting his own tax advisor.

Particularly since the vote of a majority of *all* shares (not merely shares represented at the meeting) is required for approval of the transfer of assets to the Trusts and for amending the Executive Stock Incentive Plan, the vote of each stockholder is important.

Yours very truly,



Galbraith McF. Weaver
Chairman of the Board of Directors



Jon Brumley
President and Chief Executive Officer

THE TRANSACTION DESCRIBED IN THESE MATERIALS IS VERY IMPORTANT TO SOUTHLAND AND TO YOUR INVESTMENT. PLEASE TAKE TIME TO READ THESE MATERIALS AND THEN TO SIGN AND RETURN YOUR PROXY.

SOUTHLAND ROYALTY COMPANY

NOTICE OF SPECIAL MEETING OF STOCKHOLDERS

September 30, 1980

To the Stockholders of
Southland Royalty Company:

Notice is hereby given that a special meeting of stockholders of Southland Royalty Company ("Southland") will be held in the Horizon Room on the 12th floor of the Fort Worth Club Building, Fort Worth, Texas at 10:00 a.m., Fort Worth time, on October 23, 1980 for the following purposes, all on the terms and conditions described in the accompanying Proxy Statement:

(1) To consider and act upon a proposal to adopt a resolution authorizing and approving the transfer of net overriding royalty interests (equivalent to net profits interests) in certain producing oil and gas properties to the Permian Basin Royalty Trust and the San Juan Basin Royalty Trust, the distribution of units of beneficial interest in each such Trust to Southland's stockholders as of a specified record date ("Distribution Record Date") and the appointment of a trustee of each such Trust.

(2) To consider and act upon a proposal to amend the "Southland Royalty Executive Stock Incentive Plan" to accelerate the exercisability of certain outstanding options and stock appreciation rights granted under such plan so that they can be exercised prior to the Distribution Record Date and to adjust the exercise price and certain other terms of such options and rights which are not exercised prior to the Distribution Record Date.

(3) To consider and act upon a proposal to approve the adoption of a new "Southland Royalty Company 1980 Stock Incentive Plan" under which the board of directors may grant options and stock appreciation rights to key employees, including officers.

(4) To transact such other business as properly comes before the meeting or any adjournment.

The close of business on October 1, 1980 has been fixed as the record date for determining stockholders entitled to notice of and to vote at the meeting.

By order of the Board of Directors

Lucy H. Lowry
Secretary

Fort Worth, Texas
September 30, 1980

**SOUTHLAND ROYALTY COMPANY
PROXY STATEMENT**

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SUMMARY OF CERTAIN INFORMATION

The following summary is qualified by reference to the more detailed information and financial statements elsewhere in this Proxy Statement.

THE MEETING

Place: Horizon Room on the 12th floor of the Fort Worth Club Building, Fort Worth, Texas.

Time and Date: 10:00 a.m., Fort Worth time, on October 23, 1980.

Record Date: Holders of common stock of Southland ("Common Stock") of record at the close of business on October 1, 1980 will be entitled to notice of and to vote at the meeting.

Matters to be considered and acted upon:

- (i) The proposed adoption of a resolution authorizing and approving the transfer of net overriding royalty interests (equivalent to net profits interests) in certain producing oil and gas properties to the Permian Basin Royalty Trust and the San Juan Basin Royalty Trust ("Trusts"), the distribution ("Distribution") of all units of beneficial interest ("Units") in each Trust and the approval of the Trustee ("Trustee") of each Trust. The transfer of interests to the Trusts, the Distribution of Units and related matters are sometimes collectively referred to as the "Transaction".
- (ii) The proposed amendment of the "Southland Royalty Executive Stock Incentive Plan" ("1978 Plan") so as to accelerate the exercisability of outstanding options and stock appreciation rights granted under the 1978 Plan and to adjust the price and certain other terms of such options and rights which are not exercised.
- (iii) The proposed approval of the "Southland Royalty Company 1980 Stock Incentive Plan" ("1980 Plan") under which the board of directors may grant options and stock appreciation rights to key employees, including officers.

Vote Required: Approval of the Transaction and amendment of the 1978 Plan will each require the affirmative vote of the holders of not less than a majority of the outstanding shares of Common Stock. Approval of the 1980 Plan will require the affirmative vote of the holders of at least a majority of the shares of Common Stock represented at the meeting. Shares owned by persons who hold options and stock appreciation rights granted under the 1978 Plan will not be counted in determining whether the required vote for amending the 1978 Plan has been obtained.

Proxies: The enclosed proxy is solicited by Southland's board of directors and can be revoked before it is voted.

THE DISTRIBUTION

Holders of record of Common Stock at the close of business on November 3, 1980 will receive one Unit in each Trust for each share of Common Stock so held.

THE TRUSTS

The assets of the Permian Basin Royalty Trust will consist of net overriding royalty interests in primarily oil producing properties located principally in the Permian Basin in Texas. Its Trustee will be The First National Bank of Fort Worth, Fort Worth, Texas.

The assets of the San Juan Basin Royalty Trust will consist of a net overriding royalty interest in primarily gas producing properties in the San Juan Basin in New Mexico. Its Trustee will be The Fort Worth National Bank, Fort Worth, Texas.

Neither Trust will engage in any active business. Each Trustee will collect income attributable to Trust properties, pay or make provision for Trust expenses and liabilities and distribute available cash to holders of Units in such Trust on a monthly basis.

Units of each Trust will be transferable entirely separately from Units of the other Trust and from shares of Common Stock. The Common Stock's listing on the New York Stock Exchange will not be affected by the Distribution, and applications to list the Units on the Exchange will be filed.

EFFECT ON SOUTHLAND

After the Distribution, Southland will continue its present business of exploring for, developing and producing oil and gas. Its assets, revenues and income will be reduced by the transfers to the Trusts. See "Proposed Distribution of Units – Certain Comparative Data" for financial data concerning Southland and the Trusts. It is expected that after the Distribution the cash dividends paid on the Common Stock will be substantially reduced.

Selected data regarding Southland

	As of December 31, 1979(1)	
	Historical	Pro forma assuming the Distribution
Estimated proved oil reserves (Bbls)	126,713,000	85,166,000
Estimated proved gas reserves (Mcf)	1,274,836,000	653,767,000
Estimated future net revenue from proved developed and undeveloped reserves	\$5,402,663,000	\$2,233,455,000
Present value of estimated future net revenue discounted at 10%	\$1,897,861,000	\$ 948,267,000

(1) The reserve estimates do not include reserves acquired in the acquisition of P&O Oil Corporation. See "Continuing Business and Properties of Southland". Estimated reserves attributable to the P&O properties at December 31, 1979, totaled 16,248,000 barrels of oil and 24,754,000 Mcf of gas. Estimated future net revenue and present value of estimated future net revenue are \$309,254,000 and \$136,480,000, respectively.

INCOME TAX CONSEQUENCES

The Distribution will be treated in part as a dividend on the Common Stock for federal income tax purposes. Detailed information as to the federal income tax treatment of the Distribution and certain other tax information is provided under "Income Tax Consequences."

CERTAIN DEFINITIONS

Certain oil and gas terms are used in this Proxy Statement with the meanings stated under "Definitions of Certain Terms".

SOUTHLAND ROYALTY COMPANY
1000 Fort Worth Club Tower
Fort Worth, Texas 76102

PROXY STATEMENT
Special Meeting of Stockholders To
Be Held October 23, 1980

GENERAL

The accompanying proxy is solicited by the board of directors of Southland Royalty Company ("Southland" or "Company") for use in connection with a special meeting of stockholders to be held at the time and place and for the purposes stated in the accompanying Notice and with any adjournment of such meeting. All properly executed proxies will be voted, and where a choice has been specified by the stockholder as provided on the proxy, it will be voted in accordance with the specification so made. If no choice is specified it will be voted "for" each of the proposals described in this Proxy Statement. Any stockholder giving a proxy may revoke it at any time prior to its use at the meeting by giving written notice of revocation or by signing and submitting a proxy bearing a later date. The proxy will automatically be revoked if the stockholder votes in person at the meeting.

Proxy materials are expected to be mailed or delivered to holders of common stock ("Common Stock") on or about October 2, 1980.

Expenses of Solicitation

All expenses of solicitation will be borne by Southland. Solicitation may be made by mail, telephone and personal contact by officers, directors and regular employees of the Company without additional compensation. In addition the Company has retained the firm of Georgeson & Co. to aid in the solicitation of proxies. Georgeson & Co. has advised Southland that it expects to solicit proxies by personal interview, mail, telephone and telegraph, and brokers, banks and others serving in fiduciary capacities will be requested to forward proxy material to the beneficial owners of shares of Common Stock registered in their names and will be reimbursed for their reasonable out-of-pocket expenses of so doing. Georgeson & Co. will be paid a fee, excluding expenses, not to exceed \$6,500.

PURPOSES OF THE MEETING

At the meeting the stockholders will consider and act upon the following three matters:

1. The proposed transfer of net overriding royalty interests (equivalent to net profits interests) in certain oil and gas properties to the Permian Basin Royalty Trust ("Permian Trust") and the San Juan Basin Royalty Trust ("San Juan Trust"), respectively, and in connection therewith the distribution ("Distribution") of all Units in both trusts ("Trusts") to Southland's stockholders of record on the specified record date ("Distribution Record Date") and the approval of the trustee ("Trustee") of each Trust.
2. The proposed amendment of the "Southland Royalty Executive Stock Incentive Plan" ("1978 Plan") so as to permit all outstanding options and stock appreciation rights under the 1978 Plan as of the date of this Proxy Statement to be exercised in full during the ten days prior to the Distribution Record Date (in lieu of the vesting schedule now provided by the 1978 Plan) and to adjust the price and certain other terms of such options and rights which are not exercised prior to the Distribution Record Date.
3. The proposed approval of the "Southland Royalty Company 1980 Stock Incentive Plan" ("1980 Plan"), under which the board of directors may grant options and stock appreciation rights to key employees, including officers.

Southland is aware of no other matter to be acted upon at the meeting. However, if any such matter is properly brought before the meeting, proxies will be voted on such matter in accordance with the judgment of the persons voting the proxies.

VOTING AT THE MEETING

Votes Required

Proposal Number 1. The Distribution will constitute a dividend for purposes of Delaware law, and the declaration of a dividend does not ordinarily require action by stockholders. However, Southland has been advised by legal counsel that the transfer of assets to the Trusts may be alleged to be analogous to a sale or exchange of substantially all the Company's property and therefore may require stockholder approval. In view of this possibility, and in view of the basic importance of the proposal to Southland and its stockholders, the transfers of assets to the Trusts, the Distribution of Units and related matters ("Transaction") will be undertaken only if a resolution authorizing and approving them is adopted by the holders of at least a majority of all shares of Common Stock outstanding on the record date for determining stockholders entitled to vote at the meeting ("Meeting Record Date"). This is the same vote which would be required to approve a sale or exchange of all Southland's property.

Proposal Number 2. Section 18 of the 1978 Plan provides that "no amendment may affect any of the outstanding options or rights granted under it and any outstanding portion thereof." Southland has been advised by legal counsel that this provision can be overridden only if the proposed amendments are approved by the same vote by which the stockholders adopted the 1978 Plan — the affirmative vote of at least a majority of all shares of Common Stock outstanding on the Meeting Record Date. Shares held by persons who hold any options or rights under the 1978 Plan will not be counted for purposes of determining whether such a majority has been obtained.

Proposal Number 3. The 1980 Plan will be approved only if it receives the affirmative vote of the holders of not less than a majority of the shares of Common Stock represented in person or by proxy at the meeting.

Relationship of the Three Proposals

The proposed amendments to the 1978 Plan will become effective, even if adopted by the stockholders, only if the Transaction is approved. Likewise, the 1980 Plan will become effective, notwithstanding stockholder approval, only if the Distribution is effected. Consummation of the Transaction, on the other hand, is not dependent upon a favorable stockholder vote in regard to either of the other two proposals to be voted upon at the meeting.

Information as to Certain Stockholders

The following table shows as of June 30, 1980 information with respect to each person known by Southland to own beneficially more than 5% of the outstanding Common Stock:

<u>Name and address</u>	<u>Amount and nature of beneficial ownership</u>	<u>Percent of shares outstanding</u>
Ella C. McFadden Trust(1) 1202 First National Bldg. Fort Worth, Texas 76102	4,192,704 shares (record owner)	9.0
Ella C. McFadden Charitable Trust(1) 1202 First National Bldg. Fort Worth, Texas 76102	2,408,592 shares (record owner)	5.2

(1) Galbraith McF. Weaver, chairman of the board of directors and of the executive committee of the Company, is one of the two trustees of the Ella C. McFadden Trust and one of three trustees of the Ella C. McFadden Charitable Trust. Mr. Weaver disclaims any beneficial interests in the shares owned by these trusts but has shared voting and investment powers in regard to them.

The following table shows as of June 30, 1980 information with respect to the beneficial ownership of Common Stock by each director of the Company and by the directors and officers of the Company as a group:

<u>Name of individual or identity of group</u>	<u>Amount and nature of beneficial ownership(1)</u>	<u>Percent of shares outstanding</u>
Galbraith McF. Weaver	1,299,042 shares(2)(3)	2.80
Jon Brumley	99,612 shares(2)	.22
Jerry L. Brownlee	2,800 shares	(4)
Alton C. Goodrich	117,503 shares(2)	.25
Edgar H. Keltner, Jr.	496 shares	(4)
James N. Ludlum	144,784 shares(5)	.31
Paul W. Mason	2,520 shares	(4)
Dr. W. M. Pearce	40 shares	(4)
Dr. William R. Weaver	414,776 shares(6)	.89
All directors and officers as a group (22 persons)	2,245,624 shares(7)	4.84

(1) Except as otherwise indicated, all shares are owned directly and the owner has sole voting and investment powers with respect thereto.

(2) Includes shares in which this officer has beneficial interests as a participant in the Company's Employees' Thrift Plan and Employee Stock Ownership Plan. With respect to the shares held under the Employee Stock Ownership Plan, he has sole voting powers, but otherwise he does not have voting or investment powers as to such shares.

(3) Excludes all shares owned by the Ella C. McFadden Trusts. See footnote (1) to the preceding table.

(4) Less than .10%.

(5) Includes 2,520 shares owned by Mr. Ludlum's wife as to which he disclaims any beneficial interests and as to which he does not have voting or investment powers and 111,384 shares owned by his mother as to which he disclaims any beneficial interests but as to which he has sole voting and investment powers.

(6) Includes 41,560 shares owned by Dr. Weaver's wife as to which he disclaims any beneficial interests and does not have voting or investment powers and 252,656 shares owned by his minor children as to which he is custodian or guardian with voting and investment powers but as to which he disclaims any beneficial interests.

(7) Includes both direct and indirect ownership. Excludes all shares owned by the Ella C. McFadden Trust and the Ella C. McFadden Charitable Trust and 125,700 shares subject to unexercised employee stock options but includes all shares in which officers of the Company have beneficial interests as participants in the Company's Employees' Thrift Plan and Employee Stock Ownership Plan and 224 shares owned by minor children of three officers as to which such officers disclaim any beneficial interests but have voting and investment powers.

PROPOSED DISTRIBUTION OF UNITS

Reasons for the Transaction

The creation of the Trusts and the Distribution of the Units were approved in principle in June 1980 by Southland's board of directors, and the specific terms of the actual agreements and related matters were approved in August 1980. In both cases all directors voted in favor of the Transaction.

The board of directors believes that the Distribution will be in the best interests of Southland and its stockholders. Some of the possible benefits considered by the directors include those described below, but there is, of course, no assurance that such benefits will be achieved.

Any stockholder who receives Units in the Trust as a result of the Distribution and who thereafter wishes to retain an interest in all the assets held by Southland prior to the Distribution can retain his Common Stock and his Units in both Trusts. On the other hand, the separation of the Trusts will also permit investors after the Distribution to choose from three alternative investments in the energy industry: an active oil and gas exploration, development and production concern in the case of Southland, an investment primarily in producing oil properties in the case of the Permian Trust and an investment primarily in producing gas properties in the case of the San Juan Trust. It is possible, although there is no assurance whatsoever, that the aggregate market value of all equity securities of Southland and the Trusts after the Distribution will exceed the market value of the Common Stock prior to the announcement of the Distribution.

Since each of the Trusts will have significant income from production and since their expenses will be relatively small, holders of Units in either Trust should receive regular income. Since the Trusts should not be taxpaying entities, income from their properties should not be subject to tax both when received by the Trusts and when distributed to holders of Units. Accordingly, the income would not be subject to "double taxation" as in the case of income distributed as dividends by a corporation. It is anticipated, however, that upon receipt of the Units stockholders, depending upon their own status for tax purposes, will recognize significant taxable income. See "Income Tax Consequences."

Southland is retaining significant assets, including all its undeveloped properties, and will continue to actively engage in exploring for, developing and producing oil and gas. Since the Company's reserves will be significantly reduced by the Transaction, any future discovery would have a relatively more significant impact on the Company's reserves and revenues.

Effect on Holders of Common Stock

Holders of Common Stock who receive Units, depending upon their own status for tax purposes, will recognize significant taxable income, and thereafter holders of the Units will be subject to tax on income from the Trusts. See "Income Tax Consequences".

The rights of holders of Common Stock will not be affected by the Distribution. However, the voting rights of holders of Units will not be as extensive as those of holders of common stock in a typical corporation. See "Description of the Trust Indentures – Voting Rights of Unit Holders".

Holders of Units will receive distributions of Trust income and periodic reports as described under "Description of Units in the Trusts – Distribution of Net Income" and "Description of Units in the Trusts – Periodic Reports", respectively.

Holders of Units in either Trust may have liability for certain liabilities of the Trust, although the Company believes that the actual imposition of any such liability is extremely unlikely. See "Description of Units in the Trusts – Liability of Holders of Units". Holders of shares of Common Stock do not have such potential liability.

Certain holders of Units may be required to divest their Units under specified circumstances. See "Description of Units in the Trusts – Possible Requirement that Units be Divested". Holders of Common Stock are not subject to such possible divestment.

Nature of the Trusts

Neither Trust will carry on any business activity. As more fully described below, the Trustees duties will be essentially ministerial in nature and will be specified in detail in the trust indentures ("Trust Indentures") to be entered into by Southland and the respective Trustees. The economic function of the Trustee of each Trust will be to collect from Southland net revenues attributable to the Trust's properties and to distribute such income on a monthly basis to the holders of Units in such Trust after paying or making provision for all expenses and liabilities. Each Trust will pay its own administrative expenses, including the fees of its Trustee.

Selection of the Properties

The selection of interests to be transferred to the Trusts was governed by several considerations. In view of the passive nature of the Trusts, it was determined that neither Trust should hold any working interest or any interest in unproven properties. In addition, since neither Trust will acquire additional assets, Southland selected for each Trust interests in properties which in its opinion have reserves which should produce sufficient future revenue to make such Trust a viable investment vehicle.

A "net overriding royalty" is a mineral interest which represents a share of production as measured by net profits from the operation of a property or properties. In this regard, a "net overriding royalty" is equivalent to a "net profits interest" and differs from an "overriding royalty", which is a share of gross production not reduced by the costs of exploration, development and production.

The net overriding royalties conveyed to the Permian Trust will include a 75% net overriding royalty carved out of Southland's fee mineral interest in the Waddell Ranch in Crane County, Texas and a 95% net overriding royalty carved out of Southland's major producing royalty properties in Texas. See "Permian Basin Royalty Trust Properties - Interests to be Conveyed". The San Juan Basin Royalty Trust will receive a 75% net overriding royalty interest carved out of Southland's working interests and royalty interests in the San Juan Basin in northwestern New Mexico. See "San Juan Basin Royalty Trust Properties - Interests to Be Conveyed". At the present time the Company owns a fee mineral interest in the Waddell Ranch ranging from 37.5% to 50%. Its royalty and working interests in the other properties out of which the net overriding royalty interests of the Trusts will be carved are held under many different leases and other arrangements, and the extent of Southland's interests varies widely.

Procedure for the Distribution

The close of business on November 3, 1980 has been fixed as the record date ("Distribution Record Date") for the determination of stockholders entitled to receive the Distribution. The Distribution will be made as early as practicable in November 1980 to stockholders of record on the Distribution Record Date by mailing to each such stockholder one certificate representing the Units in the Permian Trust and another certificate representing the Units in the San Juan Trust to which such stockholder is entitled.

Right to Abandon Transaction

It is the present intention of the board of directors of Southland to effect the Distribution if the Transaction is approved by shareholders and if the Company receives a ruling or opinion substantially as described under "Income Tax Consequences". However, in declaring the Distribution the board of directors specifically reserved the right to abandon or delay the Transaction, even if it is approved by shareholders, if there arises any event or condition which is determined by the board, in its sole discretion, to indicate that such termination or delay would be appropriate.

Consents of Lenders

Consummation of the Transaction will require the consent of certain banks and insurance companies (the "Lenders") which hold promissory notes of Southland. The Lenders have verbally agreed to give such consent, and formal written consents will be signed before the Transaction is effected. In consideration for the consents of those lenders which hold fixed rate notes (the insurance companies) Southland has agreed to increase the annual interest rate paid on such notes by $\frac{1}{4}$ of 1%.

Expenses of the Distribution

All expenses of the Transaction (estimated at \$500,000) will be paid by Southland.

Subsequent Trading of Units

The Units in the Permian Trust and the San Juan Trust will be transferable independently of the Common Stock and independently of each other. Each Trustee intends to apply for listing of the Units of its Trust on the New York Stock Exchange ("Exchange") and has received approval from the Exchange to make such application. It is expected that trading markets will develop for the Units of each of the Trusts. However, Southland can give no assurance as to the level of trading activity with respect to the Units of either Trust.

Under the Indentures, the Trustees are obligated to cause the Trusts to file all registration statements, reports and other materials required by law, including the Securities Exchange Act of 1934 and the rules thereunder, or by any securities exchange on which the Units are listed at any time. The costs of preparing such materials for each Trust will be borne by such Trust.

State Law Considerations

The Units of the Permian Trust and the San Juan Trust may be deemed to constitute property or interests in property in Texas and New Mexico, respectively, and thus may be subject to such States' probate laws and related inheritance, gift and similar taxes. Information as to the applicability of State income tax laws to the Trusts and to holders of Units is provided under "Income Tax Consequences". Each stockholder is advised to consult his own counsel concerning the foregoing matters and their application to his individual circumstances.

Certain Comparative Data

The following table shows certain comparative information regarding Southland on a historical and pro forma basis as of June 30, 1980 and for the six months then ended. See Note 1 in "Notes to Pro Forma Financial Statements" for a discussion of the pro forma adjustments.

	As of June 30, 1980 and the six months then ended	
	Historical	Pro forma After Distribution
	(unaudited)	
	(In thousands)	
Financial data:		
Total assets	\$695,455	\$563,417
Stockholders' equity	193,176	83,679
Production:		
Oil (Bbls)	4,826	3,756
Gas (Mcf)	45,880	31,234

The following table shows comparative net income and earnings per share for Southland on a historical and pro forma basis for the five years ended December 31, 1979 and the six months ended June 30, 1979 and 1980. See Note 1 in "Notes to Pro Forma Financial Statements" for a discussion of pro forma adjustments.

	Year Ended December 31,					Six Months Ended June 30,	
	1975	1976	1977	1978	1979	1979	1980
	(Unaudited)						
	(In thousands except per share amounts)						
Historical net income	\$19,165	\$26,717	\$36,668	\$42,540	\$54,752	\$21,907	\$34,186
Pro forma net income	\$ 4,867	\$ 303	\$ 7,870	\$11,786	\$14,792	\$ 3,773	\$ 7,966
Historical earnings per share	\$.41	\$.56	\$.77	\$.90	\$1.18	\$.47	\$.74
Pro forma earnings per share	\$.10	\$.01	\$.17	\$.25	\$.32	\$.08	\$.17

The following table shows certain proved oil and gas reserve data of Southland as of December 31, 1979 and indicates the reserves of the Company before the Distribution and on a pro forma basis after the Distribution. The reserve information is based on information provided by independent petroleum engineers as described under "Continuing Business and Properties of Southland - Reserves." The following reserve estimates do not include the reserves of P&O Oil Corporation ("P&O"), which was acquired in January 1980. See "Continuing Business and Properties of Southland."

	Before Distribution	Pro Forma		
		After Distribution	Percentage Distributed Retained	
(In thousands)				
Reserve data, as of December 31, 1979				
Proved reserves				
Oil (Bbls)	126,713	85,166	33%	67%
Gas (Mcf)	1,274,836	653,767	49%	51%
Estimated future net revenue from proved reserves ...	\$5,402,663	\$2,233,455	59%	41%
Present value of estimated future net revenue discounted at 10%	\$1,897,861	\$ 948,267	50%	50%

The following table shows distributable income and distributable income per unit for the Permian Trust and San Juan Trust, combined, on a pro forma basis for the five years ended December 31, 1979, and the six months ended June 30, 1979 and 1980. See "Permian Basin Royalty Trust Properties - Distributable Income and Production" and "San Juan Basin Royalty Trust Properties - Distributable Income and Production" for such information for each Trust. The amounts presented below have not been reduced for costs and expenses of the Trustee, which are not expected to initially exceed \$400,000 annually.

	Year Ended December 31,					Six Months Ended June 30,	
	1975	1976	1977	1978	1979	1979	1980
(In thousands except per unit amounts)							
Distributable income	\$27,390	\$51,414	\$54,237	\$54,862	\$68,396	\$31,284	\$46,878
Distributable income per unit(1)	\$.59	\$1.11	\$1.17	\$1.18	\$1.47	\$.67	\$1.01

(1) Based on 46,412,464 Units outstanding. See "Description of Units in the Trusts - Number of Units to be Distributed".

The following table shows the estimated future net revenue from proved developed and undeveloped reserves attributable to the Permian Trust and the San Juan Trust as of December 31, 1979, as estimated by independent petroleum engineers and as further described under "Permian Basin Royalty Trust Properties - Reserves" and "San Juan Basin Royalty Trust Properties - Reserves."

	Permian Trust		San Juan Trust	
	Amount	Per Unit(1)	Amount	Per Unit(1)
(In thousands except per unit amounts)				
Estimated future net revenue				
1980	\$ 62,597	\$ 1.35	\$ 38,423	\$.83
1981	65,893	1.42	43,080	.93
1982	70,207	1.51	42,893	.92
Remainder	947,568	20.42	1,898,547	40.91
Total	<u>\$1,146,265</u>	<u>\$24.70</u>	<u>\$2,022,943</u>	<u>\$43.59</u>
Present value of estimated future net revenue discounted at 10%	<u>\$ 514,646</u>	<u>\$11.09</u>	<u>\$ 434,948</u>	<u>\$ 9.37</u>

(1) Based on 46,412,464 Units outstanding. See "Description of Units in the Trusts - Number of Units to be Distributed."

DESCRIPTION OF THE TRUST INDENTURES

The Trusts will be created pursuant to Trust Indentures substantially in the forms included in the Proxy Statement as Exhibit I (with respect to the Permian Trust) and Exhibit II (with respect to the San Juan Trust), respectively. The two Trust Indentures are identical in all material respects. While the following paragraphs summarize certain important provisions of the Trust Indentures, reference is made to the actual language of the Trust Indentures for a full statement of such provisions.

As mentioned under "Voting Rights of Unit Holders" below, either Trust Indenture may generally be amended only upon an affirmative vote of the holders of Units in the Trust formed under such Trust Indenture. Certain amendments are absolutely prohibited, and certain other amendments and other matters require special votes.

The Trustees

The Trustee of the Permian Trust will be The First National Bank of Fort Worth, headquartered in Fort Worth, Texas. At December 31, 1979 this Bank held deposits of \$1,042,637,000 and had assets of \$1,310,636,000. It is a subsidiary of First United Bancorporation, Inc., a bank holding company.

The Trustee of the San Juan Trust will be The Fort Worth National Bank, headquartered in Fort Worth, Texas. At December 31, 1979 this Bank held deposits of \$1,096,176,000 and had assets of \$1,550,363,000. It is a subsidiary of Texas American Bancshares, Inc., a bank holding company.

Southland has engaged in transactions in the ordinary course of business with both The First National Bank of Fort Worth and The Fort Worth National Bank, and it expects to continue to do so. Paul W. Mason, chairman of the board of directors of The First National Bank of Fort Worth, is a director of Southland. See "Remuneration - Certain Transactions". In addition, officers and directors of Southland have engaged and expect to continue to engage in business transactions with both Trustees.

As stated more fully below, the powers of the Trustee under each Trust Indenture are essentially ministerial in nature. The Trusts will not be active business organizations, and the role of the Trustees will not be analogous to that of the board of directors of a corporation or of the manager of a business.

Either Trustee may resign at any time or be removed, with or without cause, by the holders of Units in its Trust (See "Voting Rights of Unit Holders" below). Its successor must be a bank or trust company whose aggregate capital, surplus and undivided profits (as of the end of its last fiscal year prior to its appointment) are not less than \$50,000,000.

The compensation of each Trustee will be as specified in Schedule 2 to the Trust Indenture to which it is a party.

Duties and Powers of Trustees

The duties of each Trustee will be as specified in its Trust Indenture and by the laws of Texas. The basic function of the Trustee will be to collect income from the Trust's properties, to pay out of the Trust's income and assets all expenses, charges and obligations and to pay available income to the holders of Units. Each Trustee will be obligated to use its best judgment in good faith in all matters relating to its Trust and the Trust's properties.

With respect to any liability which is contingent or uncertain in amount or which otherwise is not currently due and payable, each Trustee has the discretion to establish cash reserves for the payment thereof. Each Trustee has the power to borrow funds required to pay liabilities of its Trust as they become due and pledge or otherwise encumber the Trust properties if it determines that the cash on hand and amounts to be received will be insufficient to pay such liabilities. Such borrowings must be repaid in full before any further distributions are made to holders of Units. All

available net income of each Trust will be distributed on a monthly basis. During the period between distributions to Unit holders, each Trustee is required to invest the cash on hand in interest bearing instruments which meet certain specific criteria.

Periodic financial reports to holders of Units will be provided by the Trustees as more fully described under "Description of Units in the Trusts – Periodic Reports".

The Trust Indentures grant the Trustees only such rights and powers as are necessary to achieve the purposes of the Trusts. The Trust Indentures prohibit the Trustees from entering into or engaging in any business or commercial activity of any kind and from using any portion of the assets of the Trusts to acquire any oil and gas lease, royalty or other mineral interest. A Trustee may sell Trust properties only as authorized by a vote of the holders of Units (see "Voting Rights of Unit Holders") or upon termination of the Trust. However, pledges or other encumbrances and conveyances of production payments to secure borrowings are permitted without such authorization if the Trustee determines such action is advisable. Any sale of Trust properties must be for cash, and the Trustee is obligated to distribute the available net proceeds of any such sale to the holders of Units.

Liabilities of the Trusts

Except for routine administrative expenses such as Trustee's fees, accounting, engineering, legal or other professional fees, or certain miscellaneous expenses, it is anticipated that the Trusts will not incur any significant obligations. However, if a court were to hold that the Trusts were taxable as corporations, as more fully discussed under "Income Tax Consequences", the Trusts would incur substantial federal income tax liabilities in addition to their other expenses.

Liabilities of Trustees

Each Trustee will be indemnified out of the assets of its Trust for any expense, claim, damage or other loss incurred in the performance of its duties unless such loss results from fraud or breach of fiduciary duty. The Trustees will not be entitled to indemnification from Unit holders except in certain limited circumstances related to the replacement of mutilated, lost, stolen or destroyed certificates. See "Description of Units in the Trusts – Liability of Holders of Units".

Duration

The Trusts will be irrevocable, and Southland will have no power to terminate the Trusts or alter or amend the terms of the Trust Indentures. Each Trust will exist until it is terminated by (i) two successive fiscal years (excluding 1980) in which net revenue is less than \$1,000,000 per year, (ii) a vote of holders of Units as described under "Voting Rights of Unit Holders" or (iii) operation of the provisions of the Trust Indentures intended to permit the Trusts to comply with the "rule against perpetuities". Upon the termination of either Trust, its Trustee will continue to act in such capacity until all the assets of the Trust are distributed. The Trustee will sell all Trust properties for cash in one or more sales, and after satisfying all expenses, claims and liabilities and establishing adequate reserves for the payment of contingent liabilities will distribute all available proceeds to the holders of Units.

Voting Rights of Unit Holders

While holders of Units in each Trust will have voting rights, these rights are not comparable to those of stockholders of a corporation. For example, there is no requirement for annual meetings or for annual or other periodic re-election of the Trustee.

The Trust Indenture of either Trust may be amended by the affirmative vote of the holders of a majority of the Units who are present in person and represented by proxy at any duly called meeting of holders of Units. However, no such amendment may (i) permit the Trust to engage

in any business or any other investment activity, (ii) alter the relative rights of holders of Units or (iii) permit the Trustee to distribute the assets of the Trust "in kind" to holders of Units. In addition, certain special voting requirements relating to termination of a Trust or sale of its properties can be amended only if such amendment is approved by the holders of not less than 75% of the Units of such Trust.

The removal of the Trustee of either Trust will require the affirmative vote of the holders of at least a majority of the Units of the Trust, while the appointment of a successor will require only the affirmative vote of the holders of at least a majority of the Units represented at a meeting at which a quorum is present.

The sale of all or any part of the assets of a Trust must be authorized by the affirmative vote of the holders of at least 75% of the Units of such Trust. Either Trust can be terminated by its Unit holders only if such termination is approved by the holders of not less than 75% of the Units. The special voting requirements described in this paragraph can be amended or revoked only upon the approval of the holders of at least 75% of the Units.

Meetings of holders of Units of either Trust may be called by the Trustee of such Trust at any time at its discretion and will be called by the Trustee at the written request of holders of not less than 15% of the Units of such Trust then outstanding.

Notice of any meeting of Unit holders will be given not less than 20 nor more than 60 days prior to the date of such meeting. The notice will state the purpose of the meeting, and no other matter will be acted upon at the meeting.

DESCRIPTION OF UNITS IN THE TRUSTS

Each Unit in each Trust will represent a share of beneficial interest in that Trust. Each Unit will entitle its holder to the same rights as the holder of any other Unit, and neither Trust will have outstanding any other class of equity security. The following paragraphs describe certain features of the Units and the rights of their holders.

Number of Units to be Distributed

The number of Units to be issued by each Trust will depend solely on the number of shares of Common Stock outstanding on the Distribution Record Date. At June 30, 1980, 46,412,464 shares of Common Stock were outstanding. An additional 12,252 shares were reserved for issuance under stock options and other benefit plans which are by their present terms exercisable before the Distribution Record Date. If the stockholders approve the amendments to the 1978 Plan described under "Proposed Amendments to Executive Stock Incentive Plan," an additional 184,080 shares of Common Stock may be issued prior to the Distribution Record Date.

Neither Trust may issue additional Units after the Distribution. Under limited circumstances Units may be acquired by the Trust which issued them, and such Units may be either cancelled or reissued. See "Possible Requirement that Units be Divested."

Distributions of Net Income

Distributions of Trust income, the identity of Unit holders entitled to receive such distributions and the amounts of such distributions will generally be determined as of the last business day of each calendar month. Unit holders of record as of the Monthly Record Date (which is defined in the Trust Indentures and which, except in limited circumstances, will be the last business day of each calendar month) will be entitled to receive the calculated Monthly Distribution Amount (as defined in the Trust Indenture) for such month on or before ten business days after the Monthly Record Date. The aggregate Monthly Distribution Amount will be the excess of (i) net revenues

from the Trust properties, plus any decrease in cash reserves previously established for contingent liabilities and any other cash receipts of the Trust, over (ii) the expenses and payments of liabilities of the Trust, plus any net increase in cash reserves for contingent liabilities. It is anticipated that the first such Distribution to holders of Units will occur in January 1981.

Transferability

The Units of each Trust will be transferable on the books of the Trustee upon surrender of the certificates representing such Units in proper form for transfer in accordance with such reasonable procedures as the Trustee adopts. No service charge will be required for any such transfer, although the Trustee may require payment of transfer taxes or other fees imposed by any governmental authority.

Until a transfer is made in accordance with the procedures specified by the Trustee, the Trustee may conclusively treat as the owner of any Unit for all purposes the holder shown on its records. Any transfer of a Unit in accordance with the procedures established by the Trustee will, as to the Trustee, vest in the transferee all rights of the transferor at the date of transfer, except that a transfer of a Unit after the Monthly Record Date for a distribution will not transfer the right of the transferor to such distribution.

Each Trustee will serve as transfer agent for the Units in his Trust. See "Proposed Distribution of Units - Subsequent Trading in Units" for information as to future public trading in the Units.

Periodic Reports

Each Trustee will mail as soon as practicable after the end of each calendar quarter, to each person who was a Unit holder on any Monthly Record Date during such quarter, a report summarizing the assets and liabilities and the receipts and disbursements of the Trust for the quarter then ended and for each month in such quarter. Within 90 days after the end of each fiscal year, the Trustee will mail to holders of Units as of a specified record date an annual report containing audited financial statements of the Trust. In addition, the Trustee will furnish to the holders of Units such reports and in such manner as are at any time required by law or by regulation of any stock exchange on which the Units are listed.

Each Trustee will file federal and state income tax returns as required to comply with applicable laws and to permit each holder of Units to correctly report his share of the income and deductions of the Trust. The Trustee will treat all income and deductions recognized during each month as having been recognized on the Monthly Record Date unless otherwise advised by counsel or by the Internal Revenue Service. Such information will be included in the reports distributed by each Trustee to holders of Units. Each holder of Units and his duly authorized agents will have the right, during reasonable business hours, to examine the books and records of the Trust in which he holds Units.

Liability of Holders of Units

The Trustee of each Trust will be liable for any excess liabilities incurred if the Trustee fails to insure that such liabilities are to be satisfied only out of Trust assets (regardless of whether the assets are adequate to satisfy the liability). The Trustee may not represent to any third party dealing with the Trustee or its Trust that such liabilities are recoverable from the amounts distributed to, or other assets owned by, the holders of Units. However, under the law of Texas, which is unsettled on this point, a holder of Units may be jointly and severally liable for any liability of the Trust if the satisfaction of such liability was not contractually limited to the assets of the Trust and the assets of the Trust and the Trustee are not adequate to satisfy such liability. In view of the nature of the Trust assets, the Trust Indentures' restrictions on the liabilities which the Trustees can incur and the financial positions of the Trustees, the imposition of any liability on a holder of Units is extremely unlikely.

Possible Requirement That Units Be Divested

The Trust Indentures impose no restrictions based on nationality or other status of the persons or other entities which are eligible to hold Units. However, the Trust Indentures provide that if at any time either Trust is named a party in any judicial or administrative proceeding which seeks the cancellation or forfeiture of any property in which such Trust has an interest because of the nationality, or any other status, of any one or more holders of Units, the following procedures will be applicable:

(i) The Trustee will give written notice ("Notice") to each holder ("Ineligible Holder") whose nationality or other status is an issue in the proceeding as to the existence of such controversy. The Notice will contain a reasonable summary of such controversy and will constitute a demand to each Ineligible Holder that he dispose of his Units, to a party not of the nationality or other status at issue in the proceeding described in the Notice, within 30 days after the date of the Notice.

(ii) If any Ineligible Holder fails to dispose of his Units, as required by the Notice, within 30 days after the date of the Notice, the Trustee will have the preemptive right, at its sole option and during the 90 days following the termination of the 30-day period specified in the Notice, to purchase any Unit not so transferred for a cash price equal to the closing price of the Units on the largest stock exchange on which the Units are then listed or, in the absence of any such listing, in the over-the-counter market, on the last business day prior to the expiration of the 30-day period stated in the Notice. The procedures for any such purchase are more fully described in the Trust Indentures.

(iii) The Trustee may, in its sole discretion, cancel any Units acquired in accordance with the foregoing procedures or may sell such Units, either publicly or privately, in accordance with all applicable laws. The proceeds of any such sale of Units will constitute revenues of the Trust.

(iv) The Trustee may, in its sole discretion, cause its Trust to borrow any amounts required to purchase Units in accordance with the procedures described above.

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SOUTHLAND ROYALTY COMPANY
PRO FORMA BALANCE SHEET (UNAUDITED)
June 30, 1980
(Note 1)
(Thousands of dollars)

ASSETS

	<u>Historical</u>	<u>Pro Forma</u>	
		<u>Reduction due to Distribution</u>	<u>After Distribution</u>
Current assets			
Cash and temporary cash investments	\$ 9,699	\$ —	\$ 9,699
Accounts receivable	49,235	—	49,235
Materials and supplies inventory, at cost	11,783	—	11,783
Other current assets	2,680	—	2,680
Total current assets	<u>73,397</u>	<u>—</u>	<u>73,397</u>
Property and equipment, at cost			
Producing royalties and leases, including			
intangible development costs	520,192	129,872	390,320
Lease and well equipment	149,242	25,754	123,488
Nonproducing royalties and leases	63,755	—	63,755
Proven undeveloped leases	52,760	6,048	46,712
Uncompleted wells, equipment and facilities	20,067	1,603	18,464
Other property and equipment	9,279	—	9,279
Total property and equipment	<u>815,295</u>	<u>163,277</u>	<u>652,018</u>
Less accumulated depreciation, depletion,			
amortization and impairment	<u>(196,437)</u>	<u>(31,239)</u>	<u>(165,198)</u>
Net property and equipment	<u>618,858</u>	<u>132,038</u>	<u>486,820</u>
Other assets	<u>3,200</u>	<u>—</u>	<u>3,200</u>
Total assets	<u>\$ 695,455</u>	<u>\$132,038</u>	<u>\$ 563,417</u>

The accompanying Notes to Unaudited Pro Forma Financial Statements are an integral part of this Pro Forma Balance Sheet. Southland follows the successful efforts method of accounting.

SOUTHLAND ROYALTY COMPANY
PRO FORMA BALANCE SHEET (UNAUDITED) – (Continued)
June 30, 1980
(Note 1)
(Thousands of dollars)

LIABILITIES AND STOCKHOLDERS' EQUITY

	Historical	Pro Forma	
		Reduction due to Distribution	After Distribution
Current liabilities			
Current maturities of long-term debt	\$ 13,955	\$ —	\$ 13,955
Accounts payable and other liabilities	40,923	—	40,923
Income taxes payable	9,358	—	9,358
Accrued interest expense	6,750	—	6,750
Total current liabilities	<u>70,986</u>	<u>—</u>	<u>70,986</u>
Long-term debt	391,323	—	391,323
Deferred revenue	14,214	—	14,214
Deferred federal income taxes	25,756	22,541	3,215
Stockholders' equity			
Common Stock, \$.125 par value: authorized, 64,000,000 shares; issued, 48,000,000 shares	6,000	—	6,000
Capital in excess of par value of Common Stock	22,190	—	22,190
Retained earnings	181,495	109,497	71,998
Total	<u>209,685</u>	<u>109,497</u>	<u>100,188</u>
Less treasury stock, at cost, 1,587,536 shares	(16,509)	—	(16,509)
Total stockholders' equity	<u>193,176</u>	<u>109,497</u>	<u>83,679</u>
Total liabilities and stockholders' equity	<u>\$ 695,455</u>	<u>\$132,038</u>	<u>\$ 563,417</u>

The accompanying Notes to Unaudited Pro Forma Financial Statements are an integral part of this Pro Forma Balance Sheet. Southland follows the successful efforts method of accounting.

SOUTHLAND ROYALTY COMPANY

PRO FORMA STATEMENT OF NET INCOME AND EARNINGS PER SHARE (UNAUDITED)

**For the Five Years Ended December 31, 1979
and the Six Months Ended June 30, 1979 and 1980 (Note 1)
(Thousands of dollars except share and per share amounts)**

	Year Ended December 31,					Six Months Ended June 30,	
	1975	1976	1977	1978	1979	1979	1980
Historical net income	\$ 19,165	\$ 26,717	\$ 36,668	\$ 42,540	\$ 54,752	\$ 21,907	\$ 34,186
Pro forma net income	\$ 4,867	\$ 303	\$ 7,870	\$ 11,786	\$ 14,792	\$ 3,773	\$ 7,966
Historical earnings per share	\$.41	\$.56	\$.77	\$.90	\$1.18	\$.47	\$.74
Pro forma earnings per share	\$.10	\$.01	\$.17	\$.25	\$.32	\$.08	\$.17
Weighted number of shares outstanding	47,295,160	47,498,740	47,620,400	47,415,736	46,349,124	46,341,884	46,401,432

The accompanying Notes to Unaudited Pro Forma Financial Statements are an integral part of this pro forma statement.

SOUTHLAND ROYALTY COMPANY
NOTES TO UNAUDITED PRO FORMA FINANCIAL STATEMENTS

1. Summary of General Assumptions

The significant accounting policies followed by Southland together with additional information are included in "Notes to Financial Statements" and should be read in conjunction with the accompanying unaudited pro forma financial statements ("pro formas").

The pro formas reflect the proposed creation of the Trusts and the effecting of the Distribution as described in this Proxy Statement. Accordingly, the pro formas reflect retroactive to the beginning of the period presented the effect of the proposed transfer of net overriding royalty interests to the Trusts.

In the accompanying pro forma balance sheet the costs related to the net overriding royalty interests to be transferred to the Trusts have been apportioned between the Trusts and Southland based on relative estimated fair value. Deferred taxes on the difference between the financial accounting basis assigned to the Trusts and the related tax basis have been reversed at the statutory rate of 46%. The difference between the financial accounting basis assigned to the properties distributed to the Trusts and the related reversal of deferred Federal income taxes has been charged to retained earnings.

The pro forma statement of net income and earnings per share reflects the elimination of historical revenues, depreciation, depletion and amortization, and income taxes associated with the net overriding royalty interests to be transferred.

The following table presents the pro forma reductions in income statement items for each period reflected in the accompanying pro forma statement of net income and earnings per share.

	Pro Forma Reduction due to Distribution						
	Year Ended December 31,					Six Months Ended June 30,	
	1975	1976	1977	1978	1979	1979	1980
	(In thousands)						
Oil revenues	\$16,868	\$24,281	\$20,112	\$21,186	\$27,501	\$11,548	\$17,129
Gas revenues	10,725	30,674	41,378	44,751	54,101	25,437	36,006
Total revenues	<u>27,593</u>	<u>54,955</u>	<u>61,490</u>	<u>65,937</u>	<u>81,602</u>	<u>36,985</u>	<u>53,135</u>
Depreciation, depletion and amortization	97	4,158	6,109	6,561	6,776	3,290	3,401
Income taxes	13,198	24,383	26,583	28,622	34,866	15,561	23,514
Total net income reduction due to distribution	<u>\$14,298</u>	<u>\$26,414</u>	<u>\$28,798</u>	<u>\$30,754</u>	<u>\$39,960</u>	<u>\$18,134</u>	<u>\$26,220</u>

See "Permian Basin Royalty Trust Properties – Reserves" and "San Juan Basin Royalty Trust Properties – Reserves" for a schedule of estimated future net revenue attributable to the Trusts' net overriding royalty interests in the Royalty properties. See "Management's Discussion and Analysis of Statements of Income."

SOUTHLAND ROYALTY COMPANY

NOTES TO UNAUDITED PRO FORMA FINANCIAL STATEMENTS – (Continued)

2. Trusts' Accounting

The pro forma opening balance sheets of the Trusts as of June 30, 1980, would be as follows:

	Permian Trust	San Juan Trust
Trust assets	\$6,594,000	\$125,444,000
Trust equity	\$6,594,000	\$125,444,000

For accounting purposes, the Trusts will recognize the assets received from Southland at the Company's historical net book value. The reduction in Southland's deferred taxes due to the Distribution will not be transferred to the Trusts and will not have any effect on the Unit holders. Each Unit holder will have his own tax basis in his Units. Depletion and Federal and state income taxes will be computed by each individual Unit holder.

3. Acquisition Subsequent to December 31, 1979

In January 1980, Southland acquired P&O Oil Corporation ("P&O") in a cash purchase as discussed in Note 3 in "Notes to Financial Statements." The assets of P&O were producing oil and gas properties located primarily in west Texas. P&O's 1979 revenue and lease operating expenses, exclusive of depreciation, depletion and amortization, were \$16,900,000 and \$4,000,000, respectively. Revenue, lease operating expense, and depreciation, depletion and amortization attributable to the properties acquired from P&O for the six months ended June 30, 1980 were \$8,009,000, \$1,340,000 and \$4,770,000, respectively. Interest expense related to the P&O acquisition was \$8,572,000 for the six months ended June 30, 1980.

PERMIAN BASIN ROYALTY TRUST PROPERTIES

Interests To Be Conveyed

The net overriding royalties conveyed to the Permian Trust will include: (1) a 75% net overriding royalty carved out of the Company's fee mineral interest in the Waddell Ranch in Crane County, Texas ("Waddell Ranch Properties"); and (2) a 95% net overriding royalty carved out of the Company's major producing royalty properties in Texas ("Texas Royalty Properties"). The net overriding royalty for the Texas Royalty Properties is subject to the provisions of the lease agreements under which it was created.

It is anticipated that the conveyances of these net overriding royalties ("Conveyances") will be effective as of November 1, 1980. The net overriding royalties (attributable to production after such effective date) will consist of the gross proceeds from the sale of production less (when applicable) production costs, development and drilling costs, applicable taxes, operating charges and other costs, deductions and reserves, all as more specifically described and provided for in the Conveyances. Such net proceeds, determined monthly, will be multiplied by 75% (in the case of the Waddell Ranch Properties) and 95% (in the case of the Texas Royalty Properties), respectively, to arrive at the amounts attributable to the net overriding royalty interests.

Producing Acreage, Wells and Drilling

Waddell Ranch Properties. The Waddell Ranch Properties consist of 78,175 gross (34,205 net) producing acres. Approximately 94% of the proved reserves are attributable to six fields: Dune, Sand Hills (Judkins), Sand Hills (McKnight), Sand Hills (Tubb), University-Waddell (Devonian) and Waddell. The Waddell Ranch Properties contain 1,274 gross (547.5 net) productive oil wells and 104 gross (49.3 net) productive gas wells.

The Waddell Ranch Properties are mature producing properties with five of the six major fields currently under waterflood. While further drilling is not considered necessary to establish boundaries of existing productive fields, recent engineering studies on each of the major fields have shown potential for increasing production through infill drilling and modification of existing waterflood operations. Implementation of the recommendations of the studies has commenced, and additional reserves and estimated future net revenues to be derived from implementation of the studies' recommendations are included in the reserve reports summarized below. Southland does not own the full working interest in any of the tracts constituting the Waddell Ranch Properties, and it is not the operator of any of the wells or other facilities on such tracts. Since further implementation of the development program will require approvals of other working interest holders as well as Southland, and is to some extent dependent upon the operator (Gulf Oil Corporation), the extent and timing of such implementation is not within the control of Southland.

During 1979, 19 gross (9.4 net) productive oil wells and 12 gross (6.0 net) productive gas wells were drilled on the Waddell Ranch Properties. During the six months ended June 30, 1980, 11 gross (4.9 net) productive oil and 5 gross (2.5 net) productive gas wells were drilled. Nine gross (3.8 net) wells were being drilled on June 30, 1980.

Texas Royalty Properties. The Texas Royalty Properties consist of 117 separate royalty interests in 31 counties, primarily located in West Texas. The Texas Royalty Properties include royalty interests in mature producing oil fields, such as Yates, Wasson, Seminole, Kelly-Snyder, Howard-Glasscock, Panhandle, N. Cowden, McElroy, East Texas, Hastings and others. The Texas Royalty Properties contain approximately 306,000 gross (approximately 66,000 net) producing acres. Detailed information concerning the number of wells on royalty properties is not generally available to the owners of royalty interests. Consequently, Southland does not have an accurate count of the number of wells located on the Texas Royalty Properties and cannot readily obtain such information.

Reserves

Southland has obtained from its independent petroleum engineers reports as to the proved oil and gas reserves as of December 31, 1979 attributable to the net overriding royalties to be included in the Permian Trust. The Company's independent petroleum engineers are Cawley, Gillespie & Associates, Inc. with respect to the Waddell Ranch Properties and Raymond F. Kravis and Associates, Inc. with respect to the Texas Royalty Properties. The texts of the foregoing reports are included in this Proxy Statement as Exhibits III and IV, respectively, and are incorporated herein by reference. The following tables summarize information presented in the reports, but such summary does not include all the information as to the assumptions, procedures and other matters specified in the reports.

ESTIMATED QUANTITIES OF PROVED RESERVES

	Oil (Bbls)	Gas (Mcf)
Proved developed and undeveloped		
Waddell Ranch Properties	27,543,000	131,085,000
Texas Royalty Properties	12,023,000	26,324,000
Total	<u>39,566,000</u>	<u>157,409,000</u>
Proved developed		
Waddell Ranch Properties	18,291,000	75,636,000
Texas Royalty Properties	12,023,000	26,324,000
Total	<u>30,314,000</u>	<u>101,960,000</u>

ESTIMATED FUTURE NET REVENUE FROM PROVED DEVELOPED AND UNDEVELOPED RESERVES

	Waddell Ranch Properties	Texas Royalty Properties	Total
1980	\$ 45,073,000	\$ 17,524,000	\$ 62,597,000
1981	50,000,000	15,893,000	65,893,000
1982	55,807,000	14,400,000	70,207,000
Remainder	792,917,000	154,651,000	947,568,000
Total	<u>\$943,797,000</u>	<u>\$202,468,000</u>	<u>\$1,146,265,000</u>

ESTIMATED FUTURE NET REVENUE FROM PROVED DEVELOPED RESERVES

	Waddell Ranch Properties	Texas Royalty Properties	Total
1980	\$ 42,399,000	\$ 17,524,000	\$ 59,923,000
1981	37,378,000	15,893,000	53,271,000
1982	35,387,000	14,400,000	49,787,000
Remainder	489,925,000	154,651,000	644,576,000
Total	<u>\$605,089,000</u>	<u>\$202,468,000</u>	<u>\$ 807,557,000</u>

**PRESENT VALUE OF ESTIMATED FUTURE NET REVENUE
DISCOUNTED AT 10%**

	Waddell Ranch Properties	Texas Royalty Properties	Total
Proved developed and undeveloped reserves . . .	\$417,433,000	\$97,213,000(1)	\$514,646,000
Proved developed reserves	\$267,028,000	\$97,213,000	\$364,241,000

(1) This amount is the same as that for proved developed reserves alone. As a royalty owner, Southland does not receive the information necessary to enable its independent petroleum engineers to estimate proved undeveloped reserves attributable to these properties, if any.

Proved reserve quantities are estimates based on information available at the time of preparation and such estimates are subject to change as additional information becomes available. The reserves actually recovered and the timing of production of those reserves may be substantially different from the original estimate. Moreover, the present values shown above should not be considered as the market values of such oil and gas reserves or the costs that would be incurred to acquire equivalent reserves. A market value determination would include many additional factors.

Reserve quantities and values presented above have been prepared based upon pricing assumptions prescribed by the Securities and Exchange Commission ("SEC") and do not reflect the effects of the "windfall profit" tax and phased decontrol of oil prices subsequent to December 31, 1979. See "Regulation and Prices" for a discussion of legislation and regulations governing the prices the Company is allowed to receive for its production. If the effects of the tax and decontrol of oil prices had been considered, the estimated future net revenue and the present value of estimated future net revenue from proved developed and undeveloped reserves for the Permian Trust would be \$1,596,563,000 and \$674,789,000, respectively.

The future net revenue shown above has not been reduced for costs and expenses of the Trustee, which are not expected to initially exceed \$200,000 annually.

There have been no events subsequent to December 31, 1979 which have caused a significant change in the estimated quantities of proved reserves referred to above.

Distributable Income and Production

Distributable income and production attributable to the net overriding royalties to be included in the Permian Trust for the five years ended December 31, 1979 and six months ended June 30, 1979 and 1980 were as follows:

	Year ended December 31,					Six months ended June 30,	
	1975(1)	1976	1977	1978	1979	1979	1980
	(In thousands except for average price and per unit amounts)						
Net oil revenue	\$16,799	\$23,341	\$19,287	\$19,579	\$25,204	\$10,621	\$15,521
Net gas revenue	10,591	19,733	19,322	15,921	15,722	7,107	11,820
Distributable income	<u>\$27,390</u>	<u>\$43,074</u>	<u>\$38,609</u>	<u>\$35,500</u>	<u>\$40,926</u>	<u>\$17,728</u>	<u>\$27,341</u>
Distributable income per unit(2)	\$.59	\$.93	\$.83	\$.76	\$.88	\$.38	\$.59
Production							
Oil (Bbls)	2,750	3,799	3,042	2,728	2,487	1,318	1,024
Gas (Mcf)	10,171	14,037	11,813	9,793	9,028	4,372	4,930
Weighted average sales price for production:							
Oil	\$6.11	\$6.14	\$6.34	\$7.18	\$10.13	\$ 8.06	\$15.16
Gas(3)	\$1.04	\$1.41	\$1.64	\$1.63	\$ 1.74	\$ 1.63	\$ 2.40

- (1) Amounts presented for 1975 are not comparable to subsequent years because the reversion of the Waddell Ranch properties from a royalty interest to a working interest occurred in July 1975.
- (2) Based on 46,412,464 Units. See "Description of Units in the Trusts – Number of Units to be Distributed."
- (3) The gas production figures shown include all gas produced without regard as to whether such gas is sold unprocessed ("raw gas") or processed into natural gas liquids ("NGL"). Revenue attributed to gas includes sales of raw gas, NGL and residue gas (the gas which remains after NGL is removed). After complying with notice periods contained in various contracts, Southland is contractually free to elect the extent to which the gas production from the Waddell Ranch Properties, which are included in the table, is processed. The percentage of gas production from the Waddell Ranch Properties which is processed varies from year to year, but Southland estimates that during 1979 and the six months ended June 30, 1980, approximately 9% and 30%, respectively, of the revenue from such gas was derived from sales of NGL. Marketing and regulatory considerations applicable to NGL vary substantially from those applicable to raw gas and residue gas. See "Pricing Information and Recent Developments" below and "Regulation and Prices."

Pricing Information and Recent Developments

Reference is made to "Regulation and Prices" for information as to federal regulation of prices of oil and natural gas. The classifications and terms in quotation marks in this section are discussed under "Regulation and Prices." The following paragraphs provide information regarding sales of oil and gas from the Waddell Ranch Properties. As a royalty owner, Southland is not furnished detailed information regarding sales of oil and gas from the Texas Royalty Properties.

Oil. During the six months ended June 30, 1980 the oil production from the Waddell Ranch Properties attributable to the net overriding royalties to be transferred to the Permian Trust was 585,000 barrels. Approximately 59% of this production was "lower tier", 18% was "upper tier" and 23% was deregulated. All production from the Waddell Ranch Properties is sold to Gulf Oil Corporation ("Gulf"), which has a right to elect to purchase such production on a year-to-year basis so long as it is operator of the Waddell Ranch Properties at the higher of (i) Gulf's posted field price or (ii) the average of the three highest prices being paid by major purchasers in the area.

Gas. During the six months ended June 30, 1980, the raw gas production from the Waddell Ranch Properties attributable to the net overriding royalty to be transferred to the Permian Trust was 3,521,000 Mcf. The Company's residue gas from the Waddell Ranch Properties is sold under long-term contracts to two purchasers. HT Gathering Company ("HT") purchases gas sold in intrastate commerce, all of which is classified as gas under "existing intrastate contracts". El Paso Natural Gas Company ("El Paso") purchases the gas sold in interstate commerce. NGL extracted from the gas produced from the Waddell Ranch Properties is sold under short-term contracts to a variety of purchasers. The processor of the gas has a preferential right to purchase the NGL by matching any other prospective purchaser's offer.

HT Contract – HT purchases gas under an intrastate contract expiring July 15, 1995. During the six months ended June 30, 1980, approximately 61% of the gas produced from the Waddell Ranch Properties was sold to HT. The contract provides for a minimum base price of \$2.13 per MMBtu as of January 1, 1980, and the price escalates 2.5¢ on January 1 and July 1 of each contract year. At the option of the Company, the contract price may be redetermined each January 1 and July 1 to an amount equal to the highest price being paid in Texas, adjusted as required to equate to the HT contract terms. The price escalations are subject to limitations imposed by the NCPA. See "Regulation and Prices." As of January 1, 1980, the redetermined base price, together with reimbursed costs and other allowances under the contract, results in a price of \$3.02 per MMBtu.

El Paso Contract – During the six months ended June 30, 1980, approximately 39% of the gas produced from the Waddell Ranch Properties was sold to El Paso. The Company and El Paso are involved in settlement proceedings before FERC regarding differences as to the prices paid for gas

sold to El Paso since July 1975, and applicable to future sales to El Paso. The Company and El Paso entered into a gas contract which became effective at the time approval of the settlement by FERC became final in August 1980. The settlement and contract terms provide for payment of the small producer replacement contract price, a special category of gas under "existing interstate contracts," or whatever higher price may be authorized by the NGPA for gas qualifying under its various categories. See "Regulation and Prices".

Approximately 93% of such gas is applicable to small producer replacement contracts and was being sold at a price of \$.886 per MMBtu at July 1, 1980. Approximately 5% of such gas is "new onshore production well" gas and was being sold at \$2.255 per MMBtu at such date. The remaining 2% of such gas is classified as "stripper well natural gas" and was priced at \$2.68 per MMBtu at July 1, 1980.

SAN JUAN BASIN ROYALTY TRUST PROPERTIES

Interests To Be Conveyed

The 75% net overriding royalty to be conveyed to the San Juan Trust will be carved out of Southland's working interests and royalty interests in the San Juan Basin in northwestern New Mexico. It is anticipated that the foregoing conveyance will be effective as of November 1, 1980. The net overriding royalty (attributable to production after such effective date) will consist of the gross proceeds from the sale of production less (when applicable) production costs, development and drilling costs, applicable taxes, operating charges and other costs, deductions and reserves, all as more specifically described and provided for in the conveyance. Such net proceeds, determined monthly, will be multiplied by 75%, to arrive at the amount attributable to the net overriding royalty interest.

Producing Acreage, Wells and Drilling

Southland's working interests and royalty interests in the San Juan Basin consist of 156,000 gross (122,000 net) producing acres in San Juan, Rio Arriba and Sandoval Counties. These properties contain 1,813 gross (834.0 net) productive gas wells, excluding wells contributed to unit operations. The Company operates 744 gross (676.1 net) wells, or 41% of the wells in which it owns an interest. Gas production is from three major formations: Pictured Cliffs, Mesa Verde and Dakota.

The net overriding royalty conveyed to the San Juan Trust will be limited to the base of the Dakota formation, which is currently the deepest significant producing formation under acreage affected by the net overriding royalty. Rights to production from deeper formations, if any, will be retained by the Company.

Southland acquired the properties to be conveyed to the San Juan Trust through the acquisition of Aztec Oil & Gas Company in January 1976. See Note 3 in "Notes to Financial Statements." Since this acquisition, the Company has conducted an active development drilling program on the properties. Through December 31, 1979 Southland had participated in the drilling of 250 gross (190 net) development wells. An infill drilling program in the Mesa Verde formation of 135 gross (101 net) wells represented the most significant portion of such development drilling activity through 1979.

The effect of development drilling in the San Juan Basin has been to offset the natural decline of production and to increase 1979 production approximately 8% over 1975 levels. Production from the wells drilled since 1975 represented approximately 36% of total production from the San Juan Basin properties in 1979.

The Dakota formation has been developed on the basis of 320 acre spacing units. In May 1979 the New Mexico Oil & Gas Conservation Commission approved an infill drilling program for the Dakota formation and reduced the spacing requirement to 160 acre units. Southland drilled or participated in drilling 40 gross (29 net) Dakota infill wells through June 30, 1980. In addition, Southland plans to drill or participate in approximately 250 gross (121 net) Dakota infill wells over a period of about five years.

In addition to the Dakota infill wells, Southland estimates that approximately 338 gross (196 net) development wells will be drilled on properties in the San Juan Basin in which the Company owns an interest over the next five years. This program will depend upon regulatory and economic conditions, the availability of funds and other factors, and there is no assurance that it will be completed.

Reserves

Southland has obtained from H. J. Gruy and Associates, Inc., independent petroleum engineers, a report as to the proved oil and gas reserves as of December 31, 1979 attributable to the net overriding royalty to be conveyed to the San Juan Trust. The text of this report is included in this Proxy Statement as Exhibit V and is incorporated herein by reference. The following tables summarize information presented in the report, but such summary does not include all the information as to the assumptions, procedures and other matters specified in the report.

ESTIMATED QUANTITIES OF PROVED RESERVES

	Oil (Bbls)	Gas (Mcf)
Proved developed and undeveloped	1,981,000	463,660,000
Proved developed	<u>1,503,000</u>	<u>371,670,000</u>

ESTIMATED FUTURE NET REVENUE FROM PROVED DEVELOPED AND UNDEVELOPED RESERVES

1980	\$ 38,423,000
1981	43,080,000
1982	42,893,000
Remainder	1,898,547,000
Total	<u>\$2,022,943,000</u>

ESTIMATED FUTURE NET REVENUE FROM PROVED DEVELOPED RESERVES

1980	\$ 43,300,000
1981	40,993,000
1982	39,200,000
Remainder	1,345,909,000
Total	<u>\$1,469,402,000</u>

PRESENT VALUE OF ESTIMATED FUTURE NET REVENUE DISCOUNTED AT 10%

Proved developed and undeveloped reserves	\$434,948,000
Proved developed reserves	<u>\$339,256,000</u>

Proved reserve quantities are estimates based on information available at the time of preparation and such estimates are subject to change as additional information becomes available. The reserves actually recovered and the timing of production of those reserves may be substantially different from the original estimate. Moreover, the present values shown above should not be considered as the market values of such oil and gas reserves or the costs that would be incurred to acquire equivalent reserves. A market value determination would include many additional factors.

Reserve quantities and values presented above were prepared based upon pricing assumptions prescribed by the SEC and do not reflect the effects of the "windfall profit" tax and phased decontrol of oil prices subsequent to December 31, 1979. See "Regulation and Prices." If the effects of the tax and decontrol of oil prices had been considered, the estimated future net revenue and the present value of estimated future net revenue from proved developed and undeveloped reserves for the San Juan Trust would be \$2,064,743,000 and \$444,036,000, respectively.

The future net revenue shown above has not been reduced for costs and expenses of the Trustee, which are not expected to initially exceed \$200,000 annually.

There have been no events subsequent to December 31, 1979 which have caused a significant change in the estimated quantities of proved reserves referred to above.

Distributable Income and Production

Distributable income and production attributable to the net overriding royalty to be included in the San Juan Trust for the four years ended December 31, 1979, and the six months ended June 30, 1979 and 1980, were as follows:

	Year ended December 31,				Six months ended June 30,	
	1976	1977	1978	1979	1979	1980
	(In thousands except for average price and per unit amounts)					
Net Oil Revenue	\$ 512	\$ 515	\$ 801	\$ 1,151	\$ 483	\$ 664
Net Gas Revenue	7,828	15,113	18,561	26,319	13,073	18,873
Distributable Income	<u>\$ 8,340</u>	<u>\$15,628</u>	<u>\$19,362</u>	<u>\$27,470</u>	<u>\$13,556</u>	<u>\$19,537</u>
Distributable Income per Unit(2)	\$.18	\$.34	\$.42	\$.59	\$.29	\$.42
Production						
Oil (Bbls)	89	94	93	105	54	46
Gas (Mcf)	13,516	14,500	14,153	15,188	8,342	9,716
Weighted average sales price for production						
Oil	\$5.75	\$5.48	\$8.61	\$10.96	\$8.94	\$14.43
Gas	\$0.58	\$1.04	\$1.31	\$ 1.73	\$1.57	\$ 1.94

(1) Information for the year ended December 31, 1975 has not been provided since Southland acquired the properties to be conveyed to the San Juan Trust in January 1976.

(2) Based on 46,412,464 Units. See "Description of Units in the Trusts - Number of Units to be Distributed."

Pricing Information and Recent Developments

Reference is made to "Regulation and Prices" for information as to federal regulation of prices of oil and natural gas. The classifications and terms in quotation marks in this section are discussed under "Regulation and Prices."

General. Gas production for the net overriding royalty interest to be owned by the San Juan Trust for the six months ended June 30, 1980, was 9,716,000 Mcf. Sales of gas produced in the San Juan Basin are made both in interstate and intrastate commerce. Interstate and intrastate sales for the San Juan Trust aggregated 6,919,000 Mcf and 2,797,000 Mcf, respectively. The more significant gas contracts under which San Juan Basin gas production is sold are summarized as follows:

Interstate gas sales. Contracts with El Paso, Southern Union Gathering Company ("Southern Union") and Northwest Pipeline Company provide for payment of the maximum lawful prices permitted by the the NGPA. See "Regulation and Prices." The principal categories of interstate gas

produced during the six months ended June 30, 1980, the percentage of such production attributable to each such category and the price or prices per MMBtu being received for such category at July 1, 1980 were as follows: gas under "existing interstate contracts," 67%, \$.45 to \$1.87; "new onshore production well" gas, 29%, \$2.255; and "stripper well natural gas," 4%, \$2.68.

Intrastate gas sales. Intrastate gas is purchased by Southern Union or its affiliate, Gas Company of New Mexico. Gas prices are redetermined annually on April 1 to the highest price levels being paid in New Mexico. The redetermined contract price on April 1, 1980, was \$2.60 per MMBtu, but the sales price is limited by federal and state regulations. See "Regulations and Prices" for information as to federal regulations. The New Mexico Natural Gas Pricing Act limits the price for intrastate gas produced from wells drilled before 1975. At July 1, 1980, such price was \$1.506 per MMBtu and such price escalates at a rate of ½% per month. Sales of gas subject to such state regulation during the six months ended June 30, 1980, was approximately 56% of total intrastate gas sales. Under this Act, gas qualifying as "stripper well natural gas" for federal regulatory purposes, which was approximately 4% of intrastate sales during the six months ended June 30, 1980, could be sold at \$2.68 per MMBtu at July 1, 1980. The remaining 40% of intrastate gas sales is not currently regulated as to price by New Mexico and is classified as gas under "existing intrastate contracts" and, by contractual provisions, was being sold at July 1, 1980 at a price of \$2.504 per MMBtu.

Recent developments. In late June, 1980 a compressor station (part of the purchasers' gathering facilities) for certain of the San Juan Basin properties was damaged by an explosion. Several hundred gas wells were "shut in" pending repairs to the plant, and the Company believes that these wells will not be restored to their prior levels of production until October 1980 or later. Production and revenues from Southland's San Juan Basin properties during July and August were reduced by approximately 26% and 16%, respectively, from the same period of 1979.

Certain of the Company's San Juan Basin properties are leased from the Jicarilla Apache Tribe (the "Tribe" or the "Jicarillas"). In 1975, the Jicarillas filed suit against the Company and others, claiming that for royalty settlement purposes on past oil and gas production from tribal lands, payments should have been based upon the value of gas without regard to the price being received by the producers. In addition, the Tribe requested the Department of Interior be directed to seek cancellation of certain oil and gas leases. In December 1978, the Tribe filed an amended complaint seeking treble damages from the price related antitrust claims, the effect of which was to restate the previous claim and seek treble damages for the \$1,500,000 in claimed royalty deficiencies. The case was tried and on November 5, 1979, the Trial Court dismissed the Tribe's antitrust claims, dismissed the claims alleging failure to develop the leases and protect the leased lands from drainage, and denied the Tribe's request that the leases be cancelled. The Court did order the Company (and the other defendants) to render an accounting for royalty calculation purposes, on a basis different from that which was previously used in paying the Tribe's royalties. This alternative form of royalty calculation would result in the Company being required to pay additional royalties to the Tribe on past production of approximately \$200,000. The foregoing judgment by the New Mexico Federal District Court is being appealed to the Tenth Circuit Court of Appeals. The Company believes, and has asserted by way of crossclaim in this litigation, that it is entitled to pass on any such additional royalty to the purchaser of the gas. This issue has not yet gone to trial.

The Company is a co-defendant in three antitrust lawsuits now pending in the United States District Court for the District of New Mexico. These cases were originally filed, respectively on December 29, 1978, July 13, 1979, and September 18, 1979. The cases allege violations of Sections 1 and 2 of the Sherman Act and complain of essentially the same transactions. In the first case filed, the plaintiffs are a group of corporations, partnerships and individuals engaged in agricultural operations in Curry and Roosevelt Counties, New Mexico. The second case is brought as a class action on behalf of all residential gas customers in New Mexico who reside within the service areas of the defendant gas purchaser or its affiliates. The third case is brought on behalf of certain named agencies, departments, and educational institutions of the New Mexico state government who purchase natural gas from the defendant gas purchaser or its affiliates. The amount of damages alleged in the first

case, after trebling, is in excess of \$120 million. The damages sought by amended complaints in the other two cases are unspecified, but are alleged to be in the millions of dollars. In earlier complaints, the damages in such cases, after trebling, were alleged to be in excess of \$100 million. Each case also seeks injunctive relief prohibiting further conduct of the defendants in violation of the federal antitrust laws. The plaintiffs allege a conspiracy by and among the defendants illegally to fix and raise the price of natural gas in New Mexico, primarily through the negotiation of alleged friendly settlements in 1976 of lawsuits between the defendant gas purchaser (and/or its affiliates) and other defendants, including the Company, who are gas producers in the San Juan Basin area of New Mexico. The 1976 lawsuits were brought by the producers to settle contract disputes with the gas purchaser relating to the interpretation of the pricing provisions of their respective gas purchase contracts. The Company believes that the settlement in 1976 of its contract suit was reached only after vigorous litigation and difficult, arms-length settlement negotiations.

The Company believes these antitrust claims are without merit and intends to defend these suits vigorously. Messrs. Vinson & Elkins, legal counsel for the Company in regard to these suits, have interviewed several officers, employees, and representatives of the Company who are familiar with the transactions complained of by the plaintiffs, and have reviewed certain documentary materials furnished by the Company. Based upon such investigation, it is the opinion of the Company's counsel that the Company has substantial legal defenses. Several of these defenses were preliminarily decided adversely to the defendants by the trial judge in the first of the three cases in summary judgment proceedings at the initial stage of such case. Such action was based upon a less than complete factual record, and counsel for the Company believes such legal defenses remain viable and intends to reurge such defenses at a later stage of the litigation following factual development through discovery. Counsel for the Company also believes, based upon their limited review to date, that the Company has factual defenses to the claims of the plaintiffs.

CONTINUING BUSINESS AND PROPERTIES OF SOUTHLAND

Southland will continue to be engaged in exploring for, developing, operating and acquiring crude oil and natural gas properties in the United States and Canada. The Company's operations in Canada are not material.

Reserves

Southland has obtained from its independent engineers, Cawley, Gillespie & Associates, Inc., H. J. Gruy and Associates, Inc., and Raymond F. Kravis and Associates, Inc., reports as to the proved oil and gas reserves attributable as of December 31, 1979 to the properties and interests ("Remaining Southland Properties") to be retained by Southland after the Transaction. The text of these reports are included in this Proxy Statement as Exhibits VI, VII and VIII, respectively, and are incorporated herein by reference. The following tables summarize information presented in the reports, but such summary does not include all the information as to the assumptions, procedures and other matters specified in the reports.

ESTIMATED QUANTITIES OF PROVED RESERVES

	Oil (Bbls)	Gas (Mcf)
Proved developed and undeveloped		
Cawley, Gillespie & Associates, Inc.	30,219,000	66,701,000
H. J. Gruy and Associates, Inc.	7,399,000	310,908,000
Raymond F. Kravis and Associates, Inc.	47,548,000	276,158,000
Total	<u>85,166,000</u>	<u>653,767,000</u>
Proved developed		
Cawley, Gillespie & Associates, Inc.	20,457,000	38,837,000
H. J. Gruy and Associates, Inc.	5,692,000	226,892,000
Raymond F. Kravis and Associates, Inc.	43,580,000	257,574,000
Total	<u>69,729,000</u>	<u>523,303,000</u>

**ESTIMATED FUTURE NET REVENUE FROM
PROVED DEVELOPED AND UNDEVELOPED RESERVES**

	Cawley, Gillespie & Asso- ciates, Inc.	H. J. Gruy and Asso- ciates, Inc.	Raymond F. Kravis and Asso- ciates, Inc.	Total
1980	\$ 15,024,000	\$ 12,965,000	\$ 126,122,000	\$ 154,111,000
1981	16,667,000	15,475,000	117,221,000	149,363,000
1982	18,602,000	18,474,000	107,411,000	144,487,000
Remainder	264,306,000	669,290,000	851,898,000	1,785,494,000
Total	\$314,599,000	\$716,204,000	\$1,202,652,000	\$2,233,455,000

**ESTIMATED FUTURE NET REVENUE FROM
PROVED DEVELOPED RESERVES**

	Cawley, Gillespie & Asso- ciates, Inc.	H. J. Gruy and Asso- ciates, Inc.	Raymond F. Kravis and Asso- ciates, Inc.	Total
1980	\$ 14,133,000	\$ 17,947,000	\$ 129,233,000	\$ 161,313,000
1981	12,459,000	16,860,000	111,070,000	140,389,000
1982	11,796,000	15,973,000	102,558,000	130,327,000
Remainder	163,308,000	474,125,000	714,733,000	1,352,166,000
Total	\$201,696,000	\$524,905,000	\$1,057,594,000	\$1,784,195,000

**PRESENT VALUE OF ESTIMATED FUTURE NET
REVENUE DISCOUNTED AT 10%**

	Cawley, Gillespie & Asso- ciates, Inc.	H. J. Gruy and Asso- ciates, Inc.	Raymond F. Kravis and Asso- ciates, Inc.	Total
Proved developed and undeveloped reserves	\$139,144,000	\$164,608,000	\$ 644,515,000	\$ 948,267,000
Proved developed reserves	\$ 89,009,000	\$132,066,000	\$ 588,756,000	\$ 809,831,000

Proved reserve quantities are estimates based on information available at the time of preparation. Such estimates are subject to change as additional information becomes available. The reserves actually recovered and the timing of production of those reserves may be substantially different from the original estimate. Moreover, the present values shown above should not be considered as the market values of such oil and gas reserves or the costs that would be incurred to acquire equivalent reserves. A market value determination would include many additional factors.

Reserve quantities and values presented above have been prepared based upon pricing assumptions prescribed by the SEC and do not reflect the effects of the "windfall profit" tax and phased decontrol of oil prices subsequent to December 31, 1979. See "Regulation and Prices." If the effects of the tax and decontrol of oil prices had been considered, the estimated future net revenue from proved developed and undeveloped reserves and the present value of estimated future net revenue for the remaining properties would be \$2,559,976,000 and \$1,041,629,000, respectively.

Subsequent to December 31, 1979, the Company purchased additional proved reserves through the acquisition of P&O as discussed in Note 3 in "Notes to Financial Statements." Independent petroleum engineers estimate that P&O had proved developed and undeveloped reserves of 16,248,000

barrels of oil and 24,754,000 Mcf of gas as of the date of acquisition. The estimated future net revenue from proved developed and undeveloped reserves and the present value of estimated future net revenue are \$309,254,000 and \$136,480,000, respectively. These reserves are not considered in the reserve estimates presented herein. There are no other events subsequent to December 31, 1979 which have caused a significant change in the estimated quantities of reserves indicated above.

See Note 11 in "Notes to Financial Statements" for information regarding costs incurred in oil and gas producing activities.

Leasehold and Royalty Acreage

The Company holds oil and gas producing and nonproducing (primarily undeveloped) leasehold, royalty and mineral interests in most of the major oil and gas producing states, offshore in the Gulf of Mexico and in Canada. The following table summarizes total acreage held at June 30, 1980:

State	LEASEHOLDS					
	Producing		Nonproducing		Total	
	Gross acres	Net acres	Gross acres	Net acres	Gross acres	Net acres
Alabama	15,820	6,077	175,592	152,672	191,412	158,749
Arizona	—	—	19,914	19,914	19,914	19,914
Arkansas	5,468	1,410	4,321	3,807	9,789	5,217
California	30	9	—	—	30	9
Colorado	9,444	5,215	79,689	55,416	89,133	60,631
Kansas	10,988	7,828	41,891	33,440	52,879	41,268
Louisiana	12,343	7,366	15,656	7,685	27,999	15,051
Mississippi	167	21	13,685	11,784	13,852	11,805
Montana	54,333	28,258	345,875	249,763	400,208	278,021
Nebraska	240	120	159,411	108,455	159,651	108,575
New Mexico	194,107	163,860	360,266	354,185	554,373	518,045
North Dakota	2,734	532	57,326	36,976	60,060	37,508
Ohio	50	1	—	—	50	1
Oklahoma	153,896	114,410	136,127	91,226	290,023	205,636
South Dakota	—	—	10,847	9,532	10,847	9,532
Texas	276,906	124,960	231,340	133,882	508,246	258,842
Utah	21,187	13,068	392,381	203,689	413,568	216,757
Wyoming	128,941	48,169	455,813	214,256	584,754	262,425
Gulf Coast — offshore	61,598	5,562	5,000	500	66,598	6,062
Canada	112,860	32,041	348,985	147,864	461,845	179,905
Total	1,061,112	558,907	2,854,119	1,835,046	3,915,231	2,393,953

ROYALTIES AND MINERALS

State	Producing		Nonproducing		Total	
	Gross acres	Net acres	Gross acres	Net acres	Gross acres	Net acres
Alabama	204	3	8,426	873	8,630	876
Arkansas	8,939	4,352	31,041	11,007	39,980	15,359
California	380	230	—	—	380	230
Colorado	3,063	384	27,185	2,723	30,248	3,107
Georgia	—	—	700	142	700	142
Idaho	—	—	39,519	1,408	39,519	1,408
Illinois	529	128	327	142	856	270
Kansas	19,722	4,037	6,116	2,598	25,838	6,635
Louisiana	32,507	2,581	2,820	222	35,327	2,803
Mississippi	2,946	275	46,464	10,856	49,410	11,131
Montana	4,917	856	155,563	14,370	160,480	15,226
Nebraska	—	—	40	20	40	20
Nevada	—	—	160	16	160	16
New Mexico	40,893	4,406	35,004	4,264	75,897	8,670
North Dakota	2,640	667	67,079	10,923	69,719	11,590
Oklahoma	63,255	11,905	45,933	9,144	109,188	21,049
Oregon	—	—	600	150	600	150
South Carolina	—	—	1,945	231	1,945	231
South Dakota	—	—	10,235	1,230	10,235	1,230
Texas	1,009,516	216,733	424,326	82,515	1,433,842	299,248
Utah	—	—	5,388	379	5,388	379
West Virginia	—	—	2,154	202	2,154	202
Wyoming	3,284	1,090	5,979	1,682	9,263	2,772
Canada	5,765	841	28,421	2,175	34,186	3,016
Total	1,198,560	248,488	945,425	157,272	2,143,985	405,760

The net producing acreage in New Mexico and Texas includes acreage that will be subject to the net overriding royalty interests to be transferred to the Trusts. (See "Producing Acreage, Wells and Drilling" for each Trust.)

Producing Wells

A summary of the Company's gross and net producing wells as of June 30, 1980 follows:

Producing Wells					
Oil		Gas		Total	
Gross	Net	Gross	Net	Gross	Net
9,397	1,795	2,750	986	12,147	2,781

The net producing wells in the San Juan Trust and the Permian Trust will not be reduced by the net overriding royalty interests to be transferred to the Trusts. (See "Producing Acreage, Wells and Drilling" for each Trust.)

One or more completions in the same bore hole are counted as one well. Of the gross wells reflected in the foregoing table, 382 contain multiple completions. The number of wells includes certain wells awaiting connection but does not include wells located on unitized properties in which the Company's interest varies to as low as one percent or wells located on properties on which Southland owns only a royalty interest.

Drilling Activities

During 1979, Southland drilled 92.4 net development wells, of which 89.5 were productive and 2.9 were dry. During the six months ended June 30, 1980, the Company drilled 50.2 net development wells, of which 47.5 were productive and 2.7 were dry. During 1979 the Company drilled 70.4 net exploration wells of which 46.7 were productive and 23.7 were dry. During the six months ended June 30, 1980, the Company drilled 42.9 net exploration wells of which 28.4 were productive and 14.5 were dry. The following table gives a summary of wells drilled during the four years 1976 through 1979 and the six months ended June 30, 1980:

	1976	1977	1978	1979	Six months ended June 30, 1980
Gross					
Oil	49	64	33	90	96
Gas	105	138	177	186	100
Dry	54	43	48	60	41
Total	<u>208</u>	<u>245</u>	<u>258</u>	<u>336</u>	<u>237</u>
Net					
Oil	22.8	20.8	11.1	32.3	26.8
Gas	27.5	64.1	100.8	103.9	49.1
Dry	20.3	13.0	19.6	26.6	17.2
Total	<u>70.6</u>	<u>97.9</u>	<u>131.5</u>	<u>162.8</u>	<u>93.1</u>

At June 30, 1980, Southland was participating in the drilling of 85 gross wells (32.1 net wells). Of these wells, 82 gross wells (31.5 net wells) were being drilled in 11 different states and in three offshore blocks. Three gross wells (.6 net wells) were being drilled in Canada.

Production

The following table summarizes the net gas and oil production of the Remaining Southland Properties during the five years ended December 31, 1979, and for the six months ended June 30, 1979 and 1980:

	Year ended December 31,					Six months ended June 30,	
	1975(1)	1976	1977	1978	1979	1979	1980
	(In thousands except for average price)						
Revenue							
Oil	\$30,263	\$42,916	\$48,976	\$50,577	\$86,371	\$34,794	\$75,863
Gas	\$13,780	\$29,649	\$47,646	\$66,410	\$87,799	\$40,669	\$52,094
Production							
Oil (Bbls)	3,583	5,279	6,141	5,609	6,694	3,263	3,756
Gas (Mcf)	18,509	37,351	46,542	55,797	61,711	30,301	31,234
Weighted average sales price for production							
Oil	\$ 8.45	\$ 8.13	\$ 7.98	\$ 9.02	\$ 12.90	\$ 10.66	\$ 20.20(2)
Gas	\$.74	\$.79	\$ 1.02	\$ 1.19	\$ 1.42	\$ 1.34	\$ 1.67

- (1) Southland acquired the properties to be conveyed to the San Juan Trust in January 1976. The reversion of the Waddell Ranch Properties from a royalty interest to a working interest occurred in July 1975. Consequently, revenue and production information for 1975 is not comparable with subsequent periods.
- (2) The weighted average sales price for production for the six months ended June 30, 1980 does not reflect the effect of the "windfall profit" tax. See "Regulation and Prices."

Pricing Information

Reference is made to "Regulation and Prices" for information as to federal regulation of prices of oil and natural gas. The classifications and terms in quotation marks in the following paragraphs are discussed under "Regulation and Prices".

Oil production from the Remaining Southland Properties during the six months ended June 30, 1980 was classified as follows for purposes of federal price regulations: 38% was "lower tier"; 18% was "upper tier"; and 44% was deregulated.

Gas production from the Remaining Southland Properties during the six months ended June 30, 1980 was classified as follows for federal regulatory purposes: gas subject to "existing interstate contracts", 36%; gas subject to "existing intrastate contracts", 32%; gas from "new onshore production wells", 27%; "stripper well natural gas", 2%; and "new natural gas", 3%.

During the past several years demand in the United States for crude oil and, with certain exceptions, natural gas has generally been strong, and prices for these products, except to the extent limited by federal or state regulation, have generally increased steadily. Nevertheless, demand for and prices of oil and gas have historically been and will continue to be subject to supply and demand factors. During the past several weeks there has been an oversupply of refined petroleum products in the United States, and some major oil companies have recently decreased their prices for deregulated crude oil. Also, the relatively mild winter of 1979-1980 has resulted in an oversupply of natural gas in some areas. Southland has not yet experienced any material decline in prices or demand for its oil or gas, but such decreases may occur if the current oversupply conditions continue or if they reoccur in the future. Over the long term, prices for both oil and gas will depend on demand, product availability, prices of alternative fuels, governmental regulation and other factors beyond the control of Southland or either Trust.

REGULATION AND PRICES

Introduction

Many aspects of the production, pricing and marketing of crude oil and natural gas are regulated by federal and state agencies. The pricing of crude oil and natural gas is regulated chiefly by the Department of Energy ("DOE"). The Federal Energy Regulatory Commission ("FERC"), an agency of DOE, is primarily responsible for the regulation of natural gas matters, and the Economic Regulatory Administration ("ERA") is responsible for the regulation of certain first sales of crude oil and petroleum products. In addition, Southland and the Trusts' operations will be regulated with respect to environmental matters by numerous federal, state, and local agencies.

The revenues of Southland and the Trusts will also be substantially affected by state and federal tax laws and regulations which, like energy regulations, are subject to significant change due to political and economic developments. Likewise, a number of federal and state conservation laws and regulations play a direct role in the rates of production, spacing of oil and natural gas wells, authorization to drill wells, prevention of waste or pollution and similar matters.

The principal effect of federal regulatory controls upon Southland and the Trusts is expected to continue to be the control of pricing of domestic production of crude oil and natural gas. However, the other laws and regulations referred to above have substantive impacts on Southland's operations and on the revenues which will be received by the Trusts.

The information provided below is intended only to provide information of a general nature and to define certain terms. Reference is made to "Permian Basin Royalty Trust Properties – Pricing Information and Recent Developments", "San Juan Basin Royalty Trust Properties – Pricing Information and Recent Developments" and "Continuing Business and Properties of Southland – Pricing Information" for more specific information as to the various categories of oil and gas production significant to each concern.

Overview of Natural Gas Regulation

The FERC has authority to regulate natural gas producers under both the Natural Gas Act ("NGA") and the Natural Gas Policy Act of 1978 ("NGPA"). Under the NGPA, the FERC is primarily charged with administering and enforcing a series of maximum lawful price ceilings for all first sales of natural gas produced and sold for resale, with certain limited exceptions. In addition, under the NGA, the FERC retains non-price regulatory jurisdiction over certain natural gas and may require certification and abandonment authorization before initiation or termination of certain natural gas sales in the interstate market. Under the NGPA, the FERC may require that preferential rights to purchase gas be given to purchasers whose interstate contracts have expired, or that certain contracts have a minimum duration period. The FERC has certain broad general investigatory and other regulatory power under both the NGA and the NGPA to administer those laws.

As a result of passage of the NGPA, the FERC now regulates the prices paid for gas sold in the intrastate market as well as the interstate market.

Maximum lawful prices are presently established for the following categories of natural gas production: new natural gas, new onshore production wells, existing interstate contracts, existing intrastate contracts, rollover contracts, high-cost natural gas, stripper well natural gas and a general category covering natural gas production not otherwise covered by any other category established by the NGPA. Each such category carries its own distinctive pricing formula, both as to inflation and for real growth in certain categories. The NGPA provides that if any natural gas qualifies under more than one category, the category which could result in the highest price is applicable. Maximum lawful prices established by the NGPA are generally exclusive of state severance taxes and, in certain limited instances, may be adjusted upon application to and by order of the FERC to allow for the recovery of the costs of compression, gathering, liquefaction, transportation or other production costs borne by the seller. Although the NGPA establishes maximum lawful ceiling

prices for categories of first sales, the prices may not be collected in the absence of contractual authority to do so. Therefore, while gas may be otherwise qualified to collect a maximum lawful price in a particular category, in the absence of contractual authorization to do so, a producer cannot collect such price.

Certain gas categories under the NGPA remain subject to the pricing structure previously established by the FERC pursuant to its rate-making powers under the NGA, including certain Federal offshore lease gas. The rates set by the FERC and its predecessor agency, the Federal Power Commission, in a variety of area and nationwide rate cases in prior years, remain in effect with respect to gas which was committed or dedicated to interstate commerce on the day before the date the NGPA was enacted. The NGPA allows certain escalations which permit a gradual rise in price for all categories subject to continuing price ceilings, including previously committed or dedicated gas.

The following paragraphs describe the principal present categories of natural gas production:

(1) *New Natural Gas.* New natural gas is natural gas determined to be produced: (a) from a new lease on the outer continental shelf; (b) from any "new well," as defined in the Act, which is 2.5 miles or more from the nearest "marker well," as defined in the NGPA, or from any completion location of any new well which is at least 1,000 feet below the deepest completion location of each marker well within 2.5 miles of such new well; (c) from a reservoir from which natural gas was not produced in commercial quantities before April 20, 1977 subject to certain exclusions; or (d) from an old lease on the outer continental shelf if such natural gas is produced from a reservoir which was not discovered before July 27, 1976. For July 1980 the maximum lawful price for new natural gas is \$2.504 per MMBtu, with monthly adjustments for inflation and a real growth factor of 3.5% through April 1, 1981 and 4.0% thereafter.

The term "new well" is defined in the NGPA to mean any well the surface drilling of which began on or after February 19, 1977, or the depth of which was increased on or after February 19, 1977 to a completion location at least 1,000 feet below its deepest completion location before such date.

The term "marker well" means any well from which natural gas was produced in commercial quantities at any time after January 1, 1970 and before April 20, 1977.

(2) *New Onshore Production Well.* A new onshore production well is any new well (other than a well located on the outer continental shelf) which satisfies applicable well-spacing requirements and which is not within a defined pre-existing proration unit. For July 1980 the maximum lawful price for natural gas production from a new onshore production well is \$2.255 per MMBtu, with monthly adjustments thereafter for inflation.

(3) *Existing Interstate Contracts.* Existing interstate contract production is natural gas production committed or dedicated to interstate commerce on the day before the date of the NGPA's enactment and for which a just and reasonable rate under the NGA was in effect on such date. The maximum lawful price for such production is the higher of the just and reasonable rate, per MMBtu, in effect on April 20, 1977 as adjusted thereafter on a monthly basis for inflation, or any applicable just and reasonable rate established by FERC after April 20, 1977 and before the date of the NGPA's enactment.

(4) *Existing Intrastate Contracts.* Existing intrastate contract production is natural gas production sold under any existing contract, or any successor to an existing contract, which was not committed or dedicated to interstate commerce on the day before the date of the NGPA's enactment. The maximum lawful price for such production depends upon the contract price in effect on the date of the NGPA's enactment. There is no rollback of contract prices on the date of the NGPA's enactment; however, subsequent monthly adjustments to the contract price are, depending upon the specific terms of the existing contract, generally designed to bring the existing contract price, as adjusted, into balance with the new natural gas ceiling price, as adjusted.

Once that balance is obtained, the contract price may increase only at a rate equal to the monthly increase in the new natural gas ceiling price.

(5) *Rollover Contracts.* A rollover contract is defined in the NGPA as any contract entered into on or after the date of the NGPA's enactment for the first sale of natural gas that was previously subject to an existing contract which expired at the end of a fixed term. The maximum lawful price for production covered by an interstate rollover contract for a small producer is the higher of the just and reasonable rate in effect on the date of rollover, as adjusted thereafter on a monthly basis for inflation, or \$.728 per MMBtu for July 1980 as adjusted thereafter on a monthly basis for inflation. The maximum lawful price for production covered by an intrastate rollover contract is the higher of the contract price on the date of rollover, as adjusted thereafter on a monthly basis for inflation, or \$1.286 per MMBtu for July 1980 as adjusted thereafter on a monthly basis for inflation.

(6) *High-Cost Natural Gas.* High-cost natural gas means gas determined to be: (a) produced from any well the surface drilling of which began on or after February 19, 1977 if such production is from a completion location which is located at a depth of more than 15,000 feet; (b) produced from geopressurized brine; (c) occluded natural gas produced from coal seams; (d) produced from Devonian shale; or (e) produced under such other conditions as FERC determines to present extraordinary risks or costs. As of November 10, 1979 high cost natural gas, except as described in (e) above, became exempt from regulated maximum lawful prices under the NGPA and may be sold at a deregulated price. The maximum lawful price applicable to category (e) above of high-cost natural gas production is generally 150% of the Category (2) price as shown above.

(7) *Stripper Well Natural Gas.* Stripper well natural gas is defined as nonassociated natural gas produced during a specified period from a well, produced at its maximum efficient rate of flow, at a rate not in excess of an average of 60 Mcf per day. For July 1980 the maximum lawful price for stripper well natural gas is \$2.68 per MMBtu, with monthly adjustments thereafter for inflation and real growth.

(8) The final pricing category is a general provision which covers any natural gas production not otherwise covered by another maximum lawful price provision of the NGPA. For July 1980 the maximum lawful price for natural gas production covered by this general category is \$1.86 per MMBtu, with monthly adjustments thereafter for inflation.

Price controls on high-cost gas, including gas from certain wells with completion locations below 15,000 feet, expired effective December 1, 1979. Effective January 1, 1985 the ceiling prices set by the NGPA will expire with respect to certain limited categories of gas but price controls on such gas may be reimposed once, for a period not in excess of eighteen months, after May 31, 1985 by concurrent resolution of Congress or by order of the President. The order of the President may be overridden by a concurrent resolution of Congress disapproving the order. The ceiling price for an additional category of gas is scheduled to expire July 1, 1987. Except for the limited categories of gas now decontrolled or scheduled to decontrol in 1985 and 1987, the price ceilings set under the NGPA have indefinite duration.

While the NGPA eliminated non-price regulation by the FERC for a variety of categories of natural gas once such gas is legitimately qualified in that category, certain NGA non-price jurisdiction remains with respect to gas which remains "committed or dedicated to interstate commerce" as that term is defined in the NGPA. Qualified new natural gas, gas from certain onshore production wells and high-cost gas are deregulated for non-price purposes.

If natural gas remains "committed or dedicated to interstate commerce", the continuing jurisdiction of the FERC over such matters as certification and abandonment of sales of natural gas remains in effect. In addition, all the regulatory powers which the FERC had under the NGA,

such as to investigate, to require books and records to be kept in a certain manner and other matters, remains applicable with respect to such gas.

Overview of Crude Oil Price Controls

Crude oil and other liquid hydrocarbons are subject to Federal price controls established under the Emergency Petroleum Allocation Act of 1973 (the "Allocation Act"), as amended by the Energy Policy and Conservation Act of 1975 (the "Energy Act"). The Economic Regulatory Administration (the "ERA"), an agency within the U.S. Department of Energy, administers an extensive system of price and allocation regulatory controls on liquids and certain refined petroleum products, and administers a cost equalization or "entitlements" program. Prices of NGL were formerly regulated by the ERA, but since January 1, 1980 such prices (except for propane, which is not material to Southland) have been deregulated.

The Allocation Act established a two tier pricing structure for domestic crude oil by classifying crude oil as "lower tier" or "upper tier." The structure was designed to maintain a composite weighted national average price of \$7.66 per barrel, with periodic adjustments to the ceiling prices based upon the rate of inflation and a production incentive factor (provided such adjustments do not exceed an aggregate increase of 10% per year). The ERA has adopted special rules giving added incentive for unitized operation of properties and for the institution of tertiary recovery techniques. Complicated regulations control actual computation of production and prices applicable to specific properties. Production from "stripper wells," defined as a property on which production averages ten or less barrels of crude per day per well during any consecutive twelve month period after December 31, 1972 is exempt from price controls.

On April 5, 1979 the President announced his intention to phase out price controls on domestic crude oil beginning June 1, 1979 and culminating in full decontrol upon the expiration of price control authority established by the Energy Act on October 1, 1981. Effective June 1, 1979 the ERA established regulations permitting "newly discovered crude oil" and incremental new production from wells employing specified enhanced recovery techniques to be sold at world free market prices. The regulations defined "newly discovered crude oil" as production from an onshore property which produced no crude oil in calendar year 1978 or from an offshore property leased after 1978. Also, a new category of price controlled production was established (designated "marginal") in which certain lower tier properties could reclassify approximately 80% of production as upper tier effective June 1, 1979 and 100% effective January 1, 1980. Beginning January 1, 1980 upper tier crude oil is being gradually decontrolled so that all upper tier production is scheduled to reach the world free market price on October 1, 1981. Similarly, lower tier oil is being gradually decontrolled on a phased basis ending October 1, 1981. The President, however, has retained the authority to modify this phased decontrol plan and Congress has the authority to enact new legislation extending price controls on crude oil.

Windfall Profit Tax. An integral part of this decontrol program is the imposition of a tax on revenues from sales of crude oil pursuant to the Crude Oil Windfall Profit Tax Act of 1980 (the "Act"), which is administered by the Internal Revenue Service.

The following are the principal provisions of the Act, which was enacted effective March 1, 1980:

Tier one oil – a tax rate of 70% will be imposed on the producer's "windfall profit" from the sale of most crude oil from properties that were in production prior to 1979.

Tier two oil – a tax rate of 60% will be imposed on the producer's "windfall profit" from the sale of crude oil from a stripper property (if the property does not qualify under the tier three tax).

Tier three oil – a tax rate of 30% will be imposed on the producer's "windfall profit" from the sale of crude oil from a property from which there was no production before 1979 (in the case of offshore properties, only if the lease was entered into after 1978) or from the sale of crude oil which qualifies as "incremental tertiary" or "heavy" oil.

A lower rate of tax will be imposed under the tier one tax and the tier two tax on the proceeds from the sale of not more than 1,000 barrels of average daily production in the case of so-called independent producers.

In general, "windfall profit" is defined as the sales price of crude oil in excess of the applicable base price, as adjusted, for the particular tier of oil involved. The initial base price is approximately \$12.81 per barrel of tier one oil, \$15.20 per barrel of tier two oil and \$16.55 per barrel of tier three oil. The base price is subject to adjustment for inflation (plus an additional increase in the case of the tier three oil). A special rule limits the amount of the "windfall profit" to 90% of the producer's net income (as defined in the Act) from the property. However, it is anticipated that such special rule will not provide any significant benefit to the owners of Units.

The tax is collected pursuant to a withholding system so that the net overriding royalties paid to the Trusts will be reduced by the amount of tax withheld.

INCOME TAX CONSEQUENCES

The creation of the Trusts, the transfer of the Trust properties to the Trusts and the Distribution of the Units raise a number of significant federal income tax issues. The Company has requested certain advance rulings from the Internal Revenue Service ("IRS") dealing with the tax consequences described below. The principal rulings requested are (i) that the Distribution will be treated as a distribution of property by a corporation with respect to its stock in which no gain will be recognized to the Company and (ii) that the Trusts will be taxable as grantor trusts and not as corporations. Since the IRS refused to issue rulings with respect to a similar transaction, the Company is uncertain whether the IRS will issue the requested rulings. The Company will proceed with the Distribution, notwithstanding shareholder approval, only if it has received the requested rulings or the opinion of Butler, Binion, Rice, Cook & Knapp, counsel to the Company, that (i) the Distribution should be treated as a dividend distribution in which (subject to recapture provisions) no gain will be recognized to the Company and (ii) the Trusts should be taxable as trusts and not as corporations, and, if such ruling or opinion is not received, the Transaction will not be consummated. In the event the Company obtains such opinion, it may, in its sole discretion, withdraw all or part of the request for rulings. Counsel has advised the Company that such tax consequences are supported by the existing Internal Revenue Code and the regulations and rulings thereunder or authoritative court decisions. The opinion of counsel will not be binding on the IRS or the courts.

Tax Consequences of Transfer of Royalties to the Trusts and Distribution of Units

Consequences to the Company. The transfer of the Trust properties to the Trusts followed by the Distribution of the Units to the Company's stockholders will be treated as a distribution of the Trust properties to its stockholders which should not result in the recognition of any gain or loss by the Company. Revenue payable with respect to the Trust properties will not be taxable to the Company following the Distribution.

Consequences to the Company's Stockholders. While the stockholders will actually receive Units, each stockholder will be deemed for tax purposes to have received undivided fractional interests in the Trust properties equal to his fractional share interest in the Company and to have then contributed the fractional interest in the oil and gas properties located in New Mexico to the San Juan Trust in exchange for Units of that Trust and the fractional interest in the oil and gas properties located in Texas to the Permian Trust in exchange for Units of that Trust. References in the subsequent discussion to the basis or holding period of Units are for convenience only and it should be kept in mind that the stockholder should not have a tax basis or holding period in a Unit separate or distinct from the basis or holding period in the underlying assets which the Unit represents.

Each noncorporate stockholder will be deemed to have received a distribution of an amount equal to the fair market value of the Units distributed to him on the date of the Distribution. If on such date there is an established market for the Units, their fair market value will be the mean of the high and low sale prices in such market. If no such market exists, each noncorporate stockholder will be deemed to have received an amount equal to the fair market value of the Units distributed to him and the Company will report its opinion of the fair market value to both the IRS and the stockholders. The Company's opinion as to such value is binding on neither the IRS nor the stockholders.

Each corporate stockholder will be deemed to have received a distribution of an amount equal to the lesser of the fair market value of the Units distributed to it, or the tax basis which the Company has in the Trust properties at the time of the Distribution. The Company's current tax basis in the Trust properties is approximately \$2.00 per share.

The amount deemed to be distributed to either a noncorporate or corporate stockholder will be taxable as a dividend to the extent of the Company's earnings and profits (as determined for federal income tax purposes) which have accumulated since the Company's formation through 1980. The Company's calculations indicate that its cumulative earnings and profits for tax purposes will be approximately \$4.50 per share by the end of 1980. If the amount of the Distribution attributable to a share of Common Stock is in excess of the portion taxable as a dividend, the excess will reduce (but not below zero) the stockholder's basis in such share. If the amount of the Distribution attributable to a share of Common Stock is in excess of both the portion taxable as a dividend and the portion used to reduce basis, the excess will be taxable as gain from the sale of such share of Common Stock. If a share of Common Stock has been owned for more than twelve months, the gain will be long-term capital gain. If the Common Stock is held by a dealer for resale, the gain will be ordinary income. Each stockholder will initially have a basis in each Unit equal to the amount deemed to be distributed as determined under the above discussion.

A corporate stockholder's holding period for a Unit will include the period that the Trust properties have been held by the Company (which is in excess of one year). A noncorporate stockholder's holding period will begin on the date of the Distribution.

The above discussion of the tax consequences is not directly applicable to stockholders of the Company who are foreign corporations. Generally a foreign corporation is treated as a noncorporate stockholder if the distribution is not effectively connected with its conduct of a trade or business in the United States. Generally, a distribution made by a corporation from earnings and profits to a nonresident alien individual or foreign corporation which is not effectively connected with a United States trade or business is subject to a 30% U.S. withholding tax (or lower treaty rate). It should be noted that the federal income taxation of nonresident alien individuals and foreign corporations is a highly complex matter. Therefore, nonresident alien individuals and foreign corporations should consult their tax advisors as to the tax consequences of the Distribution to them.

Taxation of Royalty Trusts and Unit Holders

Classification of Trusts. Each Trust should be classified for federal income tax purposes as a trust and not as an association taxable as a corporation. Trusts are classified as grantor trusts, or "simple" or "complex" trusts ("non-grantor trusts"), for federal income tax purposes. Each Trust should be classified as a grantor trust which, unlike a non-grantor trust, is not subject to tax at the trust level. The grantors, or in this case the owners of the Units, would be considered for tax purposes to own the Trusts' income and principal as though no trust were in existence. A grantor trust simply files an information return, reporting all items of income or deductions which must be included in the returns of the grantors.

Taxation of Unit Holders. Since it is anticipated that the Trusts will be treated as grantor trusts, the income of each 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 Trusts and not when distributed by the Trusts. Income will be recognized by Unit holders consistent with their method of accounting and without regard to the taxable year or accounting method employed by the Trusts.

The income from the Trust properties will be subject to an allowance for the greater of cost depletion or (under certain conditions) percentage depletion. Both the percentage depletion allowance and the cost depletion allowance must be computed separately by each owner of Units rather than by the Trusts since the Trusts should be treated as grantor trusts. Percentage depletion is calculated on the basis of the applicable depletion rate applied to the income eligible for percentage depletion. Beginning in 1981, the current percentage depletion rate of 22% will be reduced in the case of primary production by two percentage points per year through 1983 and by one percentage point in 1984, when the percentage depletion rate will be 15%. The rate for oil and gas produced by secondary and tertiary recovery processes will continue to be 22% through December 31, 1983, when the special treatment for secondary and tertiary production ceases. Under the "independent producers" exemption, independent producers and royalty owners are allowed a percentage depletion deduction on a limited amount of domestic oil and gas production. Generally this exemption will cover the first 1,000 barrels of the taxpayer's average daily production of domestic crude oil during 1980 and thereafter, or if the prescribed election is made, up to 6,000 Mcf of average daily production of domestic natural gas during 1980 and thereafter. For purposes of computing average daily production of crude oil or natural gas, an owner of Units will be treated as realizing production from each net overriding royalty interest held by a Trust equal in amount to the total production from such net overriding royalty interest multiplied by the percentage participation of such owner of Units in the revenues of such net overriding royalty interest.

Generally, the benefit of the independent producers exemption does not extend to transferees of a "proven" oil or gas property with respect to primary production from that property. Under proposed Treasury regulations, it appears that all properties comprising the Trust properties are proven properties. Thus, any owner of Units will not be entitled to percentage depletion with respect to revenue derived from primary production attributable to the Trust properties.

Under the proposed regulations, however, certain income of the transferred properties from qualified production attributable to secondary or tertiary recovery processes remains eligible for percentage depletion through December 31, 1983. The Company estimates that 75% of the current oil production of the properties to be transferred to the Permian Trust is attributable to secondary recovery processes. In determining the amount of production subject to percentage depletion under the independent producers exemption, the taxpayer's tentative quantity must first be reduced by the taxpayer's average daily secondary and tertiary production of both crude oil and natural gas. Thus, if the taxpayer has secondary and tertiary production equal to the tentative quantity (including equivalent barrels resulting from the conversion of natural gas production), he is entitled to no percentage depletion on primary production under such exemption.

If the taxpayer's average daily production of crude oil or gas exceeds the maximum average daily production quantities permitted, then the allowable percentage depletion on each property will be equal to the percentage depletion otherwise allowable, multiplied by a fraction, the numerator of which is the depletable oil quantity (or depletable natural gas quantity, as the case may be) and the denominator of which is the taxpayer's average daily production of crude oil (or natural gas). The production quantity limit to the percentage depletion deduction which is available as a result of the independent producers exemption is subject to allocation among family members, component members of a controlled group of corporations and certain business entities under common control. Percentage depletion may not, in any event, exceed (i) 50% of the taxable income from the particular property (computed without allowance for depletion) or (ii) 65% of taxable income of a Unit holder (reduced by the zero bracket amount, if applicable) from all sources computed without regard to such depletion, any net operating loss carryback and any capital loss carryback.

Income from the Trust properties not eligible for percentage depletion will qualify for cost depletion. In computing cost depletion for each oil and gas property for any year, the adjusted

tax basis of such property is divided by the estimated total units (e.g., barrels of oil or Mcfs of gas) recoverable from such property to determine the per-unit allowance for such property. The per-unit allowance is then multiplied by the number of units produced and sold from such property during the year. Cost depletion for a property cannot exceed the adjusted tax basis of such property. Since the Trusts should be taxed as grantor trusts, each Unit holder will compute cost depletion using his basis in the Unit. A Unit holder's share of production from the Trust properties attributable to primary production will not affect the Unit holder's computation of percentage depletion with respect to such Unit holder's other oil and gas properties. However, a Unit holder's share of production from the Trust properties attributable to qualified secondary or tertiary production could affect a Unit holder's percentage depletion for other properties if his combined secondary or tertiary production from the Trust properties and his other qualifying production exceed the eligible quantity limit.

A 15% minimum tax is imposed on the amount by which specified items of tax preference exceed the greater of (a) \$10,000 (\$5,000 in the case of husband and wife filing separate returns) or (b) one-half of regular federal income taxes. This tax is commonly referred to as the add-on minimum tax. An item of tax preference which may result from ownership of the Units is the excess of the allowable depletion deduction for the taxable year over the adjusted basis of the property at year-end (determined without regard to the depletion deduction for the taxable year).

The Revenue Act of 1978 removed capital gains of individual taxpayers from the items of tax preference for the purposes of the add-on minimum tax. However, after January 1, 1979, such capital gains are subject to a new minimum tax (the "alternative minimum tax"). The alternative minimum tax is computed in a three-step approach. First, the alternative minimum taxable income is computed which, in general, is the sum of taxable income, the 60% capital gain deduction and the taxpayer's adjusted itemized deductions. Second, the following rate schedule is applied to the alternative minimum taxable income:

\$0-\$20,000	— 0%
\$20,000-\$60,000	— 10%
\$60,000-\$100,000	— 20%
over \$100,000	— 25%

The third step is to compare the tax computed under the schedule with the sum of the taxpayer's regular taxes (net of certain tax credits) and the add-on minimum tax for the tax year. If the amount computed under the schedule is greater than the sum of such taxes, the excess is the alternative minimum tax for the year; if the amount computed under the schedule is less than the sum of such taxes, the alternative minimum tax is zero. Capital gains arising from the Distribution or sale of Units could trigger or increase a Unit holder's exposure to the alternative minimum tax. Since these computations are rather complicated, a Unit holder should consult his tax advisor in order to determine the applicability of the add-on minimum tax or alternative minimum tax.

The maximum federal income tax rate on an individual's "personal service taxable income" is 50%. However, personal service taxable income is reduced, for purposes of applying such 50% rate, by the total amount of the taxpayer's items of tax preference (other than items of tax preference arising from capital gain income) in the taxable year. To the extent that personal service taxable income is reduced, such income is subject to tax at normal rates applicable to ordinary income. Thus, items of tax preference resulting from ownership of Units will decrease the amount of the Unit holder's personal service taxable income qualifying for the 50% maximum rate.

Unit holders who are nonresident alien individuals or foreign corporations, in general, will be subject to tax on the gross income produced by the Trust properties at a rate equal to 30% (or lower treaty rate) of the gross income from production, without any deductions. This tax will be withheld by the Trustee and remitted directly to the Internal Revenue Service.

Generally, a Unit holder will realize gain or loss on the sale or exchange of his Units measured by the difference between the amount realized on the sale or exchange and his adjusted basis

for such Units. Gain or loss on the sale of Units by a holder who is not a dealer with respect to such Units and who has a holding period for the Units of more than one year will be treated as long-term capital gain or loss. The initial basis in a Unit received in the Distribution is determined under the rules described above. This initial basis is reduced, however, by deductions for depletion claimed by the Unit holder.

The Trustee will furnish to Unit holders of record quarterly and annual reports in order to permit computation of tax liability. In particular each Unit holder will be supplied with sufficient information to permit a computation of depletion.

Areas of Potential Tax Controversy

In the event that the IRS refuses to grant the advance rulings requested by the Company and the Distribution is nonetheless made, there are certain aspects of the Transaction which may give rise to a dispute with the IRS.

Classification of Trusts as Associations Taxable as Corporations. The IRS might contend that for federal income tax purposes the Trusts should be taxed as corporations rather than as trusts. If this characterization were to prevail, the IRS would contend that the stockholders would still be taxed on the Distribution in the same manner as previously described. The significant difference is that the Trusts would be required to pay tax on their income at corporate tax rates. For taxable income over \$100,000 the tax rate is 46%. Any income tax paid by the Trusts will significantly reduce the amount of cash available to the Trusts for distribution to the Unit holders. If the Trusts are taxed as corporations, then the Unit holders will be taxed only on distributions made by the Trusts. Such distributions will be taxable in the year received. To the extent of the Trusts' earnings and profits the distributions will be taxed as dividends. Any distributions in excess of earnings and profits will reduce the Unit holder's basis in the Units and distributions in excess of basis will constitute gain from the sale of property.

Classification of Trusts as Non-Grantor Trusts. Assuming the Trusts are not taxable as corporations, a further issue exists as to whether the Trusts are taxable under the rules applicable to grantor trusts or non-grantor trusts. All rulings published by the IRS involving trusts established by corporations for the benefit of stockholders have held that the trusts were grantor trusts of which the stockholders were the grantors. A grantor trust is not a taxable entity, rather all its income and deductions are reported in the returns of the grantors. A non-grantor trust, however, is a taxpaying entity. It is taxable on its income, but is entitled to a deduction for amounts distributed to the Unit holders. Since it is contemplated that the Trusts will distribute substantially all their income, the Trusts are likely to pay little, if any, income tax if classified as non-grantor trusts. If the Trusts are non-grantor trusts, however, depletion will be computed at the trust level and it is possible that the IRS would contend that each Trust's basis for computing cost depletion is a carryover of the Company's basis in the transferred assets, regardless of the basis of the Unit holders in the Units.

With respect to the Unit holder, the amount distributed by a non-grantor trust would be taxable to the Unit holder in the taxable year of the Unit holder in which or with which the taxable year of the Trust ends (or earlier if the Unit holder's interest in the Trust ends). Moreover, the Unit holder would recognize income only upon the receipt of distributions of the Trust, whereas in the case of a grantor trust, the Unit holder would be taxed on the income of the Trust, regardless of whether such income is distributed to the Unit holder. Again, since the Trusts are expected to distribute all their income on a current basis this difference would not likely be significant, although timing differences could occur with respect to income earned by the Trusts late in the year but not distributed until the following year.

Procedural Matters

Filing Corporate Returns in the Absence of a Favorable Ruling. If the IRS does not grant the rulings requested by the Company, then for 1980, their first year of operation, the Trusts will file

corporate income tax returns and pay tax on the income earned in 1980. The Trusts will then file claims for refund with the IRS on the ground that they are not taxable as corporations. If the refund claims are denied, the Trusts will institute litigation. The reason for this strategy is to resolve the tax status of the Trusts as quickly and as cheaply as possible. Despite this strategy, the issue may not be resolved for several years and legal fees and litigation expenses will be paid by the Trusts, reducing the amounts available for distribution. With respect to subsequent years, the Trusts would file grantor trust returns on the assumption that their status as trusts will be upheld. By filing grantor trust returns and distributing all available cash, the Unit holders will enjoy the benefits sought through the use of Trusts. However, the Trustee will follow this procedure only so long as the remaining values of the Trust properties are sufficient to pay the taxes owed if it were ultimately determined that the Trusts were taxable as corporations. If such a determination were made, the Trustee would have to borrow against the Trust properties to obtain the funds necessary to pay the tax liabilities of the Trusts. The Trustee would be forced to cease making distributions until it had paid any tax and interest found to be due and any debts incurred in connection therewith.

Reporting by Unit Holders. The tax classification of the Trusts will directly affect the reporting by the Unit holders of the Trusts' income and distributions. For 1980, it is anticipated that the Trusts will not make any distributions. Thus, a Unit holder who treats the Trusts taxable as corporations would report no income for 1980. A Unit holder who treats the Trusts as grantor trusts would pay tax attributable to the Trusts' income received or accrued (depending on his method of accounting) in 1980, even though no income was distributed. If a Unit holder reports income attributable to the Trusts in a manner which is inconsistent with the final determination of the Trusts' status, such Unit holder may be liable for a deficiency or may need to file a claim for refund to obtain any over-payment of taxes.

It should also be noted that the mere ownership of Units may result in the returns of Unit holders being subject to special scrutiny by the IRS. It is possible that the IRS may affirmatively seek out taxpayers who own Units. Thus, returns which otherwise would not be subject to examination may be examined. Furthermore, once a return is selected for examination, the IRS may make adjustments to it which are unrelated to the proposed transaction. In addition, any tax deficiency or refund claim arising out of a Unit holder's reporting of the Trusts' income could increase the likelihood of an audit of a Unit holder's tax return.

State Tax Considerations

Since Texas does not have a state income tax, no tax will be levied by Texas against the Unit holders with respect to income earned in Texas. New Mexico imposes its income taxes upon non-residents and residents. In the case of nonresidents, income derived from tangible property within the state is subject to tax. Thus, assuming the Trusts are taxed as trusts, the Unit holders of the San Juan Trust will be subject to the New Mexico income tax. The Unit holders may also be subject to tax by the state in which they reside on income derived from the Trusts.

PROPOSED AMENDMENTS TO EXECUTIVE STOCK INCENTIVE PLAN

The Southland Royalty Executive Stock Incentive Plan ("1978 Plan")

The 1978 Plan was adopted by Southland's board of directors on April 7, 1978 and was approved by Southland's stockholders on May 23, 1978. The 1978 Plan provides for the grant of units ("Incentive Plan Units") to executive employees, including officers but excluding directors who are not also full time employees of Southland. Each Incentive Plan Unit consists of an option ("Option") to purchase one share of Common Stock (at a price equal to 100% of the fair market value of the Common Stock on the date of grant ("Grant Date") of the Incentive Plan Unit) and a cash payment ("Stock Appreciation Right Payment"), to be made at the time the Option is exercised, equal to an amount by which the fair market value of the Common Stock on the date the Option is exercised exceeds the purchase price ("Option Price") under the Option. "Fair market value" as defined in the 1978 Plan is essentially the price of the Common Stock on the Exchange.

The total number of Incentive Plan Units which may be granted under the 1978 Plan (adjusted for stock splits effected since the date the Plan was adopted) is 400,000. As of the date of this Proxy Statement, 194,900 Incentive Plan Units were outstanding. The board of directors does not intend to grant any additional Incentive Plan Units under the 1978 Plan, assuming the Distribution is effected.

Incentive Plan Units may be exercised only in accordance with the provisions of the 1978 Plan and become exercisable over a ten-year period after the Grant Date as follows: to the extent of 20% two years after the Grant Date and to the extent of an additional 10% on the anniversary of the Grant Date during each of the next eight years. Subject to certain limitations stated in the Plan, the right to exercise is cumulative. The incremental exercisability feature of the Plan is consistent with its purpose to induce employees to remain employed by Southland, since unexercised Incentive Plan Units are forfeited by any holder who ceases to be employed by Southland except as permitted by the 1978 Plan. Another provision of the 1978 Plan, which was included in order to comply with certain regulations under the Exchange Act, provides that each Incentive Plan Unit may be exercised only during a period beginning on the third business day and ending on the twelfth business day following the date of public release of a statement of Southland's quarterly or annual revenues and income.

Proposed Amendments

Southland's board of directors believes that the foregoing restrictions are reasonable under ordinary circumstances. However, if they are not modified the Distribution would unfairly penalize holders of Incentive Plan Units, since the substantial decrease in Southland's assets which will result from the Distribution may reasonably be expected to be reflected in a substantial decrease in the market price of the Common Stock. The adjustment provisions of the 1978 Plan do not cover an event such as the Distribution, and holders of Incentive Plan Units who exercise them after the Record Date will not upon such exercise acquire any interest in either Trust.

In view of the foregoing, the board of directors has recommended that the 1978 Plan be amended so as to provide (i) that all Incentive Plan Units outstanding as of the date of this Proxy Statement may be exercised in full during the ten days prior to the Record Date and (ii) that with respect to any outstanding Incentive Plan Unit which is not exercised during such period, and effective as of the Distribution, the number of shares of Common Stock which could be purchased on any exercise of an Option, and the price per share, would be adjusted.

The following table provides information as to the effect of the proposed amendments on the exercisability of outstanding Incentive Plan Units:

Name of individual or identity of group	Number of Incentive Plan Units which may be exercised prior to the Record Date	
	If the amend- ments are not adopted	If the amend- ments are adopted
Jon Brumley(1)	1,360	23,800
Alton C. Goodrich(1)	1,040	21,000
All persons who hold Options, as a group (20 persons)(2)	10,820	194,900

- (1) These persons are two of the five highest paid officers of Southland during 1979. One of the other three of such five officers, Galbraith McF. Weaver, holds no Incentive Plan Units and the two other officers left Southland's employment and thereby forfeited all Incentive Plan Units held by them. See "Remuneration."
- (2) As indicated above, directors who are not also full time employees are not eligible to receive Incentive Plan Units. Of Southland's nine directors, seven do not hold any Incentive Plan Units.

As shown in the foregoing table, approval of the amendments will significantly increase the number of Incentive Plan Units which may be exercised prior to the Record Date. Inasmuch as the exercise prices of Options under outstanding Incentive Plan Units range from \$10.99 to \$33.94 per share, while the closing price per share of the Common Stock as of September 25, 1980 (the last trading date prior to the date of this Proxy Statement) on the Exchange was \$62⁵/₈, it is likely that substantially all exercisable Incentive Plan Units will be exercised.

With respect to any Options which are not exercised prior to the Record Date, the extent of the reduction in the Option price per share, and therefore of the increase in the number of shares which could be purchased on exercise of the Option, would be determined by the market price of the Common Stock on the Exchange immediately prior to, and immediately after, the date as of which shares of Common Stock are traded "ex dividend" with respect to the Distribution. This would be done as follows:

(i) The closing price of the Common Stock on the Exchange on the last trading day prior to the "ex dividend" date (for example, \$50 per share) would be expressed as the denominator of a fraction, and the closing price of the Common Stock on the Exchange on the first trading day after such ex dividend date (for example, \$30 per share) would be expressed as the numerator of such fraction.

(ii) The Option price per share under any Option would be adjusted by the fraction resulting from the foregoing calculation ($30/50 = 3/5$) so as to produce a new Option price per share. For example, an Option whose exercise price per share was formerly \$20 would be reduced by $\frac{2}{5}$ so as to produce a new Option price per share (\$12) equal to $\frac{3}{5}$ of the old Option price per share.

(iii) Upon exercise of the Option, the holder would still pay \$20. However, since the exercise price per share would be \$12, upon such exercise he would receive a proportionately increased number of shares.

The Stock Appreciation Right Payment features of Incentive Plan Units remaining unexercised would be adjusted to reflect the change in the Option price. However, the schedule according to which Incentive Plan Units remaining outstanding after the Record Date could be exercised would be the same as that which existed prior to the adoption of the amendments.

The price figures used in the foregoing discussion are by way of example only and do not constitute a forecast of any actual price at which the Common Stock may trade, either before or after the Distribution.

The board of directors (of which a majority of the members, as stated above, do not hold Incentive Plan Units) believes that the amendments to the 1978 Plan are in the best interest of Southland and should be adopted. It is believed that effecting the Distribution without approval of the amendments would unfairly deprive Incentive Plan Unit holders of a significant portion of the benefits which they now hold. Approval of the amendments will significantly benefit holders of Incentive Plan Units since it will very substantially increase the number of Incentive Plan Units which can be exercised in 1980 and will result in a significant reduction of the Option Price of Incentive Plan Units which are not exercised before the Distribution. In addition, since Units which are exercised do not thereafter provide an incentive for continued employment, this original objective of the 1978 Plan will be diminished by the adoption of the amendments to the extent that Incentive Plan Units are exercised prior to the Distribution Record Date.

See "Voting at the Meeting" for information as to the vote required for adoption of the amendments to the 1978 Plan and "Remuneration - 1978 Plan" for additional information as to Incentive Plan Units outstanding under the 1978 Plan.

PROPOSED ADOPTION OF 1980 STOCK INCENTIVE PLAN

Adoption. The board of directors adopted the "Southland Royalty Company 1980 Stock Incentive Plan" in August 1980. However, such adoption was subject to the two following conditions: (i) the 1980 Plan must be approved by the holders of not less than a majority of the Common Stock represented in person or by proxy at the meeting at which the Plan is considered and (ii) the Distribution must take place. If both these conditions are satisfied, the 1980 Plan will become effective as of the date of the Distribution.

Purpose. As stated elsewhere in this Proxy Statement, Southland expects after the completion of the Transaction to continue to engage actively in oil and gas exploration, development and production. Success in these activities is dependent upon recruiting and retaining qualified management personnel, including key technical personnel and professional personnel and other supervisors. The purpose of the 1980 Plan is to provide an additional incentive which Southland can offer to key executives and other employees.

Operation of the 1980 Plan. The 1980 Plan is substantially similar in most respects to the 1978 Plan whose amendment will be considered at the meeting as described under, "Proposed Amendments to Executive Stock Incentive Plan." It basically provides for the granting of units ("Units") consisting of (i) an option ("Option") to purchase one share of Common Stock at a price equal to the fair market value (as defined) of such share on the date the Unit is granted ("Grant Date") and (ii) a cash payment ("Stock Appreciation Right" or "SAR"), to be received when the Option is exercised, equal to the amount by which the fair market value (as defined) of the Common Stock on the date of exercise ("Exercise Date") of the Option exceeds the price paid under the Option. Payment for shares purchased may be made, at the option of the purchaser, in cash or in shares of Common Stock (valued at their fair market value).

The following example illustrates the operation of the 1980 Plan: If the fair market price of a share of Common Stock is \$25 on the Grant Date, that will be the purchase price of the share when it is purchased upon exercise of the Option. If on such Exercise Date the fair market value of a share of Common Stock is \$35, the Stock Appreciation Right will result in a cash payment of \$10.

The primary purpose of the SAR feature of the 1980 Plan is to provide cash with which a holder of Units can pay his federal income tax due upon exercise of an Option thereby eliminating the holder's immediate need for cash to pay income taxes at a time when he might not have the requisite cash without disposing of the Common Stock just acquired. Under existing tax laws, the Company will recover substantially all of the cash outlay resulting from the SAR through reduced income taxes as a result of deductions available to the Company when Units are exercised.

The total number of Units which may be granted under the 1980 Plan is 1,500,000. Not more than 400,000 Units may be granted during any single year and the number of Units granted to any one employee may not exceed 75,000 in any year. Units not granted in any year may be granted in any future year. This number is subject to adjustment to reflect stock splits, stock dividends, recapitalizations and other corporate events which affect outstanding shares of Common Stock. If any such event occurs while Units are outstanding under the 1980 Plan, similar adjustments will be made in the number of shares, and the purchase price per share, under Options included in outstanding Units. For example, if the Company declares a 50% stock dividend, or effects a three-for-two split of the Common Stock, an Option which formerly entitled its holder to purchase one share of Common Stock, will automatically be adjusted to cover 1½ shares. The total price to be paid upon exercise of the Option would not change, but the price on a per share basis would be reduced proportionately.

Administration and eligible employees. The 1980 Plan will be administered by Southland's board of directors. The board of directors will grant Units and will make all decisions regarding interpretations of the 1980 Plan. Units may be granted to any key employee. Officers, but not directors who are not also full time employees, will be eligible to receive Units. Any grant of Units to an otherwise

eligible member of the board of directors may be made only if a majority of all directors and a majority of the directors acting on the grant are "disinterested persons" who are not at such time, and have not been for at least one year, eligible to receive grants of Units.

Exercise. 40% of the Units granted to any person on a Grant Date will become exercisable on the date two years after the Grant Date, and an additional 20% of such units will become exercisable on the anniversary of such date in each of the next three years. Accordingly, all the Units granted to a person on a particular Grant Date become exercisable during the five years after the Grant Date. If a Unit is otherwise exercisable and the closing sales price on the Exchange is more than two times the Option price for ten consecutive trading days, the Unit will expire unless exercised during the next "exercise period" (a period beginning on the third and ending on the twelfth business day, after Southland publicly reports quarterly or annual sales and earnings).

All outstanding Units will become exercisable during a limited period prior to the consummation of any merger of Southland (if it is not the surviving corporation), sale of substantially all Southland's assets or dissolution of Southland but will terminate on the consummation of such transaction. In addition, all Units will become exercisable if any party, together with its affiliates, acquires ownership or control of a majority of the outstanding Common Stock.

A holder of Units will forfeit all his unexercised Units if, prior to exercise, he ceases to be an employee of Southland for any reason except death, retirement (including early retirement) or disability. If employment terminates because of any of these reasons, Units may be exercised during limited periods thereafter.

Units under the 1980 Plan are nontransferable, except that the estate of a deceased holder of Units may exercise such Units to the extent specified in the 1980 Plan.

Tax aspects. When Units are exercised, the holder will be required to include in his gross income, for federal income tax purposes, (i) the amount by which the fair market value of the shares which he purchases exceeds his Option price and (ii) the cash payment represented by his SAR. The Units will be special incentive compensation and will not be taken into account in determining pension or similar benefits. Upon exercise of a Unit, Southland will be entitled to a deduction for federal income tax purposes equal to the amount of income recognized by the holder who exercised such Unit.

Proposed grants. If the 1980 Plan is approved and becomes effective, it is contemplated that an aggregate of 389,000 Units will be granted effective as of the date of the Distribution. The Option price per share will be based on the fair market value of the Common Stock at that time and cannot now be predicted. The following table shows the number of Units proposed to be granted to (i) each officer who was among the five highest paid officers of Southland in 1979, (ii) all officers as a group and (iii) all employees other than officers.

<u>Name of officer or identity of group</u>	<u>Number of Units</u>
Jon Brumley(1)(2)	50,000
Alton C. Goodrich(1)(2)	35,000
All officers as a group (13 persons)	264,000
All employees other than officers (53 persons)	125,000

- (1) These persons are two of the five highest paid officers of Southland during 1979. One of the other three of such five officers, Galbraith McF. Weaver, will not be granted any 1980 Plan Units, and the two other officers left Southland's employment and will not be granted any 1980 Plan Units. See "Remuneration".
- (2) As indicated above, directors who are not also full time employees are not eligible to receive 1980 Plan Units. Of Southland's nine directors, only two are expected to receive 1980 Plan Units.

STOCK PRICES AND DIVIDENDS

The Common Stock is listed on the New York Stock Exchange, Inc. The following table lists the high and low sales prices reported for the Common Stock, and the dividends paid per share, during the indicated periods:

<u>Period</u>	<u>Market prices</u>		<u>Dividends per share</u>
	<u>High</u>	<u>Low</u>	
1978			
First quarter	\$11.16	\$ 9.56	\$.0625
Second quarter	11.41	9.88	.0625
Third quarter	12.31	9.81	.0625
Fourth quarter	13.62	10.62	.0625
1979			
First quarter	14.94	12.25	.0625
Second quarter	18.94	14.62	.0750
Third quarter	24.25	17.62	.0750
Fourth quarter	31.94	20.06	.0750
1980			
First quarter	38.00	23.00	0.10
Second quarter	54.25	24.25	0.10
Third quarter (through September 25)	65.00	50.75	0.10

Dividends per share and market prices have been adjusted to reflect a 2-for-1 stock split in June 1979 and a subsequent 2-for-1 stock split in June 1980.

Southland expects to continue to pay cash dividends after the Distribution, but the amount of such dividends will likely be substantially decreased. The amount of future dividends, if any, will depend on the availability of funds, Southland's cash needs and other factors.

DESCRIPTION OF COMMON STOCK

Southland's Certificate of Incorporation authorizes it to issue up to 64,000,000 shares of Common Stock, par value \$.125 per share. No shares of preferred stock are authorized. All the outstanding shares of Common Stock are fully paid and non-assessable. The holders of Common Stock do not have preemptive rights, and no reduction or conversion provisions are applicable to the Common Stock. Upon any liquidation or dissolution of Southland, the holders of Common Stock would be entitled to share equally and ratably in any assets remaining after payment of all debts and liabilities.

All holders of record of shares of Common Stock are entitled to participate ratably in dividends declared by the board of directors.

Holders of Common Stock are entitled to one vote per each share held of record on all matters voted on by stockholders, including the election of directors. As stated under "Voting at the Meeting" shares owned by persons who hold Incentive Plan Units will not be allowed to vote on the proposed amendment of the 1978 Plan. The Common Stock has noncumulative voting rights, and therefore holders of a majority of the outstanding shares can elect all of the directors of Southland if they choose to do so.

Transfer Agents and Registrars for Common Stock

The transfer agents and registrars for the Common Stock of the Company are Morgan Guaranty Trust Company of New York, located in New York, New York, and The First National Bank of Fort Worth, Fort Worth, Texas.

Reports to Stockholders

The Distribution will not affect Southland's practice of furnishing holders of Common Stock annual reports containing certified financial statements and quarterly reports containing unaudited financial information.

REMUNERATION

The following table sets forth certain information regarding the remuneration of each of the five most highly compensated executive officers or directors of the Company during 1979 and of all persons who served as directors and officers of the Company during that period as a group.

Name and capacity in which remuneration was received	Cash and cash-equivalent forms of remuneration		Aggregate of contingent forms of remuneration (amounts expended by the Company in 1979)(3)
	Salaries, fees, directors fees and bonuses(1)	Securities or property, insurance benefits or reimbursement, personal benefits(2)	
Galbraith McF. Weaver, Chairman of the board of directors, chairman of the executive committee and director	\$ 116,000	\$ 17,000	\$ —
Jon Brumley, President, chief executive officer and director	250,000	81,000	71,000
Alton C. Goodrich, Executive vice president and director	155,000	22,000	71,000
Donald B. Brown Formerly senior vice president-exploration(4)	85,000	246,000	21,000
Thomas W. Morris Formerly vice president-production(4)	62,000	136,000	35,000
All directors and officers as a group (22 persons)	1,430,000	597,000	448,000

- (1) These figures include awards paid in 1980 under the Company's Corporate Management Incentive Plan (see "Corporate Management Incentive Plan" below) for achievements in 1979.
- (2) These figures include vested portion of Company contributions in 1979 under the Company's Employees' Thrift Plan (see "Employees' Thrift Plan" below); the value of the Company's Common Stock allocated under the Company's Employee Stock Ownership Plan (see "Employee Stock Ownership Plan" below); the difference between the purchase price and market value of shares of Company's Common Stock acquired upon exercise of qualified stock options as described below under "Qualified Stock Option Plans"; and estimations of the value of the benefit of personal use of Company owned automobiles by certain executive officers. Values for the personal benefits obtained from the use of Company owned club memberships afforded certain of its employees are excluded. The Company is reimbursed for personal charges by such employees and for club dues proportionate to such charges. Premiums for group life and health insurance programs covering employees generally are also excluded.
- (3) These figures include Company contributions for non-vested participants under the Company's Employees' Thrift Plan, Company contributions under the Company's Retirement Plan (see "Retirement Plan" below); and amounts expended by the Company under the 1978 Plan (see "1978 Plan" below).

- (4) Mr. Brown served as senior vice president-exploration until his resignation as an employee on November 15, 1979. Mr. Morris served as vice president-production until his resignation as an employee on March 15, 1980.

Corporate Management Incentive Plan

The Corporate Management Incentive Plan was adopted by the board of directors in 1977. Under this plan certain key management personnel can receive annual incentive awards in amounts approved by the board for achievements against performance goals during the prior fiscal year. Payments made under the Corporate Management Incentive Plan for the period from its inception through December 31, 1979 were as follows: Weaver, \$—; Brumley, \$150,000; Goodrich, \$101,000; Brown, \$94,000; Morris, \$41,000; all officers and directors as a group, \$529,000; and all employees other than officers and directors, \$532,000.

Employees' Thrift Plan

The Employees' Thrift Plan is a voluntary participation plan available to all employees of the Company. Under this plan the employee contributes an amount determined by him up to 10% of his salary which amount is matched by the Company. Such contributions are paid to a corporate trustee to be invested according to an election of the employee in either (a) Common Stock, (b) other securities selected by the Administrative Committee or (c) national bank savings accounts and certificates of deposit. The total amounts contributed by the participant and the Company are payable when the participant retires (normal retirement is at age 65) in a lump sum payment or up to 15 annual installments. Such amounts are also payable if employment is terminated due to total and permanent disability or death. Upon termination of employment for other reasons certain forfeitures of Company contributions are applicable. The amount of forfeitures is allocated among the participants remaining in the plan. The Company's matching portion of contributions to the Employee's Thrift Plan for the five year period from January 1, 1975 to December 31, 1979 were as follows: Weaver, \$52,000; Brumley, \$80,000; Goodrich, \$52,000; Brown, \$40,000; Morris, \$26,000; all officers and directors as a group, \$454,000; and all employees other than officers and directors, \$2,107,000.

Retirement Plan

The Retirement Plan is a non-contributory retirement and death benefit plan available to all eligible employees of the Company after completion of a specific period of employment. The benefits of the plan, provided by a group insured annuity contract, are funded by the Company's payment of annual insurance premiums on a level premium basis. Retirement benefits are determined by a formula which considers, among other things, length of service, average monthly salary as defined in the plan, and age at date of retirement. Company contributions to the Retirement Plan for the five year period from January 1, 1975 to December 31, 1979 were as follows: Weaver, \$—; Brumley, \$64,000; Goodrich, \$102,000; Brown, \$50,000; Morris, \$38,000; all directors and officers as a group, \$558,000; and all employees other than officers and directors, \$1,602,000.

Employee Stock Ownership Plan

The Employee Stock Ownership Plan was established in accordance with the Internal Revenue Code, which permits an additional 1% investment tax credit to the Company if it applies an equivalent amount to the purchase of shares of Common Stock for the benefit of participating employees. Participation in the plan is limited to those employees who have completed 12 months of employment of not less than 1,000 hours of service. Stock purchased by the Company is allocated among participants in the ratio that each participant's salaried compensation bears to the aggregate salaried compensation for all participants. The shares held in a participant's account are distributable to him upon his separation from the service of the Company. Company contributions to the Employee Stock Ownership Plan for the five year period from January 1, 1975 to December 31, 1979 were as

follows: Weaver, \$7,000; Brumley, \$7,000; Goodrich, \$6,000; Brown, \$6,000; Morris, \$3,000; all directors and officers as a group, \$54,000; and all employees other than officers and directors, \$266,000.

Qualified Stock Option Plans

In May 1972 the stockholders of the Company approved the Company's Executive Employee Qualified Stock Option Plan ("Company Plan"), and in 1976 and incident to its acquisition of Aztec Oil & Gas Company the Company assumed certain outstanding options granted under Aztec's 1973 Qualified Stock Option Plan ("Aztec Plan") by substituting options to purchase shares of Common Stock. Except for the options presently outstanding under the Company Plan, both have been terminated and no more shares are available for grant under either. As of June 30, 1980 options extending to 1,432 shares of Common Stock were outstanding under the Company Plan, and no options are outstanding under the Aztec Plan. Each outstanding option under the Company Plan provides for an option price of 100% of the fair market value of the Common Stock as of the date of grant and for an option period of five years from the date of grant. The option price under the Aztec Plan, upon the substitution of shares of Common Stock, was adjusted so as to preserve the same value of the options on June 30, 1976 when extending to shares of Aztec common stock. The following table sets forth as to the directors and officers named in the remuneration table above and as to all directors and officers as a group (22 persons) (i) the amount of options to purchase Common Stock granted since January 1, 1975; (ii) the amount of shares acquired since that date through the exercise of options granted since that date or prior thereto; and (iii) the number of shares subject to all unexercised options held as of June 30, 1980:

<u>Common Stock</u>	<u>G.McF. Weaver</u>	<u>Jon Brumley</u>	<u>Alton C. Goodrich</u>	<u>D. B. Brown(1)</u>	<u>T. W. Morris(1)</u>	<u>All Directors and Officers as a Group(2)</u>
Granted						
Number of shares	None	None	None	32,000	33,968	97,968
Average per share option price	—	—	—	\$5.70	\$6.98	\$6.70
Exercised						
Number of shares	None	40,920	50,400	32,000	33,968	355,332
Aggregate option price of options exercised ..	—	\$147,458	\$241,125	\$182,250	\$237,152	\$1,680,485
Aggregate market value of shares on date options exercised	—	\$342,556	\$357,994	\$483,650	\$656,616	\$3,582,138
Unexercised						
Number of shares	None	None	None	None	None	300
Average per share option price	—	—	—	—	—	\$8.16

(1) Mr. Brown served as senior vice president-exploration until November 15, 1979, and Mr. Morris served as vice president-production until March 15, 1980.

(2) No Director of the Company who was not a full time employee was entitled to options under the above Plans.

1978 Plan

The 1978 Plan is described under "Proposed Amendments to Executive Stock Incentive Plan." Since the 1978 Plan was adopted, 227,800 Incentive Plan Units have been granted. Of this number, 32,900 have been forfeited and 194,900 are outstanding as of the date of this Proxy Statement. The exercise price of Options included in outstanding Incentive Plan Units ranges from \$10.99 to \$33.94.

The schedule under which Incentive Plan Units become exercisable is described under "Proposed Amendments to Executive Stock Incentive Plan." The following table shows the number of Incentive Plan Units which become exercisable during each of the next ten years (assuming the amendments are not adopted).

1980	10,820	1986	19,490
1981	18,330	1987	19,490
1982	27,110	1988	19,490
1983	19,490	1989	14,080
1984	19,490	1990	7,620
1985	19,490		

The following table sets forth as to the officers and directors named in the remuneration table above and as to all directors and officers as a group (13 persons) the number of Options (included in Incentive Plan Units) granted since approval of the 1978 Plan and outstanding at June 30, 1980:

<u>Common Stock</u>	<u>Jon Brumley(1)</u>	<u>Alton C. Goodrich(1)</u>	<u>All directors and officers as a group (1)(2)(4)</u>
Granted			
Number of shares	23,800	21,000	139,800
Average per share option price	\$22.11	\$23.18	\$23.76
Exercised			
Number of shares(3)	None	None	None
Unexercised			
Number of shares	23,800	21,000	125,400
Average per share option price	\$22.11	\$23.18	\$24.86

- (1) Only two of the five highest-paid officers for 1979 have unexercised options as of June 30, 1980. Mr. Galbraith McF. Weaver was not granted any options under the 1978 Plan. Mr. D. B. Brown's options and Mr. T. W. Morris' options were forfeited upon their resignation.
- (2) No director of the Company who is not also a full time employee is eligible to receive options under the 1978 Plan.
- (3) No Options were exercisable prior to June 30, 1980.
- (4) This table does not include 14,800 Options (at an average price of \$12.65) granted to current officers before they became officers.

See "Proposed Amendments to Executive Stock Incentive Plan" for information as to proposed amendments to this Plan and the effect on outstanding Incentive Plan Units.

Certain Transactions

During 1979 and the six months ended June 30, 1980 the Company paid legal fees to Hudson, Keltner, Smith, Cunningham & Payne aggregating approximately \$67,000 and \$31,000, respectively. Edgar H. Keltner, Jr., a director of the Company, is a member of such firm.

The Company had various banking transactions in the ordinary course of business during 1979 and the six months ended June 30, 1980 with The First National Bank of Fort Worth, of which Paul W. Mason, a director of the Company, is chairman of the board of directors. During these periods the balances of borrowings by the Company from this Bank ranged from \$1,500,000 to \$7,600,000 at interest rates ranging from 10.75% to 20.80%.

ADDITIONAL INFORMATION

Southland has filed with the SEC a Registration Statement (File No. 2-68719) under the Securities Act of 1933. As permitted by the Rules and Regulations of the SEC, certain items in the Registration Statement, including certain exhibits, are not contained in this Proxy Statement. Interested persons are referred to the Registration Statement and the exhibits thereto for further information concerning the Units and the Company.

EXPERTS

The historical financial statements of the Company as of December 31, 1979 and for each of the five years in the period then ended included in this Proxy Statement have been examined by Deloitte Haskins & Sells, independent certified public accountants, as stated in their opinion appearing herein, and have been so included in reliance upon such opinion given upon the authority of that firm as experts in accounting and auditing.

The firm of Deloitte Haskins & Sells has been approved by the audit committee of the board of directors as the Company's independent certified public accountants for 1980 and has been the Company's independent certified public accountants since 1967. One or more representatives of Deloitte Haskins & Sells will be available at the meeting to respond to any appropriate questions and will be given the opportunity to make a statement if desired.

Audit services performed by Deloitte Haskins & Sells in 1979 included examinations of the Company's financial statements, limited reviews of interim financial information, services related to filings with the Securities and Exchange Commission and consultations relating to financial reporting. Fees for non-audit services were approximately 7% of audit fees. Non-audit services consisted of the review of the federal tax return (approximately 5% of audit fees) and consultations regarding acquisitions. The audit committee of the board approved in advance the engagement of Deloitte Haskins & Sells for such audit and non-audit services and considered the possible effect of the non-audit services on that firm's independence.

The estimates of proved reserves of oil and gas and related future net revenue and present values included herein under "Permian Basin Royalty Trust Properties" have been included herein on the authority of Cawley, Gillespie & Associates, Inc., and Raymond F. Kravis and Associates, Inc., independent petroleum engineers. Estimates of proved reserves of oil and gas and related future net revenue and present values included herein under "San Juan Basin Royalty Trust Properties" have been included herein on the authority of H. J. Gruy and Associates, Inc., independent petroleum engineers. Estimates of reserves and related future net revenue and present value included in this Proxy Statement under "Continuing Business and Properties of Southland" have been included on the authority of each of the three above named independent petroleum engineers. The studies for which each of the firms are responsible, and the reports issued by each thereon, are more fully described under the foregoing specific captions.

LEGAL OPINION

The validity of the Units is being passed upon for the Company by Messrs. Butler, Binion, Rice, Cook & Knapp, 1100 Esperson Buildings, Houston, Texas 77002.

DEFINITIONS OF CERTAIN TERMS

The following is a listing of technical oil and gas production and exploration terms used in this Proxy Statement.

Bbl – 42 U.S. gallons, being the basic unit for measuring the production of oil and condensate.

Btu – The quantity of heat required to raise the temperature of one pound of water one degree Fahrenheit at or near 39.2 degrees Fahrenheit. Used to measure the energy content of gas.

Development Well – A well drilled to a known proved formation in a previously discovered field.

Dry Hole – A well found to be incapable of producing either oil or gas in sufficient quantities to justify completion as an oil or gas well.

Estimated Future Net Revenues – Computed by applying current prices of oil and gas (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 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.

Exploratory Well – A well drilled to find and produce oil or gas in an unproved area, to find a new reservoir in a field previously found to be productive of oil or gas in another reservoir or to extend the limits of a known reservoir.

Field – A geographical area in which a number of oil or gas wells produce from a continuous reservoir. The term generally refers to the surface area, although at times it may refer to both the surface and the underground productive formations. In a single field there may be several separate reservoirs at varying depths.

Formation – A porous geological stratum that may contain oil or gas deposits.

Gas – Natural gas and natural gas liquids.

Gross Acres – The total number of acres in which the Company has any working interest.

Gross Production – The total production of oil, gas and other hydrocarbons from all wells on any lease for a specific period of time.

Gross Wells – The total number of wells in which the Company owns a working interest.

Infill Well – A well drilled between known producing wells to better exploit the reservoir.

Lease – Full or partial interest in oil or gas properties authorizing the owner of the lease to drill for, produce, and sell oil and gas upon the payment of consideration such as bonuses, delay rentals, or/and landowner's royalty.

Mcf – A volume of 1,000 cubic feet under prescribed conditions of pressure and temperature and represents the basic unit for measuring the production of gas.

MMBtu – Means one million Btus.

Multiple Completion – A well from which two or more separate formations are produced.

Net Acres – The sum of the Company's working interests in gross acres.

Net Wells – The sum of the Company's fractional interests owned in gross wells.

Natural Gas Liquids (NGL's) – Liquid hydrocarbons extracted from natural gas as liquified petroleum gas, natural gasoline and other products.

Non-operating Interest – Non-operating interest is the portion of the working interest not charged with operational responsibility on the lease.

Oil – Crude oil and condensate.

Present Value of Estimated Future Net Revenue – For SEC purposes, computed using the estimated future net revenue and a discount factor of 10%.

Production Tax – A tax on the removal of oil or gas from the ground. Also referred to as severance tax.

Proved Reserves – Those quantities of crude oil, natural gas and natural gas liquids, which, upon analysis of geological and engineering data, appear with reasonable certainty to be recoverable in the future from known oil and gas reservoirs under existing economic and operating conditions.

Proved Developed Reserves – Those proved reserves which can be expected to be recovered through existing wells with existing equipment and operating methods.

Proved Undeveloped Reserves – Those proved reserves which are expected to be recovered from new wells on undrilled acreage, or from existing wells where a relatively major expenditure is required.

Reservoir – A subsurface, porous and permeable rock body in which there is a natural accumulation of oil and/or gas that is confined by impermeable rock or water.

Royalty – That part of oil, gas or minerals paid by the lessee to the lessor or to one who has acquired possession of the royalty rights, based on a certain percentage of the gross production from the property.

Unitized Properties – Properties consolidated under an agreement which allows them to be operated as a single unit allocating revenues, costs and expenses proportionately among the various property owners.

Waterflood – A method of enhancing the recovery of oil from mature oil fields wherein water is forced under pressure into oil reservoirs through injection wells forcing oil toward producing wells.

Working Interest – The interest in an oil or gas lease or mineral rights which is responsible for payment of any portion of the cost or expense of development, operation or maintenance.

SOUTHLAND ROYALTY COMPANY
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OPINION OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

Southland Royalty Company:

We have examined the balance sheet of Southland Royalty Company as of December 31, 1979 and the related statements of income, stockholders' equity and changes in financial position for each of the five years in the period then ended. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements referred to above present fairly the financial position of Southland Royalty Company at December 31, 1979 and the results of its operations and changes in financial position for each of the five years in the period then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

DELOITTE HASKINS & SELLS

Fort Worth, Texas
February 22, 1980

MANAGEMENT'S DISCUSSION AND ANALYSIS OF STATEMENTS OF INCOME

(Not covered by opinion of independent certified public accountants)

Summarized below are comments on significant variations in revenues and expenses in the statements of income between the years 1979 and 1978, between the years 1978 and 1977, and between the six months ended June 30, 1980 and 1979. See Note 1 of Notes to Financial Statements for a summary of accounting policies that are significant in evaluating these results.

1979 versus 1978

The total revenues of the Company increased 40% to \$256,611,000 and net income increased 29% to \$54,752,000 in 1979. Gas revenue was \$141,900,000, an increase of 28% over 1978. Oil revenue increased 59% to \$113,872,000 in 1979.

Oil production increased 856,000 barrels or 10% to 9,286,000 barrels primarily due to 1,552,000 barrels of production from properties acquired during 1979. This new production was partially offset by natural declines of 10% to 2,679,000 barrels for the Waddell Ranch, and 9% to 3,211,000 barrels for other working interest properties. Declines on other working interest properties occurred primarily in Texas and Wyoming. The average price for oil increased 44% to \$12.26. The increase in average price is due to increases in oil prices not subject to regulation, normal escalations allowed by the Department of Energy (DOE) and phased decontrol of oil prices beginning in June 1979. The average price for oil on producing properties acquired in 1979 was \$16.92 compared to an average price of \$11.33 on other properties of the Company.

Gas production increased 6,184,000 MCF or 8% to 85,927,000 MCF. Gas production increased 87% to 5,484,000 MCF in Oklahoma and 3% to 32,954,000 MCF in the San Juan Basin of New Mexico due to connection of new wells. In other areas of New Mexico, gas production increased 27% to 3,550,000 MCF. Newly acquired producing properties added 6,728,000 MCF to the Company's gas production during 1979. Production declined 24% to 7,919,000 MCF on offshore properties, 6% to 12,214,000 MCF on the Waddell Ranch and 16% to 6,027,000 MCF on other working interest properties in Texas. Average gas prices increased 19% to \$1.65 per MCF due to normal contract escalations and price increases allowed by the Natural Gas Policy Act of 1978.

Total expenses increased \$60,846,000 or 43% to \$201,859,000 primarily due to increases in production, exploration and interest expenses. Exploration, lease rental and nonproductive well costs increased 54% to \$19,354,000 due to increased activity at higher costs. Increased exploration activity resulted in a 56% increase in nonproductive well cost to \$13,919,000 and a 27% increase in leasehold impairment to \$7,145,000. Production expenses increased 46% to \$28,875,000 primarily as a result of the acquisition of producing properties. Taxes on production and property increased 33% to \$17,292,000 due to increased revenue. Depreciation, depletion and amortization were up 39% to \$39,571,000 due to 1979 acquisitions.

General and administrative expenses increased 25% to \$15,077,000 due to higher legal, consulting, building occupancy and payroll expenses related to increasing operations and acquisition activities. Interest expense increased 116% to \$32,588,000 due to increased debt to fund acquisitions and higher interest rates.

Income taxes increased \$7,799,000 or 22% to \$43,974,000 due to the increase in pretax income partially offset by a decrease in the statutory tax rate to 46% from 48%. The Company's effective tax rate was 45% in 1979 compared to 46% in 1978. Net income was \$54,752,000 or \$1.18 per share, compared with \$42,540,000 or \$.90 per share in 1978.

Pro Forma Effect of Proposed Distribution

The effect on the December 31, 1979 Statement of Income of the proposed formation of the San Juan Basin Royalty Trust and Permian Basin Royalty Trust had they been formed at January 1,

1979, would have been to decrease oil revenue and gas revenue by \$27,501,000 and \$54,101,000, respectively. Depreciation, depletion and amortization and income taxes would have been reduced by \$6,776,000 and \$34,866,000 respectively, resulting in a decrease in net income of \$39,960,000 or \$.86 per share.

1978 versus 1977

The total revenues of the Company increased 16% to \$183,553,000 and net income increased 16% to \$42,540,000 in 1978. Gas revenue was \$111,161,000, an increase of 25% over 1977. Oil revenue increased 4% to \$71,763,000 in 1978.

Oil production decreased 847,000 barrels or 9% to 8,430,000 barrels principally due to natural decline. Major areas of decline were the Waddell Ranch, other properties in Texas and properties in Wyoming. These three areas had decreases of 304,000, 135,000 and 250,000 barrels, respectively. The average price for oil increased 14% to \$8.51. Prices increased for the Waddell Ranch, royalty and other working interest properties due to reclassification of older properties from lower tier to stripper and price increases allowed by the DOE. Price increases in the San Juan Basin and offshore Louisiana were due to increased production from newer wells eligible for upper tier prices.

Gas production increased 6,888,000 MCF or 9% to 79,743,000 MCF due principally to increased gas production from the Company's properties in the San Juan Basin of New Mexico, offshore Louisiana and Oklahoma. San Juan Basin gas production was 31,955,000 MCF, up 2% over 1977, due primarily to the connection of new wells. Offshore gas production increased 79% to 10,368,000 MCF in 1978. The Company's offshore production was minimal prior to the fourth quarter of 1977. Gas production in Oklahoma increased 2,000,000 MCF over 1977 due to connection of new wells. These production increases were partially offset by a 15% decrease in gas production to 13,030,000 MCF from the Waddell Ranch. Average gas prices increased 14% to \$1.39 per MCF due to normal contract escalations and a higher percentage of gas production from wells drilled since 1972 (thus eligible for higher prices).

Total expenses increased \$19,102,000 or 16% to \$141,013,000, primarily due to increases in production, exploration and income tax expenses. Exploration, lease rentals and nonproductive well costs increased 94% to \$12,597,000, primarily due to increased exploratory drilling at higher costs in 1978 than in 1977, which caused nonproductive well costs to rise 125% to \$8,912,000. Production expenses increased 22% to \$19,731,000 due to higher lease operating expenses for new wells and increased well repairs. Taxes on production and property increased 12% to \$12,975,000 due to higher revenues. General and administrative expenses increased 16% to \$12,110,000 due to higher payroll related expenses, consulting fees and building occupancy expense.

Income taxes increased \$6,148,000 or 20% to \$36,175,000 due to the increase in pretax income. The Company's effective tax rate was 46% in 1978 compared to 45% in 1977. Net income was \$42,540,000, or \$.90 per share, compared with \$36,668,000, or \$.77 per share in 1977.

Pro Forma Effect of Proposed Distribution

The effect on the December 31, 1978 Statement of Income of the proposed formation of the Permian Easin Royalty Trust and the San Juan Basin Royalty Trust had they been formed at January 1, 1978, would have been to decrease oil revenue and gas revenue by \$21,186,000 and \$44,751,000, respectively. Depreciation, depletion and amortization and income taxes would have been reduced by \$6,561,000 and \$28,622,000, respectively, resulting in a decrease in net income of \$30,754,000 or \$.65 per share.

June 30, 1980 versus June 30, 1979

Revenues for the six months ended June 30, 1980 increased to \$182,971,000, 62% over the comparable period in 1979. Gas revenue was \$88,100,000, a 33% increase over 1979. Oil revenues increased 101% to \$92,992,000.

Oil production increased 4% to 4,826,000 barrels primarily due to 354,000 barrels added by 1980 acquisitions and because only five months of production are included in 1979 on Permian Basin properties acquired in February 1979. Production on Permian Basin properties increased 10% to 1,530,000 barrels. Waddell Ranch production decreased 5% to 1,277,000 barrels due to natural decline. The average oil price increased 93% from \$10.00 to \$19.27 per barrel due to phased decontrol of oil prices allowed by the DOE. The 1980 average price per barrel, net of the newly imposed Federal excise tax on oil, was \$16.74, an increase of 67%.

Gas production rose 2,865,000 MCF or 7% to 45,880,000 MCF primarily as a result of the connection of new wells resulting from the Company's infill drilling programs (mainly in the San Juan Basin) and producing property acquisitions. San Juan Basin gas production increased 8% to 17,964,000 MCF, while 1980 producing property acquisitions added 781,000 MCF. Permian Basin production was up 12% to 6,941,000 MCF primarily as a result of 1979 producing property acquisitions. Average gas prices rose 25% to \$1.92 primarily because of normal price escalations under the NGPA, higher priced new production in the San Juan Basin and normal contractual price escalations elsewhere.

Total expenses before income taxes increased 64% to \$121,193,000. Production expenses, taxes on production and property and depreciation, depletion and amortization rose 29%, 61% and 38%, respectively, due to 1979 and 1980 producing property acquisitions and increased revenue. The new Federal excise tax on oil added \$12,222,000 to expenses. Exploration related expenses rose 84% due to a 125% increase in nonproducing well cost to \$12,261,000. General and administrative expenses rose 44% due to increased payroll, land and scouting, and franchise taxes. Interest expenses rose 72% to \$25,194,000 due to increased debt related to 1979 and 1980 producing property acquisitions and higher interest rates.

Income taxes increased 61% to \$27,592,000 due to higher pretax income. The Company's effective tax rate was 45% and 44% for the first half of 1980 and 1979, respectively. Net income increased 56% to \$34,186,000 or \$.74 per share from \$21,907,000 or \$.47 per share, for the first half of 1979.

Dilutive Effect of P&O Acquisition

As discussed in Note 3 in Notes to Financial Statements, the Company acquired P&O Oil Corporation in January 1980. For the six months ended June 30, 1980, revenue from the P&O properties was \$8,009,000, production expenses and taxes on production and property totaled \$1,340,000, depreciation, depletion and amortization was \$4,770,000 and interest expense related to the acquisition was \$8,572,000. The net loss, after taking into account interest expense and income tax benefits, related to the P&O properties was \$3,603,000 or \$.08 per share.

Pro Forma Effect of Proposed Distribution

The effect on the June 30, 1980 Statement of Income of the proposed formation of the San Juan Basin Royalty Trust and Permian Basin Royalty Trust had they been formed at January 1, 1980 would have been to decrease oil revenue and gas revenue by \$17,129,000 and \$36,006,000, respectively. Depreciation, depletion and amortization and income taxes would have been reduced by \$3,401,000 and \$23,514,000, respectively, for a net decrease in net income of \$26,220,000 or \$.57 per share.

SOUTHLAND ROYALTY COMPANY

BALANCE SHEET
(Note 1)
(Thousands of dollars)

ASSETS

	<u>December 31,</u> <u>1979</u>	<u>June 30,</u> <u>1980</u>
		(Unaudited)
Current Assets		
Cash and temporary cash investments	\$ 27,626	\$ 9,699
Accounts receivable	39,778	49,235
Materials and supplies inventory, at cost	6,127	11,783
Other current assets	4,479	2,680
Total current assets	<u>78,010</u>	<u>73,397</u>
Property and Equipment, at Cost (Notes 3, 10 and 12)		
Producing royalties and leases, including intangible development costs	405,577	520,192
Lease and well equipment	126,228	149,242
Nonproducing royalties and leases	54,281	63,755
Proven undeveloped leases	33,766	52,760
Uncompleted wells, equipment and facilities	15,275	20,067
Other property and equipment	9,762	9,279
Total property and equipment	<u>644,889</u>	<u>815,295</u>
Less accumulated depreciation, depletion, amortization and impairment	(170,443)	(196,437)
Net property and equipment	<u>474,446</u>	<u>618,858</u>
Other Assets	3,200	3,200
Total Assets	<u>\$ 555,656</u>	<u>\$ 695,455</u>

LIABILITIES AND STOCKHOLDERS' EQUITY

Current Liabilities		
Current maturities of long-term debt (Note 2)	\$ 6,128	\$ 13,955
Accounts payable and other liabilities	29,162	40,923
Income taxes payable (Note 4)	12,682	9,358
Accrued interest expense	8,364	6,750
Total current liabilities	<u>56,336</u>	<u>70,986</u>
Long-term Debt (Note 2)	<u>296,662</u>	<u>391,323</u>
Deferred Revenue (Note 8)	<u>13,104</u>	<u>14,214</u>
Deferred Federal Income Taxes (Note 4)	<u>21,615</u>	<u>25,756</u>
Commitments and Contingencies (Note 8)		
Stockholders' Equity (Notes 2, 6 and 14)		
Common stock, \$.125 par value: authorized, 64,000,000 shares; issued, 48,000,000 shares	6,000	6,000
Capital in excess of par value of stock	21,864	22,190
Retained earnings	156,591	181,495
Total	<u>184,455</u>	<u>209,685</u>
Less treasury stock, at cost, 1,630,292 shares in 1979 and 1,587,536 shares in 1980	(16,516)	(16,509)
Total stockholders' equity	<u>167,939</u>	<u>193,176</u>
Total Liabilities and Stockholders' Equity	<u>\$ 555,656</u>	<u>\$ 695,455</u>

The accompanying Notes to Financial Statements are an integral part of this balance sheet.
Southland Royalty Company follows the successful efforts method of accounting.

SOUTHLAND ROYALTY COMPANY

STATEMENT OF INCOME

(Note 1)

(Thousands of dollars except share and per share amounts)

	Years Ended December 31,					Six Months Ended June 30,	
	1975	1976	1977	1978	1979	1979	1980
						(Unaudited)	
Revenues (Notes 3, 5, 8 and 10)							
Oil	\$ 47,131	\$ 67,197	\$ 69,088	\$ 71,763	\$113,872	\$ 46,342	\$ 92,992
Gas	24,505	60,323	89,027	111,161	141,900	66,106	88,100
Other	330	455	464	629	839	381	1,879
Total revenues	<u>71,966</u>	<u>127,975</u>	<u>158,579</u>	<u>183,553</u>	<u>256,611</u>	<u>112,829</u>	<u>182,971</u>
Expenses (Note 3)							
Production expenses	5,584	14,148	16,181	19,731	28,875	13,499	17,354
Federal excise tax on oil	—	—	—	—	—	—	12,222
Taxes on production and property	5,254	9,466	11,540	12,975	17,292	7,881	12,659
Depreciation, depletion and amortization	6,052	17,759	28,338	28,541	39,571	19,163	26,507
Exploration, lease rentals and nonproductive well costs	10,675	9,775	6,504	12,597	19,354	8,190	15,030
Leasehold impairment provision	4,155	4,875	5,302	5,647	7,145	3,603	4,275
General and administrative expenses	4,328	8,371	10,476	12,110	15,077	7,484	10,763
Interest expense	631	15,436	14,606	15,111	32,588	14,622	25,194
Interest (income)	(226)	(407)	(886)	(2,007)	(1,258)	(413)	(829)
Other (income) expense, net	(58)	(168)	(177)	133	(759)	(210)	(1,982)
Total expenses	<u>36,395</u>	<u>79,255</u>	<u>91,884</u>	<u>104,838</u>	<u>157,885</u>	<u>73,819</u>	<u>121,193</u>
Income Before Taxes on Income	<u>35,571</u>	<u>48,720</u>	<u>66,695</u>	<u>78,715</u>	<u>98,726</u>	<u>39,010</u>	<u>61,778</u>
Income Taxes (Note 4)							
Current year provision	14,139	19,060	28,734	30,694	35,666	13,635	23,451
Deferred provision	2,267	2,943	1,293	5,481	8,308	3,468	4,141
Total income taxes	<u>16,406</u>	<u>22,003</u>	<u>30,027</u>	<u>36,175</u>	<u>43,974</u>	<u>17,103</u>	<u>27,592</u>
Net Income	<u>\$ 19,165</u>	<u>\$ 26,717</u>	<u>\$ 36,668</u>	<u>\$ 42,540</u>	<u>\$ 54,752</u>	<u>\$ 21,907</u>	<u>\$ 34,186</u>
Earnings Per Share	<u>\$.41</u>	<u>\$.56</u>	<u>\$.77</u>	<u>\$.90</u>	<u>\$ 1.18</u>	<u>\$.47</u>	<u>\$.74</u>
Dividends Paid Per Share	<u>\$.12</u>	<u>\$.155</u>	<u>\$.1825</u>	<u>\$.25</u>	<u>\$.2875</u>	<u>\$.1375</u>	<u>\$.20</u>
Weighted Average Number of Shares Outstanding	<u>47,295,160</u>	<u>47,498,740</u>	<u>47,620,400</u>	<u>47,415,736</u>	<u>46,349,124</u>	<u>46,341,884</u>	<u>46,401,432</u>

The accompanying Notes to Financial Statements are an integral part of this statement.

SOUTHLAND ROYALTY COMPANY
STATEMENT OF STOCKHOLDERS' EQUITY
(Note 1)
(Thousands of dollars)

	Years Ended December 31,					Six Months Ended June 30,	
	1975	1976	1977	1978	1979	1979	1980
						(Unaudited)	
Common Capital Stock:							
Balance, beginning and end of year	\$ 6,000	\$ 6,000	\$ 6,000	\$ 6,000	\$ 6,000	\$ 6,000	\$ 6,000
Capital in Excess of Par Value of Capital Stock:							
Balance, beginning of year ..	19,586	20,000	20,632	21,206	21,583	21,583	21,864
Add:							
Excess of proceeds over cost of common treasury stock issued upon exercise of stock options	414	632	574	377	281	104	326
Balance, end of year	20,000	20,632	21,206	21,583	21,864	21,687	22,190
Retained Earnings:							
Balance, beginning of year ..	25,124	37,113	56,466	84,442	115,165	115,165	156,591
Add: Net income	19,165	26,717	36,668	42,540	54,752	21,907	34,186
Less: Cash dividends paid ..	(5,675)	(7,364)	(8,692)	(11,817)	(13,326)	(6,372)	(9,282)
Adjustment for prior year deferred taxes (Note 4) ..	(1,501)	—	—	—	—	—	—
Balance, end of year	37,113	56,466	84,442	115,165	156,591	130,700	181,495
Treasury Stock at Cost:							
Balance, beginning of year ..	(405)	(308)	(67)	(49)	(16,521)	(16,521)	(16,516)
Add: Cost of common stock purchased	—	—	—	(16,478)	—	—	—
Less: Cost of common stock issued upon exercise of stock options	97	241	18	6	5	2	7
Balance, end of year	(308)	(67)	(49)	(16,521)	(16,516)	(16,519)	(16,509)
Total Stockholders' Equity	<u>\$62,805</u>	<u>\$83,031</u>	<u>\$111,599</u>	<u>\$126,227</u>	<u>\$167,939</u>	<u>\$141,868</u>	<u>\$193,176</u>

The accompanying Notes to Financial Statements are an integral part of this statement.

SOUTHLAND ROYALTY COMPANY
STATEMENT OF CHANGES IN FINANCIAL POSITION
(Thousands of dollars)

	Years Ended December 31,					Six Months Ended June 30,	
	1975	1976	1977	1978	1979	1979	1980
						(Unaudited)	
Source of Funds							
Net income	\$19,165	\$ 26,717	\$ 36,668	\$ 42,540	\$ 54,752	\$ 21,907	\$ 34,186
Noncash expenses against income:							
Depreciation, depletion and amortization	6,386	18,335	28,760	28,835	39,781	19,268	26,544
Leasehold impairment provision	4,155	4,875	5,302	5,647	7,145	3,603	4,275
Deferred income taxes and other	2,346	4,235	1,986	5,892	11,426	6,462	9,156
Cash flow from operations	32,052	54,162	72,716	82,914	113,104	51,240	74,161
Proceeds from long-term debt	5,996	200,039	772	—	140,000	131,255	108,167
Proceeds from disposal of property, equipment and other assets	543	979	619	2,566	6,796	800	4,043
Deferred revenue and other sources	511	2,786	3,556	3,855	5,720	989	1,443
Total source of funds	39,102	257,966	77,663	89,335	265,620	184,284	187,814
Application of Funds							
Expenditures for property and equipment:							
Acquisition of producing properties	6,815	194,791	1,522	11,654	153,046	154,214	131,111
Acquisition of undeveloped acreage	3,348	2,856	10,226	12,097	18,269	6,051	11,718
Productive well costs including uncompleted wells, equipment and facilities	19,954	19,894	25,826	39,330	59,320	26,444	39,454
Other property and equipment	3,250	1,288	2,257	2,734	1,696	582	1,562
Total expenditures for property and equipment	33,367	218,829	39,831	65,815	232,331	187,291	183,845
Purchase of treasury stock	—	—	—	16,478	—	—	—
Reduction in long-term debt	—	26,657	15,879	5,695	3,777	305	13,648
Cash dividends paid to stockholders ..	5,675	7,364	8,692	11,817	13,326	6,372	9,282
Other applications	—	—	—	2,132	129	143	302
Total application of funds	39,042	252,850	64,402	101,937	249,563	194,111	207,077
Change in Working Capital	\$ 60	\$ 5,116	\$ 13,261	\$(12,602)	\$ 16,057	\$ (9,827)	\$(19,263)
Change in Working Capital							
Cash and temporary cash investments	\$(3,354)	\$ 14,359	\$ 19,915	\$(15,411)	\$ 7,623	\$ (8,403)	\$(17,927)
Accounts receivable, materials and supplies inventory and other current assets	14,715	5,996	5,153	1,993	19,709	10,542	13,314
Accounts payable and other current liabilities	(800)	(4,721)	(3,903)	(4,738)	(17,548)	(8,709)	(10,147)
Income taxes payable	(7,379)	(3,009)	(2,332)	4,683	(2,931)	1,383	3,324
Current maturities of long-term debt and notes	(3,122)	(7,509)	(5,572)	871	9,204	(4,640)	(7,827)
Change in Working Capital	\$ 60	\$ 5,116	\$ 13,261	\$(12,602)	\$ 16,057	\$ (9,827)	\$(19,263)

The accompanying Notes to Financial Statements are an integral part of this statement.

SOUTHLAND ROYALTY COMPANY
NOTES TO FINANCIAL STATEMENTS
(Information Applicable to June 30, 1979 and June 30, 1980 is Unaudited)

1. Summary of Significant Accounting Policies

The significant accounting policies of the Company, as described below, conform to generally accepted accounting principles and are applied on a consistent basis. Certain reclassifications have been made in prior years' financial statements to conform to current classifications.

The financial information for the six months ended June 30, 1979 and June 30, 1980 is unaudited but reflects, in management's opinion, all adjustments (which includes only normal recurring adjustments) necessary to present fairly the results for such periods. The following is a summary of the significant accounting policies of the Company:

Property and Equipment

The Company utilizes successful efforts accounting. Costs related to drilling and equipping wells are deferred until a determination is made as to whether the well is productive. After that determination, intangible development costs related to development wells and successful exploratory wells are capitalized. Unsuccessful exploratory wells are expensed. Costs of acquiring nonproducing leases and royalties are capitalized and transferred to producing leases upon establishment of commercial production. An aggregate impairment provision is provided for onshore nonproducing leases based upon historical experience. Offshore nonproducing leases are impaired on a property-by-property basis considering, among other things, the results of exploratory drilling. All geological and geophysical costs are expensed as incurred.

The Company charges maintenance and repairs to operating expense and renewals and betterments to property and equipment. When complete units of depreciable property and equipment are retired or sold, accumulated depreciation is reduced by the related amount and any gain or loss is charged to income. When less than complete units are retired, the difference between asset cost and salvage receipts is charged to accumulated depreciation.

Depletion, depreciation and amortization of producing properties is computed by the unit-of-production method. Depreciation of other property and equipment is computed by either the declining balance or straight-line method.

Materials and supplies inventory is stated at cost with items removed being credited at weighted average cost.

Income Taxes

The benefits of statutory depletion and investment tax credit reduce income tax expense in the year realized. Deferred income taxes are provided at the statutory rate for timing differences between financial and taxable income, principally deductions of productive intangible drilling and development costs.

Earnings Per Share

Earnings per share are based on the weighted average number of shares outstanding. The dilutive effect on earnings per share of outstanding stock options and purchase of treasury stock is not material.

In June, 1980, the Company effected a two-for-one stock split of its common stock. Two-for-one stock splits had previously been effected in 1976 and 1979. All share and per share figures in this proxy statement have been restated to reflect the stock splits.

2. Long-Term Debt

Long-term debt at December 31, 1979 and June 30, 1980 consisted of the following:

	(In thousands)	
	December 31, 1979	June 30, 1980
Notes to Banks:		
Promissory notes, due in quarterly installments through 1/1/90	\$ 76,667	\$180,000
Notes to Insurance Companies:		
Promissory notes, due in quarterly installments from 1981-1992 at an interest rate of 8.7%	130,000	130,000
Promissory notes due in semi-annual installments from 1984-1993 at an interest rate of 9.875%	90,000	90,000
Other:		
Advance payment agreements and other, principally noninterest bearing, due in monthly installments through 1988	6,123	5,278
	<u>\$302,790</u>	<u>\$405,278</u>
Less: Current Maturities	6,128	13,955
	<u>\$296,662</u>	<u>\$391,323</u>

Maturities of long-term debt are as follows after June 30, 1980:

	(In thousands)				
	Notes to Banks	Notes to Insurance Companies		Other	Total
		8.7%	9.875%		
1980 Remainder	\$ —	\$ —	\$ —	\$ 305	\$ 305
1981	17,000	15,000	—	2,116	34,116
1982	22,000	15,000	—	2,756	39,756
1983	23,000	15,000	—	17	38,017
1984	23,000	15,000	3,500	17	41,517
1985-1989	91,000	57,500	42,500	67	191,067
1990-1993	4,000	12,500	44,000	—	60,500
Total	<u>\$180,000</u>	<u>\$130,000</u>	<u>\$90,000</u>	<u>\$5,278</u>	<u>\$405,278</u>

Under its loan agreement with banks, the Company has the option of borrowing domestic funds at floating rates of interest based on the domestic prime rate or borrowing Eurodollar funds at interest rates fixed for periods of three, six, nine or twelve months based on the London Interbank Offered Rate (LIBOR). The Company may borrow up to \$200,000,000 prior to January 1, 1981. These loans must be paid down to \$179,500,000, or less, by January 1, 1981. The balance at that date will mature in quarterly installments commencing April 1, 1981, and ending January 1, 1990. At June 30, 1980, \$20,000,000 in domestic loans and \$150,000,000 in Eurodollar loans were outstanding. Interest on the domestic loans is 104% of the prime rate through 1982, 106.5% from 1983 through 1985, and 110% from 1986 to 1990. The interest rate on the domestic loans was 11.96% at June 30, 1980. Interest on the Eurodollar loans is the applicable LIBOR rate plus 5/8% through 1982, plus 3/4% from 1983 through 1985, and plus 7/8% from 1986 to 1990. The interest rate on the Eurodollar loans was 10.75% at June 30, 1980. In addition, the Company had outstanding on June 30, 1980 a \$10,000,000 note due July 28, 1980 at an interest rate of 9.75% from one of the banks. The loan agreement with banks

also provides for a commitment fee of .5% and a balance fee of 7.5% of the domestic prime interest rate on the unused portion of the \$200,000,000 commitment prior to January 1, 1981. The Company is not required to maintain compensating balance deposits with the banks. In September, 1980, the Company obtained consent by its bank lenders to extend the option to borrow up to \$200,000,000 to January 1, 1982, and defer scheduled quarterly installments by one year.

The loan agreements with insurance companies and banks include certain restrictions relating to disposition or encumbrances of assets, additional indebtedness and other matters. The total of cash dividends, treasury stock purchases and certain investments is restricted to \$30,000,000 plus 75% of net income (less 100% of net losses) cumulative from January 1, 1977. In addition, acceleration of principal payments may occur if the Company's present value of projected net revenues from proved producing properties is less than 200% of outstanding debt, or if projected cash flow from operations is less than 110% of scheduled debt payments in any year. Acceleration of the payments would require 90% of cash flow from operations to be applied to debt until certain tests are met. The debt with both insurance companies and banks is senior unsecured debt of the Company.

Consummation of the proposed distribution discussed in Note 15 will require the consent of the Company's lenders. The Company has obtained verbal consent from its lenders concerning the distribution. In consideration for the consents of those lenders which hold fixed rate notes (the insurance companies) Southland has agreed to increase the annual interest rate paid on such notes by $\frac{1}{4}$ of 1%.

3. Acquisitions

Upon expiration of an oil and gas lease in July 1975, the Company began realizing its full eight-eighths of the production accruing to its mineral interest in the Waddell Ranch properties of West Texas. Previously, the Company had been receiving a royalty interest in the production. This resulted in an increase in revenues in 1975 of approximately \$21,000,000. In 1976, these revenues rose to approximately \$49,000,000, or \$23,000,000 more than revenues from the Waddell Ranch in 1975. Operating expenses increased proportionately. The Waddell Ranch properties comprise the bulk of the properties involved in the proposed distribution to the Permian Basin Royalty Trust as discussed in Note 15.

The Company acquired Aztec Oil and Gas Company in January 1976, for \$182,300,000 in cash. This purchase added substantially to the Company's gas reserves and production, principally due to Aztec's large San Juan Basin, New Mexico gas holdings. These holdings comprise the bulk of the properties involved in the proposed distribution to the San Juan Basin Royalty Trust, as discussed in Note 15. Revenues from the Aztec properties for eleven months in 1976 were approximately \$24,000,000. Depreciation, depletion and amortization and interest expense increased approximately \$9,000,000 and \$15,000,000, respectively, over 1975, as a direct result of the acquisition.

During 1979, the Company, in separate transactions, purchased producing oil and gas properties from various companies and individuals for combined purchase prices of approximately \$153,000,000. The most significant transaction involved the Company's acquisition of properties located in the Permian Basin of West Texas and Southeastern New Mexico from Shenandoah Oil Corporation for approximately \$126,000,000, effective February 1, 1979. During 1979, the unaudited revenues and operating expenses, including depreciation, depletion and amortization, of all producing properties acquired in 1979 were approximately \$34,000,000 and \$20,000,000, respectively.

In January 1980, the Company acquired all of the outstanding stock of P&O Oil Corporation (P&O) from its parent P&O American Holdings, Ltd. (itself a subsidiary of Peninsular & Oriental Steam Navigation Company of London, England). This transaction was a cash purchase for approximately \$129,000,000. The purchase was financed through the loan agreement with banks as discussed in Note 2 and by cash flow from operations. P&O was subsequently merged into the Company. The principal assets of P&O are long-lived producing oil properties located primarily in West Texas.

The Company accounted for the acquisition of P&O as a purchase of assets. The following represents certain income statement items for the three years ended December 31, 1979 and certain balance sheet items as of December 31, 1979, acquired by the Company:

	Year Ended December 31,		
	1977	1978	1979
	(In thousands)		
Revenues	\$2,171	\$9,265	\$16,894
Production expenses	908	2,966	2,847
Taxes on production and property	160	615	1,069
Operating income	<u>\$1,103</u>	<u>\$5,684</u>	<u>\$12,978</u>
			As of December 31, 1979
Assets acquired:			
Current assets			\$ 3,251
Property and equipment at cost, net of accumulated depreciation, depletion and amortization			47,137
Other assets			217
Total assets acquired			<u>\$50,605</u>
Current liabilities assumed			<u>\$ 1,295</u>

P&O followed the successful efforts method of accounting.

During the six months ended June 30, 1980, the P&O properties had revenues of \$8,009,000, production expenses of \$830,000, taxes on production and property of \$510,000, and depreciation, depletion and amortization of \$4,770,000. Interest expense on debt related to the P&O acquisition was \$8,572,000. The net loss, after taking into account interest expense and income tax benefits, related to the P&O properties was \$3,603,000 or \$.08 per share.

4. Income Taxes

The effective income tax rate was less than the statutory Federal income tax rate of 46% (48% before 1979) for the following reasons:

	1975	1976	1977	1978	1979	Six Months Ended June 30,	
						1979	1980
Income taxes at the statutory Federal rate	48.0%	48.0%	48.0%	48.0%	46.0%	46.0%	46.0%
Reduction in income taxes resulting from:							
Investment tax credit ..	(1.8)	(1.8)	(1.7)	(1.7)	(1.8)	(2.1)	(1.9)
Excess of tax depletion over book depletion ..	(2.2)	(.6)	(1.2)	(.5)	(.2)	(.2)	(.2)
State income taxes	—	.1	.1	.2	.5	.2	.5
Other — net	2.2	(.5)	(.2)	—	—	(.1)	.3
Income tax expense	<u>46.2%</u>	<u>45.2%</u>	<u>45.0%</u>	<u>46.0%</u>	<u>44.5%</u>	<u>43.8%</u>	<u>44.7%</u>

The investment tax credit after 1976 includes the additional one percent credit applicable to the Company's employee stock ownership plan discussed in Note 7.

The deferred tax provision results from timing differences in the recognition of income and expense for tax and financial reporting purposes. The sources of the timing differences for the years ended December 31, 1975 through 1979, and six month periods ended June 30, 1979 and 1980, were as follows:

	(In thousands)					Six Months Ended June 30,	
	1975	1976	1977	1978	1979	1979	1980
Intangible drilling and development costs	\$ 3,789	\$ 3,283	\$ 7,489	\$11,532	\$16,786	\$ 7,168	\$10,482
Depreciation and amortization	(1,464)	(80)	(4,547)	(3,477)	(5,819)	(2,517)	(3,789)
Deferred revenues	—	(527)	(1,433)	(1,714)	(1,553)	(406)	(1,464)
Geological and geo-physical costs	(58)	182	(252)	(701)	(1,166)	(777)	(426)
Other — net	—	85	36	(159)	60	—	(662)
Deferred tax provision	<u>\$ 2,267</u>	<u>\$ 2,943</u>	<u>\$ 1,293</u>	<u>\$ 5,481</u>	<u>\$ 8,308</u>	<u>\$ 3,468</u>	<u>\$ 4,141</u>

Prior to January 1, 1975, the Company provided for deferred taxes on intangible development costs at the Company's average effective tax rate which reflected the benefit of statutory depletion. The Tax Reduction Act of 1975 substantially reduced statutory depletion available to oil and gas producing companies. The resultant Financial Accounting Standards Board Statement No. 9, required interperiod tax allocation commencing on January 1, 1975. The Company adopted the retroactive restatement method of interperiod tax allocation and, consequently, charged a net increase in deferred taxes for all years prior to 1975 of \$1,501,000 against retained earnings as of January 1, 1975.

5. Sales to Major Customers

The Company had sales to three customers during the three years ended December 31, 1979, which exceeded ten percent of total revenues. These customers were:

	Revenues		
	1977	1978	1979
Southern Union Company	\$ 26,300,000	\$ 33,300,000	\$ 48,400,000
Gulf Oil Corporation	21,700,000	27,900,000	36,100,000
H. T. Gathering Company	25,000,000	19,300,000	20,400,000
Total Revenues	158,579,000	183,553,000	256,611,000

No other customers accounted for ten percent of total revenues. The Company has long-term contracts with its major gas purchasers, and should the loss of either a gas or oil purchaser occur, the Company believes that replacement purchasers could be obtained at prices comparable to those now received in view of current price regulations and market conditions.

6. Stock Options

The Company has a Qualified Stock Option Plan and an Executive Stock Incentive Plan for certain key employees. Options were granted under the Qualified Stock Option Plan from 1972 through 1976. The options granted under this plan allow the grantee to purchase common stock of the Company at a price equal to the average market price on the date of grant. The options remain exercisable for five years from the date of grant and there are no options available for future grant.

The Executive Stock Incentive Plan permits options to be granted in the form of a unit consisting of a share of stock and a related stock appreciation right (SAR). The grant price for these units is

the average market price of the stock at the date of grant. The related SAR allows the grantee to receive an amount equal to the difference between the grant price and the market price at the date of exercise. Options were granted under this plan in 1978, 1979 and 1980 and are exercisable over a ten-year period following the grant date, with none exercisable before the second anniversary of the grant. Two years after the grant date, 20% of the options granted become exercisable, with 10% of the options becoming exercisable on the third through the tenth anniversary of the grant. There were 263,000 units available for option at December 31, 1979. Options for 79,800 units were granted during the first six months of 1980 and 14,200 were forfeited, leaving 197,400 units available for future grant. Detail of options of both plans, option prices and fair market value of options for the five years ended December 31, 1979 and the six months ended June 30, 1980, is presented in the following table. (Numbers of shares and related prices and values have been adjusted to reflect the two-for-one stock splits discussed in Note 1.)

	Number of Shares	Option Price		Fair Market Value	
		Per Share	Total	Per Share	Total
<u>At Date of Grant</u>					
Options outstanding at:					
June 30, 1980	204,032	\$ 8.16-33.94	\$4,528,249	\$ 8.16-33.94	\$4,528,249
December 31, 1979	189,188	\$ 5.10-18.25	2,439,599	\$ 5.85-18.25	2,455,825
<u>At Date Option Became Exercisable</u>					
Options which became exercisable during year:					
1980 (through 6/30/80)	—	—	—	—	—
1979	4,656	\$ 5.10	\$ 23,745	\$19.22	\$ 89,488
1978	13,032	\$ 4.80- 5.10	64,472	\$10.10-11.68	141,825
1977	17,692	\$ 4.63- 5.10	86,044	\$ 9.88-10.88	181,942
1976	123,184	\$ 4.63- 8.59	976,145	\$ 6.79- 8.59	1,017,337
1975	68,000	\$ 5.12- 6.30	387,375	\$ 5.12- 6.30	387,375
<u>At Date Option Exercised</u>					
Options exercised during:					
1980 (through 6/30/80)	42,756	\$ 5.10- 8.59	\$333,063	\$25.28-52.38	\$1,321,575
1979	42,132	\$ 4.15- 8.59	271,872	\$12.57-31.63	1,054,218
1978	55,800	\$ 3.23- 8.59	260,298	\$ 9.75-13.11	591,969
1977	106,576	\$ 3.23- 8.59	568,418	\$ 9.36-11.38	1,080,626
1976	192,728	\$ 2.27- 8.17	822,653	\$ 5.17-10.10	1,405,806
1975	141,512	\$ 2.27- 5.84	510,916	\$ 5.20- 7.52	871,983
Options forfeited during year:					
1980 (through 6/30/80)	22,200	\$ 8.51-33.94	\$286,459		
1979	12,856	\$ 5.10-18.25	175,343		
1978	—	—	—		
1977	8,000	\$ 8.17	65,313		
1976	—	—	—		
1975	1,680	\$ 4.78	8,038		

At June 30, 1980, qualified options for 1,432 shares were exercisable. The exercise of stock options resulted in additions to capital in excess of par value of common stock of \$281,000 and \$326,000 during the year ended December 31, 1979, and the six months ended June 30, 1980, respectively. Compensation expense related to SAR's was \$1,297,000 for the six months ended June 30, 1980, and \$487,000 for the year ended December 31, 1979.

In connection with the proposed distribution to the Trusts as discussed in Note 15 and subject to shareholder approval, the Company intends to amend the Executive Stock Incentive Plan so that all outstanding options will be exercisable in full prior to the proposed distribution. Options not exercised prior to the distribution will be adjusted proportionately by an increase in the number of shares subject to option and a decrease in the exercise price. If all such options were exercisable on June 30, 1980, net income for such period would be reduced by approximately \$2,300,000.

7. Employee Benefit Plans

The Company has three qualified employee benefit plans available to all eligible employees. Under the retirement and death benefit plan, benefits are provided by group insured annuity contracts funded by payment of annual premiums on a level premium basis. Under the employee thrift plan, the Company matches the employee contributions to an administered investment fund. The employee contributions are limited to ten percent of the employee's earnings. The Company's employee stock ownership plan provides for an additional one percent investment tax credit for contribution to the plan. The Company's aggregate contributions to these three plans for the five years ended December 31, 1979, and six months ended June 30, 1979, and 1980, were as follows:

Year ended December 31,		
1975	.....	\$ 281,000
1976	.....	658,000
1977	.....	1,141,000
1978	.....	1,094,000
1979	.....	1,867,000
Six months ended June 30,		
1979	.....	\$ 824,000
1980	.....	1,106,000

In 1977, the Company began a management incentive bonus plan available for employees in key management positions for achievements against performance goals. Total bonuses paid in 1977, 1978 and 1979 were \$292,000, \$314,000 and \$455,000, respectively. The Company paid bonuses of \$581,050 in the six months ended June 30, 1980 for achievements against 1979 objectives.

8. Commitments and Contingencies

Upon expiration of an oil and gas lease in July 1975, covering the Waddell Ranch properties, the Federal Power Commission (FPC), now the Federal Energy Regulatory Commission (FERC), ordered the Company to sell its interest in certain of the gas produced from such properties to an interstate purchaser, rather than the intrastate purchaser with which the Company had contracted. The Company appealed that order, but the FPC's order was ultimately sustained by the United States Supreme Court in 1978. During the course of the litigation, the Company was paid for gas delivered to the interstate purchaser based upon an interim rate which had not been approved by FERC. The Company, along with other affected producers, submitted a proposed settlement of this matter to FERC. The proposed settlement was approved by FERC and such approval became final in August, 1980. At December 31, 1979 and June 30, 1980, the Company had deferred revenues of \$6,700,000 and believes that such amount will be adequate to pay the refund amount contemplated by the settlement.

In 1975, the Jicarilla Apache Tribe filed suit against the Company and others, claiming that for royalty settlement purposes on past oil and gas production from tribal lands, payments should have been based upon the value of gas without regard to the price being received by the producers. In addition, the Tribe requested the Department of Interior be directed to seek cancellation of certain oil and gas leases. In December 1978, the Tribe filed an amended complaint seeking treble damages from price related antitrust claims, the effect of which was to restate the previous claim and seek

treble damages for the \$1,500,000 in claimed royalty deficiencies. The case was tried and on November 5, 1979, the Trial Court dismissed the Tribe's antitrust claims, dismissed the claims alleging failure to develop the leases and protect the leased lands from drainage, and denied the Tribe's request that the leases be cancelled. The Court did order the Company (and the other defendants) to render an accounting for royalty calculation purposes, on a basis different from that which was previously used in paying the Tribe's royalties. This alternative form of royalty calculation would result in the Company being required to pay additional royalties to the Tribe on past production of approximately \$200,000. The foregoing judgment by the New Mexico Federal District Court is being appealed to the Tenth Circuit Court of Appeals. The Company believes, and has asserted by way of crossclaim in this litigation, that it is entitled to pass on any such additional royalty to the purchaser of the gas. This issue has not yet gone to trial.

The Company is a co-defendant in three antitrust lawsuits now pending in the United States District Court for the District of New Mexico. These cases were originally filed, respectively on December 29, 1978, July 13, 1979, and September 18, 1979. The cases allege violations of Sections 1 and 2 of the Sherman Act and complain of essentially the same transactions. In the first case filed, the plaintiffs are a group of corporations, partnerships and individuals engaged in agricultural operations in Curry and Roosevelt Counties, New Mexico. The second case is brought as a class action on behalf of all residential gas customers in New Mexico who reside within the service areas of the defendant gas purchaser or its affiliates. The third case is brought on behalf of certain named agencies, departments, and educational institutions of the New Mexico state government who purchase natural gas from the defendant gas purchaser or its affiliates. The amount of damages alleged in the first case, after trebling, is in excess of \$120,000,000. The damages sought by amended complaints in the other two cases are unspecified, but are alleged to be in the millions of dollars. In earlier complaints, the damages in such cases, after trebling, were alleged to be in excess of \$100,000,000. Each case also seeks injunctive relief prohibiting further conduct of the defendants in violation of the federal antitrust laws. The plaintiffs allege a conspiracy by and among the defendants illegally to fix and raise the price of natural gas in New Mexico, primarily through the negotiation of alleged friendly settlements in 1976 of lawsuits between the defendant gas purchaser (and/or its affiliates) and other defendants, including the Company, who are gas producers in the San Juan Basin area of New Mexico. The 1976 lawsuits were brought by the producers to settle contract disputes with the gas purchaser relating to the interpretation of the pricing provisions of their respective gas purchase contracts. The Company believes that the settlement in 1976 of its contract suit was reached only after vigorous litigation and difficult, arms-length settlement negotiations. The Company believes these antitrust claims are without merit and intends to defend these suits vigorously. Legal counsel for the Company has interviewed several officers, employees, and representatives of the Company who are familiar with the transactions complained of by the plaintiffs, and has reviewed certain documentary materials furnished by the Company. Based upon such investigation, it is the opinion of the Company's counsel that the Company has substantial legal defenses. Several of these defenses were preliminarily decided adversely to the defendants by the trial judge in the first of the three cases in summary judgment proceedings at the initial stage of such case. Such action was based upon a less than complete factual record, and counsel for the Company believes such legal defenses remain viable and intends to reurge such defenses at a later stage of the litigation following factual development through discovery. Counsel for the Company also believes, based upon their limited review to date, that the Company has factual defenses to the claims of the plaintiffs.

9. Summarized Quarterly Results of Operations (Unaudited)

	(In thousands, except per share amounts)				
	Three Months Ended				
	March 31	June 30	September 30	December 31	Total
1977					
Total Revenue	\$34,419	\$38,684	\$39,407	\$46,069	\$158,579
Operating Income	19,824	22,860	23,128	24,902	90,714
Net Income	7,568	9,181	9,372	10,547	36,668
Earnings Per Share	\$ 0.16	\$ 0.19	\$ 0.20	\$ 0.22	\$ 0.77
1978					
Total Revenue	\$46,334	\$47,381	\$44,466	\$45,372	\$183,553
Operating Income	26,912	27,046	24,548	25,556	104,062
Net Income	11,191	11,259	10,077	10,013	42,540
Earnings Per Share	\$ 0.24	\$ 0.24	\$ 0.21	\$ 0.21	\$ 0.90
1979					
Total Revenue	\$51,360	\$61,469	\$67,552	\$76,230	\$256,611
Operating Income	27,818	32,675	40,615	43,266	144,374
Net Income	10,105	11,802	15,883	16,962	54,752
Earnings Per Share	\$ 0.22	\$ 0.25	\$ 0.35	\$ 0.36	\$ 1.18
1980					
Total Revenue	\$90,635	\$92,336			\$182,971
Operating Income	50,300	44,624			94,924
Net Income	18,800	15,386			34,186
Earnings Per Share	\$ 0.41	\$ 0.33			\$ 0.74

Total revenue is revenue from oil and gas producing activities. Operating income represents income before deduction of general and administrative, interest and income tax expenses.

10. Inflation and Changing Prices (Unaudited)

In 1979, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 33, Financial Reporting and Changing Prices. For 1979, this statement requires affected companies to report the estimated effect of inflation on income and financial position. Under current generally accepted accounting principles, financial statements reflect actual dollars spent or received without regard for inflation. Asset costs incurred over several years are combined, although, because of purchasing power changes, the dollars involved are not common measurement units. The amortization of these commingled costs from prior periods is matched against revenues recorded in current dollars to arrive at net income. An example of this disparity would be if a cost incurred in 1970 were amortized against 1979 revenue. The 1979 dollar is worth \$0.51 compared to the 1970 dollar.

The following schedules reflect certain historical financial information of the Company restated in constant dollars. Most of the Company's revenue and expense items are related to transactions occurring in the current year and are measured in comparable current year dollars. However, depreciation, depletion and amortization and the leasehold impairment provision represent the amortization of costs incurred over several years. These old cost dollars are matched against current revenue and costs in the regular Statement of Income. Therefore, in the following supplementary statement the depreciation, depletion and amortization and the leasehold impairment provision have been restated to constant 1979 dollars by use of the Consumer Price Index (CPI) of the United States Department of Labor. To convert these expenses to constant 1979 dollars, the related December 31, 1979, property and equipment accounts were separated into layers by year of acquisition. Each layer was then inflated to 1979 average dollars by use of the CPI. The restated cost layers were then amortized to arrive at

depreciation, depletion and amortization and impairment. The effect of inflation on all other revenues and expense items is insignificant and therefore, the amounts presented reflect historical dollars.

The restated information is at best an approximation of the effects of inflation. The reader is cautioned against using the restated amounts as exact measurements of inflationary effects.

**SUMMARY STATEMENT OF INCOME
ADJUSTED FOR GENERAL INFLATION
FOR THE YEAR ENDED DECEMBER 31, 1979
(THOUSANDS OF DOLLARS EXCEPT PER SHARE AMOUNTS)**

	<u>Historical Dollars</u>	<u>Constant Dollars</u>
Total Revenues	\$ 256,611	\$ 256,611
Expenses		
Depreciation, depletion and amortization (all sources)	39,781	58,779
Leasehold impairment provision	7,145	7,635
Other operating expenses	79,629	79,629
Interest and other (income) expense, net	31,330	31,330
Income taxes	43,974	43,974
Net Income	<u>\$ 54,752</u>	<u>\$ 35,264</u>
Earnings Per Share	<u>\$1.18</u>	<u>\$.76</u>
Net Assets at Year End	<u>\$ 167,939</u>	<u>\$ 180,088</u>

In the historical financial statements, depreciation, depletion and amortization is charged to both depreciation, depletion and amortization and other (income) expense. In the above schedule all depreciation, depletion and amortization is combined.

Under the guidelines of FASB Statement No. 33, income taxes are not adjusted for the effects of inflation on net income before taxes. The effective tax rate under historical dollar accounting is 44.5%, while the effective rate under constant dollar accounting is 55.5%. This indicates that income taxes are being paid on profits which in part arise from inflation.

The Company has an excess of monetary liabilities over monetary assets. Monetary items are items that are either cash-like in nature or must be liquidated through a cash payment. This includes such items as cash, accounts receivable, notes payable and accounts payable. If monetary assets are held during inflationary times, they lose value as they will purchase fewer goods or services. However, monetary liabilities benefit the debtor in times of inflation as obligations can be satisfied with less purchasing power. This gain is computed by restating net monetary items at December 31, 1978 and 1979, into average 1979 dollars. A gain is reflected because the Company is able to pay off debt of a fixed amount with increasingly less valuable dollars. In 1979, the Company's gain from decline in purchasing power of net amount owed was \$30,254,000.

The following schedule restates five years of selected financial information into constant 1979 dollars.

**SUPPLEMENTARY FINANCIAL DATA
ADJUSTED TO CONSTANT DOLLARS**

	<u>Years Ended December 31,</u>				
	<u>1975</u>	<u>1976</u>	<u>1977</u>	<u>1978</u>	<u>1979</u>
Total Revenues (in thousands)	\$97,100	\$163,252	\$190,032	\$204,313	\$256,611
Cash Dividends Per Share	<u>\$ 0.16</u>	<u>\$ 0.20</u>	<u>\$ 0.22</u>	<u>\$ 0.28</u>	<u>\$ 0.29</u>
Market Price Per Share of Common Stock at Year End	<u>\$ 6.56</u>	<u>\$ 13.38</u>	<u>\$ 13.11</u>	<u>\$ 13.94</u>	<u>\$ 27.20</u>
Average Consumer Price Index	<u>161.2</u>	<u>170.5</u>	<u>181.5</u>	<u>195.4</u>	<u>217.5</u>

11. Exploration, Development and Production Costs

The Company accounts for its oil and gas producing activities using the successful efforts method. Under this accounting method the Company had the following capitalized costs and valuation allowances related to oil and gas activities:

	<u>Cost</u>	<u>Less Valuation Allowances*</u>	<u>Net Capitalized Cost</u>
	(Thousands of dollars)		
At December 31, 1979			
Producing Royalties and Leases	\$405,577	\$108,948	\$296,629
Nonproducing Royalties and Leases	54,281	17,991	36,290
Proven Undeveloped Leases	33,766	—	33,766
Lease and Well Equipment	126,228	38,752	87,476
Uncompleted Wells, Equipment and Facilities	15,275	—	15,275
Total	<u>\$635,127</u>	<u>\$165,691</u>	<u>\$469,436</u>
At June 30, 1980			
Producing Royalties and Leases	\$520,192	\$126,908	\$393,284
Nonproducing Royalties and Leases	63,755	21,640	42,115
Proven Undeveloped Leases	52,760	—	52,760
Lease and Well Equipment	149,242	43,906	105,336
Uncompleted Wells, Equipment and Facilities	20,067	—	20,067
Total	<u>\$806,016</u>	<u>\$192,454</u>	<u>\$613,562</u>

- * Valuation allowances are as follows: Producing Royalties and Leases — Accumulated Depletion and Accumulated Amortization of Intangible Development Costs; Nonproducing Royalties and Leases — Accumulated Impairment of Undeveloped Leases; Lease and Well Equipment — Accumulated Depreciation.

The Company incurred the following costs in its oil and gas producing activities:

	<u>Year Ended December 31,</u>	
	<u>1978</u>	<u>1979</u>
	(Thousands of dollars)	
Producing Properties Acquisitions	\$11,654	\$153,046
Acquisition of Undeveloped Acreage	12,097	18,269
Exploration Costs	30,936	47,083
Development Costs	22,112	32,908
Production Expenses	32,706	46,167

These costs were incurred in the exploration, development and production of oil and gas primarily in the United States. The development costs were primarily incurred on the San Juan Basin and Waddell Ranch properties. After deduction of production expenses, net revenues from oil and gas producing activities were \$150,218,000 in 1978 and \$209,605,000 in 1979. Aggregate depreciation, depletion and amortization and leasehold impairment was \$34,188,000 in 1978 and \$46,716,000 in 1979.

12. Proved Oil and Gas Reserves (Unaudited)

Reserve Quantities

Substantially all of the Company's oil and gas reserves are located in the United States. Estimates of the Company's proved oil and gas reserves as computed under SEC guidelines at December 31, 1977, 1978 and 1979, were as follows:

	Proved Reserves As of December 31,		
	1977	1978	1979
Oil (barrels)			
Proved Developed	86,630,000	86,523,000	101,546,000
Proved Undeveloped	19,032,000	20,513,000	25,167,000
Total Proved	<u>105,662,000</u>	<u>107,036,000</u>	<u>126,713,000</u>
Gas (MCF)			
Proved Developed	871,633,000	928,074,000	996,933,000
Proved Undeveloped	190,981,000	220,975,000	277,903,000
Total Proved	<u>1,062,614,000</u>	<u>1,149,049,000</u>	<u>1,274,836,000</u>

Subsequent to December 31, 1979, the Company purchased additional proved reserves as discussed in Note 3. Independent petroleum engineers estimate proved reserves added of 16,248,000 barrels of oil and 24,754,000 MCF of gas. These added reserves are not considered in the reserve quantities presented herein. The Company has proposed a distribution of net overriding royalty interests in certain of its proved properties to two Trusts. See Note 15.

Proved reserve quantities are estimates based on information available at the time of preparation. Such estimates are subject to change as additional information becomes available. The reserves actually recovered and the timing of production of those reserves may be substantially different from the original estimate. The following schedule presents changes in the Company's proved reserves from December 31, 1977 to December 31, 1979:

	Oil (in barrels)	Gas (in MCF)
Proved reserves as of December 31, 1977	105,662,000	1,062,614,000
Revisions of previous estimates	5,772,000	84,853,000
Purchases of minerals-in-place	2,620,000	4,396,000
Extensions, discoveries and other additions	1,412,000	76,929,000
Production	(8,430,000)	(79,743,000)
Proved reserves as of December 31, 1978	<u>107,036,000</u>	<u>1,149,049,000</u>
Revisions of previous estimates	2,888,000	(27,979,000)
Purchases of minerals-in-place	22,149,000	82,821,000
Extensions, discoveries and other additions	3,926,000	156,872,000
Production	(9,286,000)	(85,927,000)
Proved reserves as of December 31, 1979	<u>126,713,000</u>	<u>1,274,836,000</u>

The revisions of previous estimates above represent changes in estimated quantities of recoverable reserves. Revisions to proved oil reserves resulted from improved production performance in most of the Company's major waterflood properties, changes in recovery estimates because production decline has not been as rapid as previously projected, and extension of the economic life due to increases in prices. The downward revision of proved gas reserves is the result of more rapid production decline than previously estimated on certain properties.

During 1979, the Company purchased producing properties from various companies and individuals. The most significant acquisitions were the purchase of the Permian Basin and Rocky Mountain properties of Shenandoah Oil Corporation, which added approximately 21,500,000 barrels of oil and 71,000,000 MCF to the Company's proved reserves. See Note 3 for a further discussion of acquisitions.

During 1979, the New Mexico Oil and Gas Conservation Commission approved an infill drilling program for the San Juan Basin of New Mexico. This program resulted in additions to proved reserves of 107,284,000 MCF of gas and 710,000 barrels of oil which is included in extensions, discoveries and other additions.

Production of proved oil and gas reserves during 1979 resulted in a reduction in proved reserves of 9,286,000 barrels of oil and 85,927,000 MCF of gas. Projected production for 1980 as estimated by independent petroleum engineers is 9,678,000 barrels of oil and 92,971,000 MCF of gas.

Future Net Revenues

Estimated future net revenues from proved reserves are computed by applying current prices to estimated future production of proved reserves as of December 31, 1979. Such revenues are presented net of estimated future development and production costs. The SEC has required the use of current prices and costs. The only price escalations allowed are those covered by existing contractual agreements or specifically allowed by current Federal regulation. Oil prices have not been escalated for the effect of decontrol of oil prices presently allowed. The only cost escalations allowed are those which result from a change in operating methods. The SEC also requires that in computing the present value of future net revenues, a discount factor of 10% be used. Based on these assumptions required by the SEC, the estimated future net revenues and present value of future net revenues are as follows:

	<u>Proved Reserves</u>	<u>Proved Developed Reserves</u>
Estimated Future Net Revenues		
1980	\$ 255,000,000	\$ 265,000,000
1981	258,000,000	235,000,000
1982	258,000,000	219,000,000
Remaining life of reserves	4,632,000,000	3,342,000,000
Total	<u>\$5,403,000,000</u>	<u>\$4,061,000,000</u>
Present Value of Future Net Revenues	<u>\$1,898,000,000</u>	<u>\$1,513,000,000</u>

The future net revenues shown above should not be construed to represent a forecast of future net revenues. In addition, the present values should not be construed as a market value of the Company's proved reserves. Market value determinations include many additional factors.

Reserve Recognition Accounting

In 1978, the SEC announced a program of financial reporting for oil and gas producers based on valuing oil and gas reserves when discovered. This method of accounting has been termed Reserve Recognition Accounting (RRA). Under RRA, a valuation of the Company's proved reserves is reflected as an asset, and a valuation of additions to proved reserves is included in earnings as they occur. Under present generally accepted methods of accounting, assets reported in the balance sheet consist of capitalized historical costs and earnings are recognized as reserves are produced, rather than when they are discovered or revised.

For 1979, the SEC has required oil and gas producers to present a Summary of Oil and Gas Producing Activities (Summary) on the basis of RRA and a Statement of Changes in Present Value of Estimated Future Net Revenues from Proved Oil and Gas Reserves (Statement of Changes in Present Value). The Summary presents the change in estimated value of proved reserves during the

year due to additions and revisions less related costs and a provision for income taxes. The Statement of Changes in Present Value presents changes which occurred during the year resulting in year-end proved reserve values.

Summary of Oil and Gas Producing Activities

In the Summary, additions include discoveries of new fields, extensions of existing fields and additions resulting from activities such as infill drilling in existing fields. Revisions are a group of related factors. Revisions due to price increases (net of related production costs) and accretion of discount are shown separately while all other revisions such as changes in reserve estimates and production timing, changes in timing of development costs and other changes are grouped. Accretion of discount is the holding gain due to estimated future production moving one year closer, thus being subject to less discount.

Costs are included in the Summary in the year such costs are evaluated. Estimated development costs are deducted from estimated future net revenues when valuing proved reserves. Acquisition costs are the costs of acquiring unproved properties. Such costs appear in the Summary in the year the property is determined to be productive or nonproductive. Acquisition costs include the actual cost of properties on which proved reserves have been found during the year and an impairment provision for the estimated cost of properties which will not result in proved reserves. The costs of drilling exploratory wells are deferred until the properties are evaluated and determined to be either productive or nonproductive, at which time they are charged to expense. Other exploration expenses such as geological and geophysical expenses and lease rentals appear in the Summary in the year incurred. The provision for income taxes is calculated by applying year-end statutory income tax rates to the difference between the RRA valuation of proved reserves and the tax basis in proved oil and gas properties. Also taken into account are any available statutory depletion carryforwards, investment tax credits and estimated statutory depletion associated with future production of proved reserves.

SUMMARY OF OIL & GAS PRODUCING ACTIVITIES ON
THE BASIS OF RESERVE RECOGNITION ACCOUNTING
FOR THE YEAR ENDED DECEMBER 31, 1979

Additions and Revisions to Proved Reserves (net of estimated production and development costs):	
Additions	\$209,000,000
Revisions to Prior Estimates of Proved Reserves due to:	
Changes in Prices (net of changes in production costs)	746,000,000
Other Revisions	(98,000,000)
Accretion of Discount	108,000,000
Total Additions and Revisions	<u>965,000,000</u>
Evaluated Costs:	
Acquisition Costs (including impairments)	8,000,000
Exploration Costs	42,000,000
Total Evaluated Costs	<u>50,000,000</u>
Net Additions and Revisions to Proved Reserves	915,000,000
Provision for Income Taxes	360,000,000
Increase in Present Value of Proved Reserves	<u><u>\$555,000,000</u></u>

This Summary does not include interest, general and administrative expenses, or "windfall profits" tax. Net earnings from oil and gas operations included in primary financial statements for 1979 was \$144,000,000 before deduction of interest, general and administrative expenses and income tax expense.

During 1979, the New Mexico Oil and Gas Conservation Commission approved an infill drilling program for the San Juan Basin of New Mexico. This program resulted in an increase in present value of proved reserves of \$71,000,000 which is included in additions. Other revisions in the Summary are primarily due to increased estimated development expenditures resulting from both increased costs and increased development activity.

The costs of acquiring unproved properties and drilling exploratory wells are deferred until the properties or the wells are evaluated, at which time they are charged to evaluated costs in the Summary. Such deferred exploration costs at December 31, 1979, net of impairment reserve, totaled \$45,000,000.

Statement of Changes in Present Value of Estimated Future Net Revenue

The Statement of Changes in Present Value presents a reconciliation showing the changes during the year which resulted in the year-end values of proved reserves. Reserve values change due to additions and revisions, purchase of reserves in place and the incurring of previously estimated development costs. Reductions in proved reserve value result from sales of reserves in place and production and sale of oil and gas. The Company had no significant sales of reserves in place during 1979.

**STATEMENT OF CHANGES IN PRESENT VALUE OF ESTIMATED
FUTURE NET REVENUE FROM PROVED OIL & GAS RESERVES
FOR THE YEAR ENDED DECEMBER 31, 1979**

Present Value of Proved Reserves at December 31, 1978	\$ 991,000,000
Increases:	
Additions and Revisions (net of production and development costs)	965,000,000
Purchase of Reserves in Place (net of production and development costs) .	119,000,000
Current Year Development Costs	33,000,000
Total Increase	<u>1,117,000,000</u>
Less:	
Sales of Oil and Gas (net of production costs of \$46,000,000)	210,000,000
Present Value of Proved Reserves at December 31, 1979	<u><u>\$1,898,000,000</u></u>

Purchases of reserves in place are included in the Statement of Changes in Present Value based on their value on the date of purchase. The combined purchase prices of acquisitions during 1979 was approximately \$153,000,000. The present value of future net revenues from acquired properties was approximately \$263,000,000 at December 31, 1979.

Windfall Profit Tax and Oil Price Decontrol

Subsequent to December 31, 1979, Congress passed a "Windfall Profit" tax (Federal excise tax) on the increased revenues resulting from the decontrol of domestic oil prices. The estimated future net revenues and present value amounts presented above do not include the effects that tax and phased decontrol of oil prices. If the "Windfall Profit" tax and phase decontrol had been considered, the estimated future net revenue from proved reserves would have been approximately \$6,221,000,000 and the present value of such revenues would be approximately \$2,160,000,000. "Windfall Profit" taxes of approximately \$920,000,000 would have been deducted in determining such estimated future net revenues.

13. Supplementary Income Statement Information

Supplementary income statement information follows:

	(In thousands)					Six Months Ended June 30,	
	Years Ended December 31,					(Unaudited)	
	1975	1976	1977	1978	1979	1979	1980
Depreciation, depletion and amortization of property, plant and equipment	\$6,386	\$18,335	\$28,760	\$28,835	\$39,781	\$19,268	\$26,544
Maintenance and repairs	\$ 26	\$ 30	\$ 3,843	\$ 4,566	\$ 5,777	\$ 2,614	\$ 3,330
Taxes on production and property:							
Production and severance	\$4,327	\$ 7,758	\$ 9,600	\$10,369	\$14,185	\$ 6,393	\$10,399
Real estate and personal property	927	1,708	1,940	2,606	3,107	1,488	2,260
Total	\$5,254	\$ 9,466	\$11,540	\$12,975	\$17,292	\$ 7,881	\$12,659

Advertising, rents and royalty expenses involve amounts less than one percent of total revenue. Prior to 1977, production related maintenance and repairs were charged to production expenses and thus were indistinguishable in the accounts.

14. Accounting Change

In 1978 the Company retroactively restated its financial statements to comply with the successful efforts accounting method required by the SEC. The successful efforts method previously used by the Company differed from the SEC's method in several ways. The SEC's method requires an impairment provision on nonproducing leases rather than expensing the leases when condemned and abandoned. Geological and geophysical costs are expensed as incurred rather than capitalizing such costs as they relate to an acquired property. The SEC method also allows a computation of depreciation, depletion and amortization on a field basis rather than on a property-by-property basis.

The effect of the restatement on net income and earnings per share for the four years ended December 31, 1978, was as follows:

	(In thousands except per share amounts)			
	1975	1976	1977	1978
Net Income before restatement	\$20,814	\$27,077	\$37,835	\$43,946
Adjustment for change in accounting principles	(1,649)	(360)	(1,167)	(1,406)
Net Income as restated	\$19,165	\$26,717	\$36,668	\$42,540
Earnings per share before restatement	\$.44	\$.57	\$.80	\$.93
Adjustment for change in accounting principles	(.03)	(.01)	(.03)	(.03)
Earnings per share as restated	\$.41	\$.56	\$.77	\$.90

The per share figures have been retroactively adjusted for stock splits as discussed in Note 1. The cumulative effect of the change on retained earnings prior to 1975 was a reduction of \$2,007,000. The Statement of Income and Statement of Stockholders' Equity reflect the above changes retroactively.

15. Proposed Distribution

The Company announced on June 17, 1980, a plan to create two independently administered trusts, units of which would be distributed to its stockholders. The "San Juan Basin Royalty Trust" would be created by the Company's transferring to such trust a 75% net overriding royalty out of the Company's existing interest in its New Mexico San Juan Basin properties. This net overriding royalty would be entitled to 75% of the excess of gross revenues from production over operating and development expenses and other related charges.

In addition, the Company would create a "Permian Basin Royalty Trust", by the transfer of a 75% net overriding royalty out of the Company's existing interest in its Waddell Ranch properties in Crane County, Texas, together with a 95% net overriding royalty in certain of the Company's producing royalty properties.

Each trust would be a passive entity which would receive the proceeds attributable to the net overriding royalties and distribute such proceeds to holders of units in the trusts.

Implementation of the plan is subject to the approval of the holders of a majority of the Company's stock. It is anticipated that a special meeting of stockholders will be held in October 1980 to consider the plan.

LIST OF EXHIBITS

The following exhibits are included in this Proxy Statement:

- Exhibit I** – Form of Trust Indenture under which the Permian Basin Royalty Trust will be formed.
- Exhibit II** – Form of Trust Indenture under which the San Juan Basin Royalty Trust will be formed.
- Exhibit III** – Report of Cawley, Gillespie & Associates, Inc. dated July 25, 1980 respecting certain properties to be transferred to the Permian Basin Royalty Trust.
- Exhibit IV** – Report of Raymond F. Kravis and Associates, Inc. dated July 11, 1980 respecting certain properties to be transferred to the Permian Basin Royalty Trust.
- Exhibit V** – Report of H. J. Gruy and Associates, Inc. dated July 14, 1980 respecting certain properties to be transferred to the San Juan Basin Royalty Trust.
- Exhibit VI** – Report of Cawley, Gillespie & Associates, Inc. dated July 25, 1980 respecting certain properties to be retained by Southland.
- Exhibit VII** – Report of H. J. Gruy and Associates, Inc. dated July 14, 1980 respecting certain properties to be retained by Southland.
- Exhibit VIII** – Report of Raymond F. Kravis and Associates, Inc. dated July 11, 1980 respecting certain properties to be retained by Southland.
- Exhibit IX** – Southland Royalty Company 1980 Stock Incentive Plan.

**PERMIAN BASIN
ROYALTY TRUST INDENTURE**

This Royalty Trust Indenture ("Indenture") entered into as of _____, 1980, between Southland Royalty Company, a Delaware corporation with its principal office in Fort Worth, Texas (the "Company"), as Trustor, and The First National Bank of Fort Worth, a banking association organized under the laws of the United States with its principal place of business in Fort Worth, Texas (the "Bank"), as Trustee, evidences that the Company has for many years been engaged in the business of exploring for, producing and marketing oil and gas, and now owns fee mineral interests, royalty and overriding royalty interests in lands located primarily in the Permian Basin area in Texas which contain proven reserves and are currently producing oil and gas; that the Company has determined that it would be in the best interest of its shareholders to carve out and distribute to such shareholders certain net overriding royalties in such mineral and royalty interests (the "Royalties") by means of the conveyances attached hereto as Exhibits 1 and 2 to this Indenture (the "Conveyances"); that since it would be impractical to distribute legal title to undivided interests in the Royalties to each shareholder, and the shareholders have approved the transfer by Company by means of the Conveyances of the Royalties to the Bank, to be held in trust for the benefit of the shareholders on the date of execution hereof, and their respective heirs, personal representatives, successors and assigns, as more particularly provided herein, and the Bank has agreed to accept the Conveyances on such terms; that the Company is contemporaneously executing the Conveyances to the Bank; and that accordingly, the Company, by delivery of the Conveyances, grants, bargains, assigns and delivers the Royalties to the Bank, as trustee in trust and the Bank accepts the Conveyances and the Royalties and the Company and the Bank agree that such assets and all other assets received by the Bank pursuant to this Indenture in trust shall be held, administered, paid and delivered for the purposes and subject to the terms and conditions hereafter provided.

ARTICLE I

DEFINITIONS

As used herein, the following terms are used with the meanings indicated:

"Business Day" means any day which is not a Saturday, Sunday or other day on which national banking institutions in the City of Fort Worth, Texas, are closed as authorized or required by law.

"Beneficial Interest" means the equitable interest of the Unit Holders in the Trust Estate as expressly set out in this Trust Indenture and all other rights of beneficiaries of express trusts created under the Texas Trust Act, subject to the limitations set forth in this Trust Indenture.

"Certificate" means a certificate issued by the Trustee pursuant to Article IV evidencing the ownership of one or more Units.

"Code" means the Internal Revenue Code of 1954 as amended.

"Distribution Date" means the date of any distribution, which shall be on or before ten (10) Business Days after a Monthly Record Date.

"Indenture" means this instrument, as originally executed, or, if amended or supplemented, as so amended or supplemented.

"Monthly Distribution Amount" for any Monthly Period means the sum of (a) the cash received by the Trustee during the Monthly Period attributable to the Royalties, (b) any cash available for distribution as a result of the reduction or elimination during the Monthly

Period of any existing cash reserve created pursuant to Section 3.08 hereof to provide for the payment of liabilities of the Trust, and (c) any other cash receipts of the Trust during the Monthly Period, including without limitation any cash received from interest earned pursuant to Section 3.04 reduced by the sum of (d) the liabilities of the Trust paid during the Monthly Period and (e) the amount of any cash used pursuant to Section 3.08 hereof in the Monthly Period to establish or increase a cash reserve for the payment of any accrued, future or contingent liabilities of the Trust. If the Monthly Distribution Amount determined in accordance with the preceding sentence shall for any Monthly Period be a negative amount, then the Monthly Distribution Amount shall be zero, and such negative amount shall reduce the next Monthly Distribution Amount.

Notwithstanding the foregoing, the Monthly Distribution Amount for any Monthly Period shall not include any amount which would have been required to be reported to any stock exchange on which the Units are listed in connection with the establishment of an 'ex' date in order to be distributed to Unit Holders who were such on the Monthly Record Date for such Monthly Period but was not so reported unless the stock exchange agrees to such amount being a part of that Monthly Period's Monthly Distribution Amount or the Trustee receives an opinion of counsel stating that none of the Trust, the Trustee or any owner of Units will be adversely affected by such inclusion. An amount which pursuant to the preceding sentence is not included in the Monthly Distribution Amount for that Monthly Period shall be included in the Monthly Distribution Amount for the next Monthly Period (unless it is reserved pursuant to Section 3.08 hereof).

"Monthly Period" means the period which commences on the day after the date of creation of the Trust or a Monthly Record Date and continues through and includes the next succeeding Monthly Record Date, which shall be the Monthly Record Date for such Monthly Period.

"Monthly Record Date" for each month means the close of business on the last Business Day of such month unless the Trustee determines that a later date is required to comply with applicable law or the rules of any exchange on which the Units may be listed, in which event it means such later date.

"Person" means an individual, a corporation, partnership, trust, estate or other organization.

"Royalties" means the net overriding royalty interests conveyed to the Trustee pursuant to the Conveyances.

"Transferee", as to any Unit Holder or former Unit Holder, means any Person succeeding to the interest of such Unit Holder or former Unit Holder in one or more Units of the Trust, whether as purchaser, donee, legatee or otherwise.

"Trust" means the express trust created hereby which shall be held and administered as provided herein and in accordance with the terms and provisions (not inconsistent with any terms and provisions hereof) of the Texas Trust Act.

"Trust Estate" means the assets held by the Trustee under this Indenture, and shall include both income and principal if separate accounts or records are kept therefor.

"Trustee" means the initial Trustee under this instrument, or any successor, during the period it is so serving in such capacity.

"Unit" means an undivided fractional interest in the Beneficial Interest, determined as hereinafter provided.

"Unit Holder" means the owner of one or more Units as reflected on the books of the Trustee pursuant to Article IV.

ARTICLE II

NAME AND PURPOSE OF THE TRUST

2.01. *Name.* The Trust shall be known as the Permian Basin Royalty Trust, and the Trustee may transact the affairs of the Trust in that name.

2.02. *Purposes.* The purposes of the Trust are:

(a) to convert the Royalties to cash either (1) by retaining them and collecting the proceeds from production until production has ceased or the Royalties have otherwise terminated or (2) by selling or otherwise disposing of the Royalties (within the limits stated herein); and

(b) to distribute such cash, net of amounts for payment of liabilities of the Trust, to the Unit Holders pro rata.

It is the intention and agreement of the Company and the Trustee to create an express trust within the meaning of Section 2 of the Texas Trust Act, for the benefit of the owners of Units, and a grantor trust for federal income tax purposes of which the owners of Units are the grantors. As set forth above and amplified herein, the Trust is intended to be limited to the receipt of revenues attributable to the Royalties and the distribution of such revenues, after payment of or provision for Trust expenses and liabilities, to the Unit Holders. It is neither the purpose nor the intention of the parties hereto to create, and nothing in this Trust Indenture shall be construed as creating, a partnership, joint venture, joint stock company or business association between or among Unit Holders, present or future, or among or between Unit Holders, or any of them, and the Trustee or the Company.

ARTICLE III

ADMINISTRATION OF THE TRUST

3.01. *General.* Subject to the limitations set forth in this Indenture, the Trustee is authorized to take such action as in its judgment is necessary or advisable best to achieve the purposes of the Trust, including the authority to agree to modifications or settlements of the terms of the Conveyances or to settle disputes with respect thereto, so long as such modifications or settlements do not alter the nature of the Royalties as rights to receive a share of the proceeds of oil and gas produced from the properties presently burdened by such Royalties which are free of any obligation for operating expenses and as rights which do not possess any operating rights or obligations. The Trustee may not dispose of all or any portion of the Royalties except as provided in Sections 3.02, 3.09 and 9.03.

The Trustee will cause the Trust to file any registration statement, report or other materials required by law (including the Securities Exchange Act of 1934 and the rules thereunder) or by any securities exchange on which the Units are at any time registered.

3.02. *Limited Power to Dispose of Royalties.* In the event the Trustee determines it to be in the best interests of the Unit Holders the Trustee may sell at any time and from time to time all or any part of any of the Royalties for cash in such a manner as it deems in the best interest of the Unit Holders if approved by the Unit Holders present or represented at a meeting held in accordance with the requirements of Article VIII but without such approval it may not sell or otherwise dispose of all or any part of the Royalties. This Section 3.02 shall not be construed to require approval of the Unit Holders for any sale or other disposition of all or any part of the Royalties pursuant to Sections 3.09 or 9.03. The Trustee is authorized to retain any of the Royalties in the form in which such property was transferred to the Trustee, without regard to any requirement to diversify investments or other requirements.

3.03. *No Power to Engage in Business or Make Investments.* The Trustee shall not, in its capacity as Trustee under the Trust, engage in any business or commercial activity of any kind whatsoever and shall not, under any circumstances, use any portion of the Trust Estate to acquire any oil and gas lease, royalty or other mineral interest other than the Royalties, or, except as permitted in Sections 3.04 and 3.15, acquire any other asset. The Trustee shall not accept contributions to the Trust other than the Royalties.

3.04. Interest on Cash on Hand. Cash being held by the Trustee as a reserve for liabilities or for distribution at the next Distribution Date shall be placed (in the Trustee's discretion) in:

(a) obligations issued by (or unconditionally guaranteed by) the United States or any agency or instrumentality thereof (provided such agency's or instrumentality's such obligations are secured by the full faith and credit of the United States); or

(b) repurchase agreements secured by obligations qualifying under subparagraph (a) above; or

(c) certificates of deposit of any bank having a capital, surplus and undivided profits in excess of \$50,000,000;

provided such repurchase agreements or certificates shall bear interest at a rate which is the greater of (i) the interest rate which the Bank or its successor pays in the normal course of business on amounts placed with it, taking into account the amounts involved, the period held and other relevant factors, or (ii) the rate of interest paid on obligations qualifying under subparagraph (a) above. Any such obligations, repurchase agreements or certificates must mature on or before the next succeeding Distribution Date and must be held to maturity. To the extent not prohibited by Section 11 of the Texas Trust Act any such cash may be placed with Bank or any successor bank serving as Trustee.

3.05. Power to Settle Claims. The Trustee is authorized to prosecute or defend, or to settle by arbitration or otherwise, any claim of or against the Trustee, the Trust or the Trust Estate, to waive or release rights of any kind and to pay or satisfy any debt, tax or claim upon any evidence by it deemed sufficient.

3.06. Power to Contract for Services. In the administration of the Trust, the Trustee is empowered to employ oil and gas consultants, accountants, attorneys, transfer agents and other professional and expert persons and to employ or contract for clerical and other administrative assistance and to make payments of all fees for services or expenses in any manner thus incurred out of the Trust Estate.

3.07. Payment of Liabilities of Trust. The Trustee shall, to the extent that funds of the Trust are available therefor, make payment of all liabilities of the Trust, including, but without limiting the generality of the foregoing, all expenses, taxes, liabilities incurred of all kinds, compensation to it for its services hereunder, and compensation to such parties as may be consulted as provided for in Section 3.06 hereof.

3.08. Establishment of Reserves. With respect to any liability which is contingent or uncertain in amount or which otherwise is not currently due and payable, the Trustee in its sole discretion may, but is not obligated to, establish a cash reserve for the payment of such liability.

3.09. Limited Power to Borrow. If at any time the cash on hand and to be received by the Trustee is not, or will not, in the judgment of the Trustee, be sufficient to pay liabilities of the Trust as they become due, the Trustee is authorized to borrow the funds required to pay such liabilities. In such event, no further distributions will be made to Unit Holders until the indebtedness created by such borrowing has been paid in full. Such funds may be borrowed from any Person, including, without limitation, the Bank or any other fiduciary hereunder. To secure payment of such indebtedness, the Trustee is authorized to mortgage, pledge, grant security interests in or otherwise encumber (and to include as a part thereof any and all terms, powers, remedies, covenants and provisions deemed necessary or advisable in the Trustee's discretion, including, without limitation, the power of sale with or without judicial proceedings) the Trust Estate, or any portion thereof, including the Royalties, and to carve out and convey production payments.

3.10. Income and Principal. The Trustee shall not be required to keep separate accounts or records for income and principal or maintain any reserves for depletion of the Royalties. However, if the Trustee does keep such separate accounts or records, then the Trustee is authorized to treat all or any part of the yield from the Royalties as income or principal, and in general to determine all questions as between income and principal and to credit or charge to income or principal or to

apportion between them any receipt or gain and any charge, disbursement or loss as is deemed advisable under the circumstances of each case.

3.11. *Term of Contracts.* In exercising the rights and powers granted hereunder, the Trustee is authorized to make the term of any transaction or contract or other instrument extend beyond the term of the Trust.

3.12. *Transactions between Related Parties.* The Trustee shall not be prohibited in any way in exercising its powers from making contracts or having dealings with itself in any other capacity (fiduciary or otherwise) or with the Company.

3.13. *No Bond Required.* The Trustee shall not be required to furnish any bond or security of any kind.

3.14. *Timing of Trust Income and Expenses.* The Trustee will use all reasonable efforts to cause the Trust and the Unit Holders to recognize income (including any income from interest earned on reserves established pursuant to Section 3.08 hereof) and expenses on Monthly Record Dates. The Trustee will invoice the Trust for services rendered by the Trustee only on a Monthly Record Date and shall cause the Trust to pay any such invoices only on the Monthly Record Date on which an invoice is rendered and will use all reasonable efforts to cause all persons to whom the Trust becomes liable to invoice the Trust for such liability on a Monthly Record Date and to cause the Trust to pay any such liabilities on the Monthly Record Date on which such liability is invoiced. In connection with the requirements of any stock exchange on which the Units are listed, the Trustee will, if required by such stock exchange, use all reasonable efforts to determine the Monthly Distribution Amount and report such amount to the exchange at such time as may be required by such stock exchange. Nothing in this Section shall be construed as requiring the Trustee to cause payment to be made for Trust liabilities on any date other than on such date as in its sole discretion it shall deem to be in the best interest of the Unit Holders.

3.15. *Divestiture of Units.* If at any time the Trust or the Trustee is named a party in any judicial or administrative proceeding which seeks the cancellation or forfeiture of any property in which the Trust has an interest because of the nationality, or any other status, of any one or more Unit Holders, the following procedures will be applicable:

(a) The Trustee will promptly give written notice ("Notice") to each holder ("Ineligible Holder") whose nationality or other status is an issue in the proceeding as to the existence of such controversy. The Notice will contain a reasonable summary of such controversy and will constitute a demand to each Ineligible Holder that he dispose of his Units, to a party which would not be an Ineligible Holder, within 30 days after the date of the Notice.

(b) If any Ineligible Holder fails to dispose of his Units as required by the Notice, the Trustee will have the preemptive right to purchase, and will purchase, any such Units at any time during the 90 days after the expiration of the 30-day period specified in the Notice. The purchase price on a per Unit basis will be determined as of the last business day ("determination day") preceding the end of the 30 day period specified in the Notice and will equal the following per Unit amount: (i) if the Units are then listed on a stock exchange, the price will equal the closing price of the Units on such exchange (or, if the Units are then listed on more than one exchange, on the largest such exchange in terms of the volume of Units traded thereon during the preceding twelve months) on the determination day if any Units were sold on such exchange on such day or, if not, on the last preceding day on which any Units were sold on such exchange, or (ii) if the Units are not then listed on any stock exchange, the price will equal the mean between the closing bid and asked prices for the Units in the over-the-counter market on the determination day if quotations for such prices on such day are available or, if not, on the last preceding day for which such quotations are available. Such purchase will be accomplished by tender of the above cash price to the Ineligible Holder at his address as shown on the records of the Trustee, either in person or by mail as provided in Section 11.06, accompanied by notice of cancellation. Concurrently with such tender the

Trustee shall cancel or cause to be cancelled all Certificates representing units then owned by such Ineligible Holder and for which tender has been made, and the Trustee shall issue or cause to be issued to itself a Certificate or Certificates representing the same number of Units as were so cancelled. In the event the tender is refused by the Ineligible Holder or if he cannot be located after reasonable efforts to do so, the tendered sum shall be held by the Trustee in an interest bearing account for the benefit of such Ineligible Holder, until proper claim for same (together with interest accrued thereon) has been made by such Holder, but subject to applicable laws concerning unclaimed property.

(c) The Trustee may, in its sole discretion, cancel any Units acquired in accordance with the foregoing procedures or may sell such Units, either publicly or privately, in accordance with all applicable laws. The proceeds of any such sale of Units, less the expenses of such sale, will constitute revenues of the Trust.

(d) The Trustee may, in its sole discretion, borrow any amounts required to purchase Units in accordance with the procedures described above.

3.16. *Miscellaneous.* Except as otherwise provided in this Indenture, this Indenture and the Trust shall be governed, construed, administered and controlled by and under the laws of the State of Texas, and the rights, powers, duties and liabilities of the Trustee shall be in accordance with and governed by the terms and provisions of the Texas Trust Act and other applicable laws of the State of Texas in effect at any applicable time.

ARTICLE IV

BENEFICIAL SHARES AND CERTIFICATES

4.01. *Creation and Distribution.* The entire Beneficial Interest shall be divided into that number of Units which is equal to the number of whole shares of common stock of the Company issued and outstanding on the record date for determination of stockholders of the Company entitled to receive Units. The ownership of the Units shall be evidenced by Certificates in substantially the form set forth on Schedule 1 hereto, containing such changes or alterations of form, but not substance, as the Trustee shall from time to time, in its discretion, deem necessary or desirable. Initially, the Company shall own all of the Units. However, the Company intends to distribute to each of its stockholders of record as of the close of business on the date fixed for determining stockholders of the Company entitled to receive Units one Unit for each share of the common stock of the Company so owned of record by such stockholder. The Trustee shall forthwith issue Certificates to such person evidencing the number of Units distributed to such person.

4.02. *Rights of Unit Holders.* The Unit Holders shall own pro rata the Beneficial Interest and shall be entitled to participate pro rata in the rights and benefits of the Unit Holders under this Indenture. A Unit Holder by assignment or otherwise takes and holds the same subject to all the terms and provisions of this Indenture and the Conveyances, which shall be binding upon and inure to the benefit of the heirs, personal representatives, successors and assigns of the Unit Holder. By an assignment or transfer of one or more Units represented by a Certificate, the assignor thereby shall, effective as of the close of business on the date of transfer and with respect to such assigned or transferred Unit or Units, part with, except as provided in Section 4.04 in the case of a transfer after a Monthly Record Date and prior to the corresponding payment date, (i) all his Beneficial Interest attributable thereto; (ii) all his rights in, to and under such Certificate; and (iii) all interests, rights and benefits under this Trust of a Unit Holder which are attributable to such Unit or Units as against all other Unit Holders and the Trustee. The Certificates, the Units and the rights, benefits and interests evidenced by either or both (including, without limiting the foregoing, the entire Beneficial Interest) are and shall be held and construed to be in all respects intangible personal property, and the Certificates and Units evidenced thereby shall be bequeathed, assigned, disposed of and distributed as intangible personal property. No Unit Holder as such shall have any legal title in or to any real property interest which is a part of the Trust Estate, including, without limiting the foregoing, the Royalties or any part thereof, but the sole interest of each Unit Holder

shall be such Unit Holder's Beneficial Interest and the obligation of the Trustee to hold, manage and dispose of the Trust Estate and to account for the same as in this Indenture provided. No Unit Holder shall have the right to call for or demand or secure any partition or distribution of the Royalties during the continuance of the Trust or during the period of liquidation and winding up under Section 9.03.

4.03. *Execution of Certificates.* All Certificates shall be signed by a duly authorized officer of the Trustee. Certificates may be signed and sealed on behalf of the Trustee by such persons as at the actual date of the signing and sealing of such Certificates shall be the proper officers of the Trustee, although at the nominal date of such Certificates any such person shall not have been such officer of the Trustee. Any such signature may be the manual or facsimile signature of such officers and may be affixed, imprinted or otherwise reproduced on the Certificate.

4.04. *Registration and Transfer of Units.* The Units shall be transferable as against the Trustee only on the records of the Trustee upon the surrender of Certificates and compliance with such reasonable regulations as it may prescribe. No service charge shall be made to Unit Holders or Transferee for any transfer of a Unit, but the Trustee may require payment of a sum sufficient to cover any tax or other governmental charge that may be imposed in relation thereto. Until any such transfer the Trustee may treat the owner of any Certificate as shown by its records as the owner of the Units evidenced thereby and shall not be charged with notice by any other party of any claim or demand respecting such Certificate or the interest represented thereby. A transfer of a Unit after any Monthly Record Date shall not transfer to the Transferee the right of the transferor to any sum payable to such transferor as the holder of the Certificate of record on said day. As to matters affecting the title, ownership, warranty or transfer of Certificates, Article 8 of the Uniform Commercial Code, the Texas Uniform Act for Simplification of Fiduciary Security Transfers under Chapter 33 of the Texas Business and Commerce Code and other statutes and rules with respect to the transfer of securities, each as adopted and then in force in the State of Texas, shall govern and apply. The death of any Unit Holder shall not entitle the Transferee to an account or valuation for any purpose, but such Transferee shall succeed to all rights of the deceased Unit Holder under this Indenture upon proper proof of title satisfactory to the Trustee.

4.05. *Mutilated, Lost, Stolen and Destroyed Certificates.* If any Certificate is lost, stolen, destroyed or mutilated, the Trustee, in its discretion and upon proof satisfactory to the Trustee, together with a surety bond sufficient in the opinion of the Trustee to indemnify the Trustee against all loss or expenses in the premises (if deemed advisable by the Trustee), and surrender of the mutilated Certificate, will issue a new Certificate to the holder of such lost, stolen, destroyed or mutilated Certificate as shown by the records of the Trustee, upon payment of a reasonable charge of the Trustee and any reasonable expenses incurred by it in connection therewith.

4.06. *Protection of Trustee.* The Trustee shall be protected in acting upon any notice, credential, certificate, assignment or other document or instrument believed by the Trustee to be genuine and to be signed by the proper party or parties. The Trustee is specifically authorized to rely upon the application of Article 8 of the Uniform Commercial Code, the application of the Texas Uniform Act for Simplification of Fiduciary Security Transfers under Chapter 33 of the Texas Business and Commerce Code and the application of other statutes and rules with respect to the transfer of securities, each as adopted and then in force in the State of Texas, as to all matters affecting title, ownership, warranty or transfer of the Certificates and the Units represented thereby, without any personal liability for such reliance, and the indemnity granted under Section 6.02 shall specifically extend to any matters arising as a result thereof.

4.07. *Determination of Ownership of Certificates.* In the event of any disagreement between persons claiming to be Transferees of any Unit Holder, the Trustee shall be entitled at its option to refuse to recognize any such claims so long as such disagreement shall continue. In so refusing, the Trustee may elect to make no delivery or other disposition of the interest represented by the Certificate involved, or any part thereof, or of any sum or sums of money, accrued or accruing thereunder, and, in so doing, the Trustee shall not be or become liable to any Person for the failure or refusal of the

Trustee to comply with such conflicting claims, and the Trustee shall be entitled to continue so to refrain and refuse so to act, until

(a) the right of the adverse claimants have been adjudicated by a final judgment of a court assuming and having jurisdiction of the parties and the interest and money involved, or

(b) all differences have been adjusted by valid agreement between said parties and the Trustee shall have been notified thereof in writing signed by all of the interested parties.

ARTICLE V

ACCOUNTING AND DISTRIBUTIONS

5.01. *Fiscal Year and Accounting Method.* The fiscal year of the Trust shall be the calendar year. The Trustee shall maintain its books in accordance with generally accepted accounting principles or such other method as will provide appropriate financial data responsive to the needs of the Unit Holders.

5.02. *Distributions.* On the Distribution Date of each month, the Trustee will distribute pro rata to Certificate Holders of record on the Monthly Record Date for such month the Monthly Distribution Amount for that month.

5.03. *Federal Income Tax Reporting.* For federal income tax purposes, the Trustee shall file such returns and statements as in its judgment are required to comply with applicable provisions of the Code and regulations and to permit each Unit Holder correctly to report such Unit Holder's share of the income and deductions of the Trust. The Trustee will treat all income and deductions of the Trust for each month as having been realized on the Monthly Record Date for such month unless otherwise advised by its counsel or the Internal Revenue Service. If prior to the due date for filing a corporate federal income tax return for 1980 there has not been received from the Internal Revenue Service a ruling confirming that the Trust will not, for purpose of such tax, be treated as an association taxable as a corporation, the Trustee will, upon advice of tax counsel, (i) file a corporate tax return and pay the tax shown thereby on income earned during 1980 and (ii) forthwith institute, and diligently prosecute to the court of last resort, a claim for refund of such tax. In all future years, the Trustee will report as a grantor trust until and unless the foregoing claim is finally decided adversely to the Trust.

5.04. *Reports to Unit Holders.* As promptly as practicable following the end of each calendar quarter, the Trustee shall mail to each Person who was a Unit Holder of record on a Monthly Record Date during such quarter a report which shall show in reasonable detail such information as is necessary to permit holders of units to make all calculations necessary for tax purposes including depletion, and which shall show the assets and liabilities and receipts and disbursements of the Trust for such quarter and for each month in such quarter. Within 90 days following the end of each fiscal year, the Trustee shall mail, to each Person of record on a date to be selected by the Trustee, an annual report containing financial statements audited by a nationally recognized firm of independent public accountants selected by the Trustee. Notwithstanding the foregoing, the Trustee will furnish to the Unit Holders such reports, in such manner, as are at any time required by law or by regulations of any stock exchange on which the Units are listed.

ARTICLE VI

LIABILITY OF TRUSTEE AND METHOD OF SUCCESSION

6.01. *Liability of Trustee.*

(a) Except as otherwise provided herein and specifically except as provided in paragraph (b) below, the Trustee, in carrying out its powers and performing its duties, may act in its discretion and shall be personally or individually liable only for fraud or for acts or omissions in bad faith and shall not individually or personally be liable for any act or omission of any agent or employee of the Trustee unless the Trustee has acted in bad faith in the selection and retention of such agent or employee.

(b) If the Trustee enters into a contract on behalf of the the Trust Estate without ensuring that any liability arising out of such contract shall be satisfiable only out of the Trust Estate and shall not in any event, including the exhaustion of the Trust Estate, be satisfiable out of amounts at any time distributed to any Unit Holder or out of any other assets owned by any Unit Holder, then Trustee, vis-a-vis the Unit Holders, shall be fully and exclusively liable for such liability, but shall have the right to be indemnified and reimbursed from the Trust Estate to the extent provided in Section 6.02.

6.02. *Indemnification of Trustee.* The Trustee shall be indemnified by, and receive reimbursement from, the Trust Estate against and from any and all liability, expense, claims, damages or loss incurred by it individually or as Trustee in the administration of the Trust and the Trust Estate or any part or parts thereof, or in the doing of any act done or performed or omission occurring on account of its being Trustee, except such liability, expense, claims, damages or loss as to which it is liable under Section 6.01(a). Trustee shall have a lien upon the Trust Estate to secure it for such indemnification and reimbursement and for compensation to be paid to Trustee. Except as provided in Section 4.05, neither the Trustee nor any agent or employee of the Trustee shall be entitled to any reimbursement or indemnification from any Unit Holder for any liability, expense, claims, damages or loss incurred by the Trustee or any such agent or employee, their right of reimbursement and indemnification, if any, being limited solely to the Trust Estate, whether or not the Trust Estate is exhausted without full reimbursement or indemnification of the Trustee or any such agent or employee.

6.03. *Resignation of Trustee.* The Trustee may resign, with or without cause, at any time by written notice to each of the then Unit Holders, given by registered mail addressed to each such holder at such holder's last known post office address as shown by the records of the Trustee at the time such notice is given. Such notice shall specify a date when such resignation shall take effect, which shall be a Business Day not less than ninety (90) days after the date such notice is mailed. In case of such resignation, the Trustee will use its best efforts to nominate a successor, to call a meeting of Unit Holders for the purpose of appointing a successor, and to solicit proxies for such meeting.

6.04. *Removal of Trustee.* The Trustee may be removed, with or without cause, at a meeting held in accordance with the requirements of Article VIII by the affirmative vote of the holders of a majority of all the Units then outstanding.

6.05. *Appointment of Successor Trustee.* In the event of a vacancy in the position of Trustee or if a Trustee has given notice of its intention to resign, the Unit Holders present or represented at a meeting held in accordance with the requirements of Article VIII may appoint a successor Trustee. Nominees for appointment may be made by (i) the resigned or removed Trustee and (ii) any Unit Holder or Unit Holders owning at least 15% of the Units. Any such successor Trustee shall be a bank or trust company having a capital, surplus and undivided profits (as of the end of its last fiscal year prior to its appointment) of at least \$50,000,000. In the event that a vacancy in the position of Trustee continues for sixty (60) days, a successor Trustee may be appointed by any State or Federal District Court holding terms in Tarrant County, Texas, upon the application of any Unit Holder, and in the event any such application is filed, such court may appoint a temporary Trustee at any time after such application is filed with it which shall, pending the final appointment of a Trustee, have such powers and duties as the court appointing such temporary Trustee shall provide in its order of appointment, consistent with the provisions of this Indenture.

Immediately upon the appointment of any successor Trustee, all rights, titles, duties, powers and authority of the succeeded Trustee hereunder shall be vested in and undertaken by the successor Trustee which shall be entitled to receive from the Trustee which it succeeds all of the Trust Estate held by it hereunder and all records and files in connection therewith. No successor Trustee shall be obligated to examine or seek alteration of any account of any preceding Trustee, nor shall any successor Trustee be liable personally for failing to do so or for any act or omission of any preceding Trustee. The preceding sentence shall not prevent any successor Trustee or anyone else from taking any action otherwise permissible in connection with any such account.

ARTICLE VII

COMPENSATION OF THE TRUSTEE

7.01. *Compensation of Trustee.* The Trustee shall receive compensation for its services as Trustee hereunder and as transfer agent as set forth in Schedule 2 attached hereto.

7.02. *Expenses.* The out-of-pocket costs incurred by the Trustee for long distance telephone calls, overtime necessitated by rush orders, travel, legal services, stationery, binders, envelopes, ledger sheets, transfer sheets, checks, Certificate list sheets, postage and insurance will be reimbursed to the Trustee at actual cost.

7.03. *Other Services.* The Trustee shall be reimbursed for actual expenditures made on account of any unusual duties in connection with matters pertaining to the Trust. In the event of litigation involving the Trust, audits or inspection of the records of the Trust pertaining to the transactions affecting the Trust or any other unusual or extraordinary services rendered in connection with the administration of the Trust, Trustee shall be entitled to receive reasonable compensation for the services rendered.

7.04. *Source of Funds.* All compensation, reimbursements and other charges owing to the Trustee will be payable by the Trust out of the Trust Estate.

ARTICLE VIII

MEETINGS OF UNIT HOLDERS

8.01. *Purpose of Meetings.* A meeting of the Unit Holders may be called at any time and from time to time pursuant to the provisions of this Article to transact any matter that the Unit Holders may be authorized to transact.

8.02. *Call and Notice of Meetings.* Any such meeting of the Unit Holders may be called by the Trustee in its discretion and will be called by the Trustee at the written request of Unit Holders owning not less than 15% in number of the Units represented by the then outstanding Certificates. All such meetings shall be held at such time and at such place in Fort Worth, Texas, as the notice of any such meeting may designate. Written notice of every meeting of the Unit Holders signed by the Trustee setting forth the time and place of the meeting and in general terms the matters proposed to be acted upon at such meeting shall be given in person or by mail not more than 60 nor less than 20 days before such meeting is to be held to all of the Unit Holders of record not more than 60 days before the date of such mailing. No matter other than that stated in the notice shall be acted upon at any meeting.

8.03. *Voting.* Each Unit Holder shall be entitled to one vote for each Unit owned by such Unit Holder, and any Unit Holder may vote in person or by duly executed written proxy. At any such meeting the presence in person or by proxy of Unit Holders holding a majority of the Units at the time outstanding shall constitute a quorum, and, except as otherwise specifically provided herein, any matter shall be deemed to have been approved by the Unit Holders if it is approved by the vote of a majority in interest of such Unit Holders constituting a quorum, although less than a majority of all of the Units at the time outstanding, except that the affirmative vote by the Unit Holders of at least 75% of all the Units then outstanding shall be required to:

- (a) approve or authorize any sale of all or any part of the assets of the Trust, or
- (b) terminate the Trust pursuant to Section 9.02(b), or
- (c) approve any amendment to or affecting this Section 8.03.

8.04. *Conduct of Meetings.* The Trustee may make such reasonable regulations consistent with the provisions hereof as it may deem advisable for any meeting of the Unit Holders, including regulations covering the closing of the transfer books of the Trustee for purposes of determining

Unit Holders entitled to notice of or to vote at any meeting, the appointment of proxies, the appointment and duties of inspectors of votes, the submission and examination of proxies, certificates and other evidence of the right to vote, the preparation and use at the meeting of a list authenticated by or on behalf of the Trustee of the Unit Holders entitled to vote at the meeting and such other matters concerning the calling and conduct of the meeting as it shall deem advisable.

ARTICLE IX

DURATION, REVOCATION AND TERMINATION OF TRUST

9.01. *Revocation.* The Trust is and shall be irrevocable and Company retains no power to alter, amend or terminate the Trust. The Trust shall be terminable only as provided in Section 9.02, and shall continue until so terminated.

9.02. *Termination.* The Trust shall terminate upon the first to occur of the following events:

(a) at such time as its gross revenue for each of two successive years after the year 1980 is less than \$1,000,000 per year,

(b) a vote in favor of termination by the Unit Holders present or represented at a meeting held in accordance with the requirements of Article VIII, or

(c) the expiration of twenty-one years after the death of the last survivor of the lawful descendants of any degree of the signers of the Declaration of Independence in being on the date of execution hereof.

9.03. *Disposition and Distribution of Properties.* For the purpose of liquidating and winding up the affairs of the Trust at its termination, the Trustee shall continue to act as such and exercise each power until its duties have been fully performed and the Trust Estate finally distributed. Upon the termination of the Trust, the Trustee shall sell for cash in one or more sales all the properties other than cash then constituting the Trust Estate. The Trustee shall as promptly as possible distribute the proceeds of any such sales and any other cash in the Trust Estate according to the respective interests and rights of the Unit Holders, after paying, satisfying and discharging all of the liabilities of the Trust, or, when necessary, setting up reserves in such amounts as Trustee in its discretion deems appropriate for contingent liabilities. In the event that any property which the Trustee is required to sell is not sold by the Trustee within three years after the termination of the Trust, the Trustee shall cause such property to be sold at public auction to the highest cash bidder. Notice of such sale by auction shall be mailed at least thirty days prior to such sale to each Unit Holder at such Unit Holder's address as it appears upon the books of the Trustee. The Trustee shall not be required to obtain approval of the Unit Holders prior to selling property pursuant to this Section. Upon making final distribution to the Unit Holders, the Trustee shall be under no further liability except as provided in Section 6.01(b).

ARTICLE X

AMENDMENTS

10.01. *Prohibited.* No amendment may be made to any provision of the Indenture which would

(a) alter the purposes of the Trust or permit the Trustee to engage in any business or investment activities substantially different from those specified herein;

(b) alter the rights of the Unit Holders vis-a-vis each other; or

(c) permit the Trustee to distribute the Royalties in kind either during the continuation of the Trust or during the period of liquidation or winding up under Section 9.03.

10.02. *Permitted.* All other amendments to the provisions of the Indenture may be made by a vote of the Unit Holders present or represented at a meeting held in accordance with the requirements

of Article VIII; provided that no amendment shall be effective without the express written approval of the Trustee.

ARTICLE XI

MISCELLANEOUS

11.01. *Inspection of Trustee's Books.* Each Unit Holder and such Unit Holder's duly authorized agents, attorneys and auditors shall have the right during reasonable business hours to examine, inspect and make audits of the Trust and records of the Trustee, including lists of Unit Holders for any proper purpose in reference thereto.

11.02. *Trustee's Employment of Experts.* The Trustee may, but shall not be required to, consult with counsel, who may be its own counsel, accountants, geologists, engineers and other parties deemed by the Trustee to be qualified as experts on the matters submitted to them, and the opinion of any such parties on any matter submitted to them by the Trustee shall be full and complete authorization and protection in respect of any action taken or suffered by it hereunder in good faith and in accordance with the opinion of any such party.

11.03. *Merger or Consolidation of Trustee.* Neither a change of name of the Trustee nor any merger or consolidation of its corporate powers with another bank or with a trust company shall affect its right or capacity to act hereunder.

11.04. *Filing of this Indenture.* Neither this Indenture nor any executed copy hereof need be filed in any county in which any of the Trust Estate is located, but the same may be filed for record in any county by the Trustee. In order to avoid the necessity of filing this Indenture for record, the Trustee agrees that for the purpose of vesting the record title to the Royalties in any successor to the Trustee, the retiring Trustee will, upon appointment of any successor Trustee, execute and deliver to such successor Trustee appropriate assignments or conveyances.

11.05. *Severability.* If any provision of this Indenture or the application thereof to any Person or circumstances shall be finally determined by a court of proper jurisdiction to be illegal, invalid or unenforceable to any extent, the remainder of this Indenture or the application of such provision to Persons or circumstances, other than those as to which it is held illegal, invalid or unenforceable, shall not be affected thereby, and every provision of this Indenture shall be valid and enforced to the fullest extent permitted by law.

11.06. *Notices.* Any notice or demand which by any provision of this Indenture is required or permitted to be given or served upon the Trustee by any Unit Holder may be given or served by being deposited, postage prepaid and by registered or certified mail, in a post office or letter box addressed (until another address is designated by notice to the Unit Holders) to the Trustee at Post Office Box 2260, Fort Worth, Texas 76113. Any notice or other communication by the Trustee to any Unit Holder shall be deemed to have been sufficiently given, for all purposes, when deposited, postage prepaid, in a post office or letter box addressed to said Unit Holder at his address as shown on the records of the Trustee.

11.07. *Counterparts.* This Indenture may be executed in a number of counterparts, each of which shall constitute an original, but such counterparts shall together constitute but one and the same instrument.

IN WITNESS WHEREOF, the Company has caused this Indenture to be executed by its duly authorized _____ and its seal to be hereunto affixed and attested by its duly authorized Secretary or Assistant Secretary and the Trustee has caused this Indenture to be executed by its duly authorized _____ and its seal to be hereto affixed and attested by its duly authorized _____, the day and year first above written at Fort Worth, Tarrant County, Texas.

SOUTHLAND ROYALTY COMPANY

ATTEST:

By _____

Secretary

TRUSTOR

ATTEST: _____

THE FIRST NATIONAL BANK OF
FORT WORTH

By _____

TRUSTEE

THE STATE OF TEXAS }
COUNTY OF TARRANT }

The foregoing instrument was acknowledged before me this _____ day of _____, 1980 by
_____ of Southland Royalty Com-

(Name) Title
pany, a corporation, on behalf of said corporation.

GIVEN UNDER MY HAND AND SEAL OF OFFICE, this the _____ day of _____, 19__ .

My Commission Expires:

*Notary Public in and for
Tarrant County, Texas*

THE STATE OF TEXAS }
COUNTY OF TARRANT }

The foregoing instrument was acknowledged before me this _____ day of _____, 1980 by
_____ of The First National Bank

(Name) Title
of Fort Worth, a banking association organized under the laws of the United States, on behalf of said
corporation.

GIVEN UNDER MY HAND AND SEAL OF OFFICE, this the _____ day of _____, 19__ .

My Commission Expires:

*Notary Public in and for
Tarrant County, Texas*

SCHEDULE 2
TRUSTEE COMPENSATION

A. Administrative Fee.

For all administrative services, preparation of quarterly and annual statements with attention to tax and legal matters:

1. 1/20 of 1% of the first \$100 million of the annual gross revenue of the Trust, and 1/30 of 1% of the annual gross revenue of the Trust in excess of \$100 million.
2. Trustee's standard hourly rates for time in excess of 300 hours annually.

B. Transfer Agency Fee.

1. \$4.92 annually per Unit Holder account for maintaining computer records of each Unit Holder, name and address of record, tax identification number, outstanding Unit balances, alternative payee, various coded fields of pertinent information; for processing change of address and tax identification numbers; posting each Certificate cancelled or issued; issuance of 10,000 Certificates; processing request and documentation required for replacement of lost or destroyed Certificates; for placing and/or removing stop transfer orders; registering Certificates; disbursing the Monthly Distribution Amounts; preparing and mailing required Internal Revenue Service forms; mailing of proxies and other related material; tabulation of proxies; and maintenance and printing of Unit Holder list.

2. For Certificates issued, registered and posted in excess of 10,000 annually, \$1.00 for each Certificate.

3. The transfer agency fees stated above will be subject to escalation based upon the general rise in prices in the economy. The index used will be the Producers Price Index as published by the United States Department of Labor, Bureau of Labor Statistics or such equivalent index as may be published from time to time. All transfer agency fees will be adjusted annually by the percentage rise in this index on a December-to-December basis beginning December 31, 1981.

C. Termination Fee.

A fee will be charged upon termination of the Trust commensurate with the amount of work and responsibility involved which shall not exceed 10% of the proceeds received and distributed in connection with the termination liquidation; provided that termination is accomplished under Article 9.02(a) of the Trust Indenture. Under any other method of termination, fees will be charged on an hourly basis only.

D. Invested Funds.

To the extent consistent with the Trust Indenture and applicable statutes and regulations, funds held by the Trustee will be invested after receipt thereof until the next succeeding Distribution Date in such investments as are permitted by the Trust Indenture and the income so earned will be disbursed to the Unit Holders in accordance with the provisions of the Trust Indenture.

After funds are disbursed on the Distribution Date, an analysis will be made by the Trustee of the disbursement account or accounts and a credit for funds as calculated under the practice as it exists in the Trustee bank at the time and, from time to time, will be applied to reduce the administrative fee described in paragraph A above charged by the Trustee at the next administrative fee payment date. In no event shall the credit exceed the administrative fee.

SAN JUAN BASIN ROYALTY TRUST INDENTURE

This Royalty Trust Indenture ("Indenture") entered into as of _____, 1980, between Southland Royalty Company, a Delaware corporation with its principal office in Fort Worth, Texas (the "Company"), as Trustor, and The Fort Worth National Bank, a banking association organized under the laws of the United States with its principal place of business in Fort Worth, Texas (the "Bank"), as Trustee, evidences that the Company has for many years been engaged in the business of exploring for, producing and marketing oil and gas, and now owns oil and gas leasehold interests, fee mineral interests, royalty and overriding royalty interests in lands located in the San Juan Basin in New Mexico which contain proven reserves and are currently producing oil and gas; that the Company has determined that it would be in the best interest of its shareholders to carve out and distribute to such shareholders certain net overriding royalties in such leasehold, mineral and royalty interests (the "Royalties") by means of the conveyance attached hereto as Exhibit I to this Indenture (the "Conveyance"); that since it would be impractical to distribute legal title to undivided interests in the Royalties to each shareholder, and the shareholders have approved the transfer by Company by means of the Conveyance of the Royalties to the Bank, to be held in trust for the benefit of the shareholders on the date of execution hereof, and their respective heirs, personal representatives, successors and assigns, as more particularly provided herein, and the Bank has agreed to accept the Conveyance on such terms; that the Company is contemporaneously executing the Conveyance to the Bank; and that accordingly, the Company, by delivery of the Conveyance, grants, bargains, assigns and delivers the Royalties to the Bank, as trustee in trust and the Bank accepts the Conveyance and the Royalties and the Company and the Bank agree that such assets and all other assets received by the Bank pursuant to this Indenture in trust shall be held, administered, paid and delivered for the purposes and subject to the terms and conditions hereafter provided.

ARTICLE I

DEFINITIONS

As used herein, the following terms are used with the meanings indicated:

"Business Day" means any day which is not a Saturday, Sunday or other day on which national banking institutions in the City of Fort Worth, Texas, are closed as authorized or required by law.

"Beneficial Interest" means the equitable interest of the Unit Holders in the Trust Estate as expressly set out in this Trust Indenture and all other rights of beneficiaries of express trusts created under the Texas Trust Act, subject to the limitations set forth in this Trust Indenture.

"Certificate" means a certificate issued by the Trustee pursuant to Article IV evidencing the ownership of one or more Units.

"Code" means the Internal Revenue Code of 1954 as amended.

"Distribution Date" means the date of any distribution, which shall be on or before ten (10) Business Days after a Monthly Record Date.

"Indenture" means this instrument, as originally executed, or, if amended or supplemented, as so amended or supplemented.

"Monthly Distribution Amount" for any Monthly Period means the sum of (a) the cash received by the Trustee during the Monthly Period attributable to the Royalties, (b) any cash available for distribution as a result of the reduction or elimination during the Monthly

Period of any existing cash reserve created pursuant to Section 3.08 hereof to provide for the payment of liabilities of the Trust, and (c) any other cash receipts of the Trust during the Monthly Period, including without limitation any cash received from interest earned pursuant to Section 3.04 reduced by the sum of (d) the liabilities of the Trust paid during the Monthly Period and (e) the amount of any cash used pursuant to Section 3.08 hereof in the Monthly Period to establish or increase a cash reserve for the payment of any accrued, future or contingent liabilities of the Trust. If the Monthly Distribution Amount determined in accordance with the preceding sentence shall for any Monthly Period be a negative amount, then the Monthly Distribution Amount shall be zero, and such negative amount shall reduce the next Monthly Distribution Amount.

Notwithstanding the foregoing, the Monthly Distribution Amount for any Monthly Period shall not include any amount which would have been required to be reported to any stock exchange on which the Units are listed in connection with the establishment of an 'ex' date in order to be distributed to Unit Holders who were such on the Monthly Record Date for such Monthly Period but was not so reported unless the stock exchange agrees to such amount being a part of that Monthly Period's Monthly Distribution Amount or the Trustee receives an opinion of counsel stating that none of the Trust, the Trustee or any owner of Units will be adversely affected by such inclusion. An amount which pursuant to the preceding sentence is not included in the Monthly Distribution Amount for that Monthly Period shall be included in the Monthly Distribution Amount for the next Monthly Period (unless it is reserved pursuant to Section 3.08 hereof).

"Monthly Period" means the period which commences on the day after the date of creation of the Trust or a Monthly Record Date and continues through and includes the next succeeding Monthly Record Date, which shall be the Monthly Record Date for such Monthly Period.

"Monthly Record Date" for each month means the close of business on the last Business Day of such month unless the Trustee determines that a later date is required to comply with applicable law or the rules of any exchange on which the Units may be listed, in which event it means such later date.

"Person" means an individual, a corporation, partnership, trust, estate or other organization.

"Royalties" means the net overriding royalty interests conveyed to the Trustee pursuant to the Conveyances.

"Transferee", as to any Unit Holder or former Unit Holder, means any Person succeeding to the interest of such Unit Holder or former Unit Holder in one or more Units of the Trust, whether as purchaser, donee, legatee or otherwise.

"Trust" means the express trust created hereby which shall be held and administered as provided herein and in accordance with the terms and provisions (not inconsistent with any terms and provisions hereof) of the Texas Trust Act.

"Trust Estate" means the assets held by the Trustee under this Indenture, and shall include both income and principal if separate accounts or records are kept therefor.

"Trustee" means the initial Trustee under this instrument, or any successor, during the period it is so serving in such capacity.

"Unit" means an undivided fractional interest in the Beneficial Interest, determined as hereinafter provided.

"Unit Holder" means the owner of one or more Units as reflected on the books of the Trustee pursuant to Article IV.

ARTICLE II

NAME AND PURPOSE OF THE TRUST

2.01. *Name.* The Trust shall be known as the San Juan Basin Royalty Trust, and the Trustee may transact the affairs of the Trust in that name.

2.02. *Purposes.* The purposes of the Trust are:

(a) to convert the Royalties to cash either (1) by retaining them and collecting the proceeds from production until production has ceased or the Royalties have otherwise terminated or (2) by selling or otherwise disposing of the Royalties (within the limits stated herein); and

(b) to distribute such cash, net of amounts for payment of liabilities of the Trust, to the Unit Holders pro rata.

It is the intention and agreement of the Company and the Trustee to create an express Trust within the meaning of Section 2 of the Texas Trust Act, for the benefit of the owners of Units, and a grantor trust for federal income tax purposes of which the owners of Units are the grantors. As set forth above and amplified herein, the Trust is intended to be limited to the receipt of revenues attributable to the Royalties and the distribution of such revenues, after payment of or provision for Trust expenses and liabilities, to the Unit Holders. It is neither the purpose nor the intention of the parties hereto to create, and nothing in this Trust Indenture shall be construed as creating, a partnership, joint venture, joint stock company or business association between or among Unit Holders, present or future, or among or between Unit Holders, or any of them, and the Trustee or the Company.

ARTICLE III

ADMINISTRATION OF THE TRUST

3.01. *General.* Subject to the limitations set forth in this Indenture, the Trustee is authorized to take such action as in its judgment is necessary or advisable best to achieve the purposes of the Trust, including the authority to agree to modifications or settlements of the terms of the Conveyance or to settle disputes with respect thereto, so long as such modifications or settlements do not alter the nature of the Royalties as rights to receive a share of the proceeds of oil and gas produced from the properties presently burdened by such Royalties which are free of any obligation for operating expenses and as rights which do not possess any operating rights or obligations. The Trustee may not dispose of all or any portion of the Royalties except as provided in Sections 3.02, 3.09 and 9.03.

The Trustee will cause the Trust to file any registration statement, report or other materials required by law (including the Securities Exchange Act of 1934 and the rules thereunder) or by any securities exchange on which the Units are at any time registered.

3.02. *Limited Power to Dispose of Royalties.* In the event the Trustee determines it to be in the best interests of the Unit Holders the Trustee may sell at any time and from time to time all or any part of any of the Royalties for cash in such a manner as it deems in the best interest of the Unit Holders if approved by the Unit Holders present or represented at a meeting held in accordance with the requirements of Article VIII but without such approval it may not sell or otherwise dispose of all or any part of the Royalties. This Section 3.02 shall not be construed to require approval of the Unit Holders for any sale or other disposition of all or any part of the Royalties pursuant to Sections 3.09 or 9.03. The Trustee is authorized to retain any of the Royalties in the form in which such property was transferred to the Trustee, without regard to any requirement to diversify investments or other requirements.

3.03. *No Power to Engage in Business or Make Investments.* The Trustee shall not, in its capacity as Trustee under the Trust, engage in any business or commercial activity of any kind whatsoever and shall not, under any circumstances, use any portion of the Trust Estate to acquire any oil and gas lease, royalty or other mineral interest other than the Royalties, or, except as permitted in Sections 3.04 and 3.15, acquire any other asset. The Trustee shall not accept contributions to the Trust other than the Royalties.

3.04. Interest on Cash on Hand. Cash being held by the Trustee as a reserve for liabilities or for distribution at the next Distribution Date shall be placed (in the Trustee's discretion) in:

(a) obligations issued by (or unconditionally guaranteed by) the United States or any agency or instrumentality thereof (provided such agency's or instrumentality's such obligations are secured by the full faith and credit of the United States); or

(b) repurchase agreements secured by obligations qualifying under subparagraph (a) above; or

(c) certificates of deposit of any bank having a capital, surplus and undivided profits in excess of \$50,000,000;

provided such repurchase agreements or certificates shall bear interest at a rate which is the greater of (i) the interest rate which the Bank or its successor pays in the normal course of business on amounts placed with it, taking into account the amounts involved, the period held and other relevant factors, or (ii) the rate of interest paid on obligations qualifying under subparagraph (a) above. Any such obligations, repurchase agreements or certificates must mature on or before the next succeeding Distribution Date and must be held to maturity. To the extent not prohibited by Section 11 of the Texas Trust Act any such cash may be placed with Bank or any successor bank serving as Trustee.

3.05. Power to Settle Claims. The Trustee is authorized to prosecute or defend, or to settle by arbitration or otherwise, any claim of or against the Trustee, the Trust or the Trust Estate, to waive or release rights of any kind and to pay or satisfy any debt, tax or claim upon any evidence by it deemed sufficient.

3.06. Power to Contract for Services. In the administration of the Trust, the Trustee is empowered to employ oil and gas consultants, accountants, attorneys, transfer agents and other professional and expert persons and to employ or contract for clerical and other administrative assistance and to make payments of all fees for services or expenses in any manner thus incurred out of the Trust Estate.

3.07. Payment of Liabilities of Trust. The Trustee shall, to the extent that funds of the Trust are available therefor, make payment of all liabilities of the Trust, including, but without limiting the generality of the foregoing, all expenses, taxes, liabilities incurred of all kinds, compensation to it for its services hereunder, and compensation to such parties as may be consulted as provided for in Section 3.06 hereof.

3.08. Establishment of Reserves. With respect to any liability which is contingent or uncertain in amount or which otherwise is not currently due and payable, the Trustee in its sole discretion may, but is not obligated to, establish a cash reserve for the payment of such liability.

3.09. Limited Power to Borrow. If at any time the cash on hand and to be received by the Trustee is not, or will not, in the judgment of the Trustee, be sufficient to pay liabilities of the Trust as they become due, the Trustee is authorized to borrow the funds required to pay such liabilities. In such event, no further distributions will be made to Unit Holders until the indebtedness created by such borrowing has been paid in full. Such funds may be borrowed from any Person, including, without limitation, the Bank or any other fiduciary hereunder. To secure payment of such indebtedness, the Trustee is authorized to mortgage, pledge, grant security interests in or otherwise encumber (and to include as a part thereof any and all terms, powers, remedies, covenants and provisions deemed necessary or advisable in the Trustee's discretion, including, without limitation, the power of sale with or without judicial proceedings) the Trust Estate, or any portion thereof, including the Royalties, and to carve out and convey production payments.

3.10. Income and Principal. The Trustee shall not be required to keep separate accounts or records for income and principal or maintain any reserves for depletion of the Royalties. However, if the Trustee does keep such separate accounts or records, then the Trustee is authorized to treat all or any part of the yield from the Royalties as income or principal, and in general to determine all questions as between income and principal and to credit or charge to income or principal or to

apportion between them any receipt or gain and any charge, disbursement or loss as is deemed advisable under the circumstances of each case.

3.11. *Term of Contracts.* In exercising the rights and powers granted hereunder, the Trustee is authorized to make the term of any transaction or contract or other instrument extend beyond the term of the Trust.

3.12. *Transactions between Related Parties.* The Trustee shall not be prohibited in any way in exercising its powers from making contracts or having dealings with itself in any other capacity (fiduciary or otherwise) or with the Company.

3.13. *No Bond Required.* The Trustee shall not be required to furnish any bond or security of any kind.

3.14. *Timing of Trust Income and Expenses.* The Trustee will use all reasonable efforts to cause the Trust and the Unit Holders to recognize income (including any income from interest earned on reserves established pursuant to Section 3.08 hereof) and expenses on Monthly Record Dates. The Trustee will invoice the Trust for services rendered by the Trustee only on a Monthly Record Date and shall cause the Trust to pay any such invoices only on the Monthly Record Date on which an invoice is rendered and will use all reasonable efforts to cause all persons to whom the Trust becomes liable to invoice the Trust for such liability on a Monthly Record Date and to cause the Trust to pay any such liabilities on the Monthly Record Date on which such liability is invoiced. In connection with the requirements of any stock exchange on which the Units are listed, the Trustee will, if required by such stock exchange, use all reasonable efforts to determine the Monthly Distribution Amount and report such amount to the exchange at such time as may be required by such stock exchange. Nothing in this Section shall be construed as requiring the Trustee to cause payment to be made for Trust liabilities on any date other than on such date as in its sole discretion it shall deem to be in the best interest of the Unit Holders.

3.15. *Divestiture of Units.* If at any time the Trust or the Trustee is named a party in any judicial or administrative proceeding which seeks the cancellation or forfeiture of any property in which the Trust has an interest because of the nationality, or any other status, of any one or more Unit Holders, the following procedures will be applicable:

(a) The Trustee will promptly give written notice ("Notice") to each holder ("Ineligible Holder") whose nationality or other status is an issue in the proceeding as to the existence of such controversy. The Notice will contain a reasonable summary of such controversy and will constitute a demand to each Ineligible Holder that he dispose of his Units, to a party which would not be an Ineligible Holder, within 30 days after the date of the Notice.

(b) If any Ineligible Holder fails to dispose of his Units as required by the Notice, the Trustee will have the preemptive right to purchase, and will purchase, any such Units at any time during the 90 days after the expiration of the 30-day period specified in the Notice. The purchase price on a per Unit basis will be determined as of the last business day ("determination day") preceding the end of the 30 day period specified in the Notice and will equal the following per Unit amount: (i) if the Units are then listed on a stock exchange, the price will equal the closing price of the Units on such exchange (or, if the Units are then listed on more than one exchange, on the largest such exchange in terms of the volume of Units traded thereon during the preceding twelve months) on the determination day if any Units were sold on such exchange on such day or, if not, on the last preceding day on which any Units were sold on such exchange, or (ii) if the Units are not then listed on any stock exchange, the price will equal the mean between the closing bid and asked prices for the Units in the over-the-counter market on the determination day if quotations for such prices on such day are available or, if not, on the last preceding day for which such quotations are available. Such purchase will be accomplished by tender of the above cash price to the Ineligible Holder at his address as shown on the records of the Trustee, either in person or by mail as provided in Section 11.06, accompanied by notice of cancellation. Concurrently with such tender the

Trustee shall cancel or cause to be cancelled all Certificates representing units then owned by such Ineligible Holder and for which tender has been made, and the Trustee shall issue or cause to be issued to itself a Certificate or Certificates representing the same number of Units as were so cancelled. In the event the tender is refused by the Ineligible Holder or if he cannot be located after reasonable efforts to do so, the tendered sum shall be held by the Trustee in an interest bearing account for the benefit of such Ineligible Holder, until proper claim for same (together with interest accrued thereon) has been made by such Holder, but subject to applicable laws concerning unclaimed property.

(c) The Trustee may, in its sole discretion, cancel any Units acquired in accordance with the foregoing procedures or may sell such Units, either publicly or privately, in accordance with all applicable laws. The proceeds of any such sale of Units, less the expenses of such sale, will constitute revenues of the Trust.

(d) The Trustee may, in its sole discretion, borrow any amounts required to purchase Units in accordance with the procedures described above.

3.16. *Miscellaneous.* Except as otherwise provided in this Indenture, this Indenture and the Trust shall be governed, construed, administered and controlled by and under the laws of the State of Texas, and the rights, powers, duties and liabilities of the Trustee shall be in accordance with and governed by the terms and provisions of the Texas Trust Act and other applicable laws of the State of Texas in effect at any applicable time.

ARTICLE IV

BENEFICIAL SHARES AND CERTIFICATES

4.01. *Creation and Distribution.* The entire Beneficial Interest shall be divided into that number of Units which is equal to the number of whole shares of common stock of the Company issued and outstanding on the record date for determination of stockholders of the Company entitled to receive Units. The ownership of the Units shall be evidenced by Certificates in substantially the form set forth on Schedule I hereto, containing such changes or alterations of form, but not substance, as the Trustee shall from time to time, in its discretion, deem necessary or desirable. Initially, the Company shall own all of the Units. However, the Company intends to distribute to each of its stockholders of record as of the close of business on the date fixed for determining stockholders of the Company entitled to receive Units one Unit for each share of the common stock of the Company so owned of record by such stockholder. The Trustee shall forthwith issue Certificates to such person evidencing the number of Units distributed to such person.

4.02. *Rights of Unit Holders.* The Unit Holders shall own pro rata the Beneficial Interest and shall be entitled to participate pro rata in the rights and benefits of the Unit Holders under this Indenture. A Unit Holder by assignment or otherwise takes and holds the same subject to all the terms and provisions of this Indenture and the Conveyances, which shall be binding upon and inure to the benefit of the heirs, personal representatives, successors and assigns of the Unit Holder. By an assignment or transfer of one or more Units represented by a Certificate, the assignor thereby shall, effective as of the close of business on the date of transfer and with respect to such assigned or transferred Unit or Units, part with, except as provided in Section 4.04 in the case of a transfer after a Monthly Record Date and prior to the corresponding payment date, (i) all his Beneficial Interest attributable thereto; (ii) all his rights in, to and under such Certificate; and (iii) all interests, rights and benefits under this Trust of a Unit Holder which are attributable to such Unit or Units as against all other Unit Holders and the Trustee. The Certificates, the Units and the rights, benefits and interests evidenced by either or both (including, without limiting the foregoing, the entire Beneficial Interest) are and shall be held and construed to be in all respects intangible personal property, and the Certificates and Units evidenced thereby shall be bequeathed, assigned, disposed of and distributed as intangible personal property. No Unit Holder as such shall have any legal title in or to any real property interest which is a part of the Trust Estate, including, without limiting the foregoing, the Royalties or any part thereof, but the sole interest of each Unit Holder

shall be such Unit Holder's Beneficial Interest and the obligation of the Trustee to hold, manage and dispose of the Trust Estate and to account for the same as in this Indenture provided. No Unit Holder shall have the right to call for or demand or secure any partition or distribution of the Royalties during the continuance of the Trust or during the period of liquidation and winding up under Section 9.03.

4.03. *Execution of Certificates.* All Certificates shall be signed by a duly authorized officer of the Trustee. Certificates may be signed and sealed on behalf of the Trustee by such persons as at the actual date of the signing and sealing of such Certificates shall be the proper officers of the Trustee, although at the nominal date of such Certificates any such person shall not have been such officer of the Trustee. Any such signature may be the manual or facsimile signature of such officers and may be affixed, imprinted or otherwise reproduced on the Certificate.

4.04. *Registration and Transfer of Units.* The Units shall be transferable as against the Trustee only on the records of the Trustee upon the surrender of Certificates and compliance with such reasonable regulations as it may prescribe. No service charge shall be made to Unit Holders or Transferees for any transfer of a Unit, but the Trustee may require payment of a sum sufficient to cover any tax or other governmental charge that may be imposed in relation thereto. Until any such transfer the Trustee may treat the owner of any Certificate as shown by its records as the owner of the Units evidenced thereby and shall not be charged with notice by any other party of any claim or demand respecting such Certificate or the interest represented thereby. A transfer of a Unit after any Monthly Record Date shall not transfer to the Transferee the right of the transferor to any sum payable to such transferor as the holder of the Certificate of record on said day. As to matters affecting the title, ownership, warranty or transfer of Certificates, Article 8 of the Uniform Commercial Code, the Texas Uniform Act for Simplification of Fiduciary Security Transfers under Chapter 33 of the Texas Business and Commerce Code and other statutes and rules with respect to the transfer of securities, each as adopted and then in force in the State of Texas, shall govern and apply. The death of any Unit Holder shall not entitle the Transferee to an account or valuation for any purpose, but such Transferee shall succeed to all rights of the deceased Unit Holder under this Indenture upon proper proof of title satisfactory to the Trustee.

4.05. *Mutilated, Lost, Stolen and Destroyed Certificates.* If any Certificate is lost, stolen, destroyed or mutilated, the Trustee, in its discretion and upon proof satisfactory to the Trustee, together with a surety bond sufficient in the opinion of the Trustee to indemnify the Trustee against all loss or expenses in the premises (if deemed advisable by the Trustee), and surrender of the mutilated Certificate, will issue a new Certificate to the holder of such lost, stolen, destroyed or mutilated Certificate as shown by the records of the Trustee, upon payment of a reasonable charge of the Trustee and any reasonable expenses incurred by it in connection therewith.

4.06. *Protection of Trustee.* The Trustee shall be protected in acting upon any notice, credential, certificate, assignment or other document or instrument believed by the Trustee to be genuine and to be signed by the proper party or parties. The Trustee is specifically authorized to rely upon the application of Article 8 of the Uniform Commercial Code, the application of the Texas Uniform Act for Simplification of Fiduciary Security Transfers under Chapter 33 of the Texas Business and Commerce Code and the application of other statutes and rules with respect to the transfer of securities, each as adopted and then in force in the State of Texas, as to all matters affecting title, ownership, warranty or transfer of the Certificates and the Units represented thereby, without any personal liability for such reliance, and the indemnity granted under Section 6.02 shall specifically extend to any matters arising as a result thereof.

4.07. *Determination of Ownership of Certificates.* In the event of any disagreement between persons claiming to be Transferees of any Unit Holder, the Trustee shall be entitled at its option to refuse to recognize any such claims so long as such disagreement shall continue. In so refusing, the Trustee may elect to make no delivery or other disposition of the interest represented by the Certificate involved, or any part thereof, or of any sum or sums of money, accrued or accruing thereunder, and, in so doing, the Trustee shall not be or become liable to any Person for the failure or refusal of the

Trustee to comply with such conflicting claims, and the Trustee shall be entitled to continue so to refrain and refuse so to act, until

(a) the right of the adverse claimants have been adjudicated by a final judgment of a court assuming and having jurisdiction of the parties and the interest and money involved, or

(b) all differences have been adjusted by valid agreement between said parties and the Trustee shall have been notified thereof in writing signed by all of the interested parties.

ARTICLE V

ACCOUNTING AND DISTRIBUTIONS

5.01. *Fiscal Year and Accounting Method.* The fiscal year of the Trust shall be the calendar year. The Trustee shall maintain its books in accordance with generally accepted accounting principles or such other method as will provide appropriate financial data responsive to the needs of the Unit Holders.

5.02. *Distributions.* On the Distribution Date of each month, the Trustee will distribute pro rata to Certificate Holders of record on the Monthly Record Date for such month the Monthly Distribution Amount for that month.

5.03. *Federal Income Tax Reporting.* For federal income tax purposes, the Trustee shall file such returns and statements as in its judgment are required to comply with applicable provisions of the Code and regulations and to permit each Unit Holder correctly to report such Unit Holder's share of the income and deductions of the Trust. The Trustee will treat all income and deductions of the Trust for each month as having been realized on the Monthly Record Date for such month unless otherwise advised by its counsel or the Internal Revenue Service. If prior to the due date for filing a corporate federal income tax return for 1980 there has not been received from the Internal Revenue Service a ruling confirming that the Trust will not, for purpose of such tax, be treated as an association taxable as a corporation, the Trustee will, upon advice of tax counsel, (i) file a corporate tax return and pay the tax shown thereby on income earned during 1980 and (ii) forthwith institute, and diligently prosecute to the court of last resort, a claim for refund of such tax. In all future years, the Trustee will report as a grantor trust until and unless the foregoing claim is finally decided adversely to the Trust.

5.04. *Reports to Unit Holders.* As promptly as practicable following the end of each calendar quarter, the Trustee shall mail to each Person who was a Unit Holder of record on a Monthly Record Date during such quarter a report which shall show in reasonable detail such information as is necessary to permit holders of units to make all calculations necessary for tax purposes including depletion, and which shall show the assets and liabilities and receipts and disbursements of the Trust for such quarter and for each month in such quarter. Within 90 days following the end of each fiscal year, the Trustee shall mail, to each Person of record on a date to be selected by the Trustee, an annual report containing financial statements audited by a nationally recognized firm of independent public accountants selected by the Trustee. Notwithstanding the foregoing, the Trustee will furnish to the Unit Holders such reports, in such manner, as are at any time required by law or by regulations of any stock exchange on which the Units are listed.

ARTICLE VI

LIABILITY OF TRUSTEE AND METHOD OF SUCCESSION

6.01. *Liability of Trustee.*

(a) Except as otherwise provided herein and specifically except as provided in paragraph (b) below, the Trustee, in carrying out its powers and performing its duties, may act in its discretion and shall be personally or individually liable only for fraud or for acts or omissions in bad faith and shall not individually or personally be liable for any act or omission of any agent or employee of the Trustee unless the Trustee has acted in bad faith in the selection and retention of such agent or employee.

(b) If the Trustee enters into a contract on behalf of the the Trust Estate without ensuring that any liability arising out of such contract shall be satisfiable only out of the Trust Estate and shall not in any event, including the exhaustion of the Trust Estate, be satisfiable out of amounts at any time distributed to any Unit Holder or out of any other assets owned by any Unit Holder, then Trustee, vis-a-vis the Unit Holders, shall be fully and exclusively liable for such liability, but shall have the right to be indemnified and reimbursed from the Trust Estate to the extent provided in Section 6.02.

6.02. *Indemnification of Trustee.* The Trustee shall be indemnified by, and receive reimbursement from, the Trust Estate against and from any and all liability, expense, claims, damages or loss incurred by it individually or as Trustee in the administration of the Trust and the Trust Estate or any part or parts thereof, or in the doing of any act done or performed or omission occurring on account of its being Trustee, except such liability, expense, claims, damages or loss as to which it is liable under Section 6.01(a). Trustee shall have a lien upon the Trust Estate to secure it for such indemnification and reimbursement and for compensation to be paid to Trustee. Except as provided in Section 4.05, neither the Trustee nor any agent or employee of the Trustee shall be entitled to any reimbursement or indemnification from any Unit Holder for any liability, expense, claims, damages or loss incurred by the Trustee or any such agent or employee, their right of reimbursement and indemnification, if any, being limited solely to the Trust Estate, whether or not the Trust Estate is exhausted without full reimbursement or indemnification of the Trustee or any such agent or employee.

6.03. *Resignation of Trustee.* The Trustee may resign, with or without cause, at any time by written notice to each of the then Unit Holders, given by registered mail addressed to each such holder at such holder's last known post office address as shown by the records of the Trustee at the time such notice is given. Such notice shall specify a date when such resignation shall take effect, which shall be a Business Day not less than ninety (90) days after the date such notice is mailed. In case of such resignation, the Trustee will use its best efforts to nominate a successor, to call a meeting of Unit Holders for the purpose of appointing a successor, and to solicit proxies for such meeting.

6.04. *Removal of Trustee.* The Trustee may be removed, with or without cause, at a meeting held in accordance with the requirements of Article VIII by the affirmative vote of the holders of a majority of all the Units then outstanding.

6.05. *Appointment of Successor Trustee.* In the event of a vacancy in the position of Trustee or if a Trustee has given notice of its intention to resign, the Unit Holders present or represented at a meeting held in accordance with the requirements of Article VIII may appoint a successor Trustee. Nominees for appointment may be made by (i) the resigned or removed Trustee and (ii) any Unit Holder or Unit Holders owning at least 15% of the Units. Any such successor Trustee shall be a bank or trust company having a capital, surplus and undivided profits (as of the end of its last fiscal year prior to its appointment) of at least \$50,000,000. In the event that a vacancy in the position of Trustee continues for sixty (60) days, a successor Trustee may be appointed by any State or Federal District Court holding terms in Tarrant County, Texas, upon the application of any Unit Holder, and in the event any such application is filed, such court may appoint a temporary Trustee at any time after such application is filed with it which shall, pending the final appointment of a Trustee, have such powers and duties as the court appointing such temporary Trustee shall provide in its order of appointment, consistent with the provisions of this Indenture.

Immediately upon the appointment of any successor Trustee, all rights, titles, duties, powers and authority of the succeeded Trustee hereunder shall be vested in and undertaken by the successor Trustee which shall be entitled to receive from the Trustee which it succeeds all of the Trust Estate held by it hereunder and all records and files in connection therewith. No successor Trustee shall be obligated to examine or seek alteration of any account of any preceding Trustee, nor shall any successor Trustee be liable personally for failing to do so or for any act or omission of any preceding Trustee. The preceding sentence shall not prevent any successor Trustee or anyone else from taking any action otherwise permissible in connection with any such account.

ARTICLE VII

COMPENSATION OF THE TRUSTEE

7.01. *Compensation of Trustee.* The Trustee shall receive compensation for its services as Trustee hereunder and as transfer agent as set forth in Schedule 2 attached hereto.

7.02. *Expenses.* The out-of-pocket costs incurred by the Trustee for long distance telephone calls, overtime necessitated by rush orders, travel, legal services, stationery, binders, envelopes, ledger sheets, transfer sheets, checks, Certificate list sheets, postage and insurance will be reimbursed to the Trustee at actual cost.

7.03. *Other Services.* The Trustee shall be reimbursed for actual expenditures made on account of any unusual duties in connection with matters pertaining to the Trust. In the event of litigation involving the Trust, audits or inspection of the records of the Trust pertaining to the transactions affecting the Trust or any other unusual or extraordinary services rendered in connection with the administration of the Trust, Trustee shall be entitled to receive reasonable compensation for the services rendered.

7.04. *Source of Funds.* All compensation, reimbursements and other charges owing to the Trustee will be payable by the Trust out of the Trust Estate.

ARTICLE VIII

MEETINGS OF UNIT HOLDERS

8.01. *Purpose of Meetings.* A meeting of the Unit Holders may be called at any time and from time to time pursuant to the provisions of this Article to transact any matter that the Unit Holders may be authorized to transact.

8.02. *Call and Notice of Meetings.* Any such meeting of the Unit Holders may be called by the Trustee in its discretion and will be called by the Trustee at the written request of Unit Holders owning not less than 15% in number of the Units represented by the then outstanding Certificates. All such meetings shall be held at such time and at such place in Fort Worth, Texas, as the notice of any such meeting may designate. Written notice of every meeting of the Unit Holders signed by the Trustee setting forth the time and place of the meeting and in general terms the matters proposed to be acted upon at such meeting shall be given in person or by mail not more than 60 nor less than 20 days before such meeting is to be held to all of the Unit Holders of record not more than 60 days before the date of such mailing. No matter other than that stated in the notice shall be acted upon at any meeting.

8.03. *Voting.* Each Unit Holder shall be entitled to one vote for each Unit owned by such Unit Holder, and any Unit Holder may vote in person or by duly executed written proxy. At any such meeting the presence in person or by proxy of Unit Holders holding a majority of the Units at the time outstanding shall constitute a quorum, and, except as otherwise specifically provided herein, any matter shall be deemed to have been approved by the Unit Holders if it is approved by the vote of a majority in interest of such Unit Holders constituting a quorum, although less than a majority of all of the Units at the time outstanding, except that the affirmative vote by the Unit Holders of at least 75% of all the Units then outstanding shall be required to:

- (a) approve or authorize any sale of all or any part of the assets of the Trust, or
- (b) terminate the Trust pursuant to Section 9.02(b), or
- (c) approve any amendment to or affecting this Section 8.03.

8.04. *Conduct of Meetings.* The Trustee may make such reasonable regulations consistent with the provisions hereof as it may deem advisable for any meeting of the Unit Holders, including regulations covering the closing of the transfer books of the Trustee for purposes of determining

Unit Holders entitled to notice of or to vote at any meeting, the appointment of proxies, the appointment and duties of inspectors of votes, the submission and examination of proxies, certificates and other evidence of the right to vote, the preparation and use at the meeting of a list authenticated by or on behalf of the Trustee of the Unit Holders entitled to vote at the meeting and such other matters concerning the calling and conduct of the meeting as it shall deem advisable.

ARTICLE IX

DURATION, REVOCATION AND TERMINATION OF TRUST

9.01. *Revocation.* The Trust is and shall be irrevocable and Company retains no power to alter, amend or terminate the Trust. The Trust shall be terminable only as provided in Section 9.02, and shall continue until so terminated.

9.02. *Termination.* The Trust shall terminate upon the first to occur of the following events:

(a) at such time as its gross revenue for each of two successive years after the year 1980 is less than \$1,000,000 per year,

(b) a vote in favor of termination by the Unit Holders present or represented at a meeting held in accordance with the requirements of Article VIII, or

(c) the expiration of twenty-one years after the death of the last survivor of the lawful descendants of any degree of the signers of the Declaration of Independence in being on the date of execution hereof.

9.03. *Disposition and Distribution of Properties.* For the purpose of liquidating and winding up the affairs of the Trust at its termination, the Trustee shall continue to act as such and exercise each power until its duties have been fully performed and the Trust Estate finally distributed. Upon the termination of the Trust, the Trustee shall sell for cash in one or more sales all the properties other than cash then constituting the Trust Estate. The Trustee shall as promptly as possible distribute the proceeds of any such sales and any other cash in the Trust Estate according to the respective interests and rights of the Unit Holders, after paying, satisfying and discharging all of the liabilities of the Trust, or, when necessary, setting up reserves in such amounts as Trustee in its discretion deems appropriate for contingent liabilities. In the event that any property which the Trustee is required to sell is not sold by the Trustee within three years after the termination of the Trust, the Trustee shall cause such property to be sold at public auction to the highest cash bidder. Notice of such sale by auction shall be mailed at least thirty days prior to such sale to each Unit Holder at such Unit Holder's address as it appears upon the books of the Trustee. The Trustee shall not be required to obtain approval of the Unit Holders prior to selling property pursuant to this Section. Upon making final distribution to the Unit Holders, the Trustee shall be under no further liability except as provided in Section 6.01(b).

ARTICLE X

AMENDMENTS

10.01. *Prohibited.* No amendment may be made to any provision of the Indenture which would

(a) alter the purposes of the Trust or permit the Trustee to engage in any business or investment activities substantially different from those specified herein;

(b) alter the rights of the Unit Holders vis-a-vis each other; or

(c) permit the Trustee to distribute the Royalties in kind either during the continuation of the Trust or during the period of liquidation or winding up under Section 9.03.

10.02. *Permitted.* All other amendments to the provisions of the Indenture may be made by a vote of the Unit Holders present or represented at a meeting held in accordance with the requirements

of Article VIII; provided that no amendment shall be effective without the express written approval of the Trustee.

ARTICLE XI

MISCELLANEOUS

11.01. *Inspection of Trustee's Books.* Each Unit Holder and such Unit Holder's duly authorized agents, attorneys and auditors shall have the right during reasonable business hours to examine, inspect and make audits of the Trust and records of the Trustee, including lists of Unit Holders for any proper purpose in reference thereto.

11.02. *Trustee's Employment of Experts.* The Trustee may, but shall not be required to, consult with counsel, who may be its own counsel, accountants, geologists, engineers and other parties deemed by the Trustee to be qualified as experts on the matters submitted to them, and the opinion of any such parties on any matter submitted to them by the Trustee shall be full and complete authorization and protection in respect of any action taken or suffered by it hereunder in good faith and in accordance with the opinion of any such party.

11.03. *Merger or Consolidation of Trustee.* Neither a change of name of the Trustee nor any merger or consolidation of its corporate powers with another bank or with a trust company shall affect its right or capacity to act hereunder.

11.04. *Filing of this Indenture.* Neither this Indenture nor any executed copy hereof need be filed in any county in which any of the Trust Estate is located, but the same may be filed for record in any county by the Trustee. In order to avoid the necessity of filing this Indenture for record, the Trustee agrees that for the purpose of vesting the record title to the Royalties in any successor to the Trustee, the retiring Trustee will, upon appointment of any successor Trustee, execute and deliver to such successor Trustee appropriate assignments or conveyances.

11.05. *Severability.* If any provision of this Indenture or the application thereof to any Person or circumstances shall be finally determined by a court of proper jurisdiction to be illegal, invalid or unenforceable to any extent, the remainder of this Indenture or the application of such provision to Persons or circumstances, other than those as to which it is held illegal, invalid or unenforceable, shall not be affected thereby, and every provision of this Indenture shall be valid and enforced to the fullest extent permitted by law.

11.06. *Notices.* Any Notice or demand which by any provision of this Indenture is required or permitted to be given or served upon the Trustee by any Unit Holder may be given or served by being deposited, postage prepaid and by registered or certified mail, in a post office or letter box addressed (until another address is designated by notice to the Unit Holders) to the Trustee at Post Office Box 2050, Fort Worth, Texas 76101. Any notice or other communication by the Trustee to any Unit Holder shall be deemed to have been sufficiently given, for all purposes, when deposited, postage prepaid, in a post office or letter box addressed to said Unit Holder at his address as shown on the records of the Trustee.

11.07. *Counterparts.* This Indenture may be executed in a number of counterparts, each of which shall constitute an original, but such counterparts shall together constitute but one and the same instrument.

IN WITNESS WHEREOF, the Company has caused this Indenture to be executed by its duly authorized _____ and its seal to be hereunto affixed and attested by its duly authorized Secretary or Assistant Secretary and the Trustee has caused this Indenture to be executed by its duly authorized _____ and its seal to be hereto affixed and attested by its duly authorized _____, the day and year first above written at Fort Worth, Tarrant County, Texas.

SOUTHLAND ROYALTY COMPANY

ATTEST:

By _____

Secretary

TRUSTOR

ATTEST:

THE FORT WORTH NATIONAL BANK

By _____

TRUSTEE

THE STATE OF TEXAS }
COUNTY OF TARRANT }

The foregoing instrument was acknowledged before me this _____ day of _____, 1980 by _____ of Southland Royalty Com-

(Name) Title
pany, a corporation, on behalf of said corporation.

GIVEN UNDER MY HAND AND SEAL OF OFFICE, this the _____ day of _____, 19 .

My Commission Expires:

*Notary Public in and for
Tarrant County, Texas*

THE STATE OF TEXAS }
COUNTY OF TARRANT }

The foregoing instrument was acknowledged before me this _____ day of _____, 1980 by _____ of The Fort Worth National

(Name) Title
Bank, a banking association organized under the laws of the United States, on behalf of said corporation.

GIVEN UNDER MY HAND AND SEAL OF OFFICE, this the _____ day of _____, 19 .

My Commission Expires:

*Notary Public in and for
Tarrant County, Texas*

SCHEDULE 2
TRUSTEE COMPENSATION

A. Administrative Fee.

For all administrative services, preparation of quarterly and annual statements with attention to tax and legal matters:

1. 1/20 of 1% of the first \$100 million of the annual gross revenue of the Trust, and 1/30 of 1% of the annual gross revenue of the Trust in excess of \$100 million.
2. Trustee's standard hourly rates for time in excess of 300 hours annually.

B. Transfer Agency Fee.

1. \$4.92 annually per Unit Holder account for maintaining computer records of each Unit Holder, name and address of record, tax identification number, outstanding Unit balances, alternative payee, various coded fields of pertinent information; for processing change of address and tax identification numbers; posting each Certificate cancelled or issued; issuance of 10,000 Certificates; processing request and documentation required for replacement of lost or destroyed Certificates; for placing and/or removing stop transfer orders; registering Certificates; disbursing the Monthly Distribution Amounts; preparing and mailing required Internal Revenue Service forms; mailing of proxies and other related material; tabulation of proxies; and maintenance and printing of Unit Holder list.

2. For Certificates issued, registered and posted in excess of 10,000 annually, \$1.00 for each Certificate.

3. The transfer agency fees stated above will be subject to escalation based upon the general rise in prices in the economy. The index used will be the Producers Price Index as published by the United States Department of Labor, Bureau of Labor Statistics or such equivalent index as may be published from time to time. All transfer agency fees will be adjusted annually by the percentage rise in this index on a December-to-December basis beginning December 31, 1981.

C. Termination Fee.

A fee will be charged upon termination of the Trust commensurate with the amount of work and responsibility involved which shall not exceed 10% of the proceeds received and distributed in connection with the termination liquidation; provided that termination is accomplished under Article 9.02(a) of the Trust Indenture. Under any other method of termination, fees will be charged on an hourly basis only.

D. Invested Funds.

To the extent consistent with the Trust Indenture and applicable statutes and regulations, funds held by the Trustee will be invested after receipt thereof until the next succeeding Distribution Date in such investments as are permitted by the Trust Indenture and the income so earned will be disbursed to the Unit Holders in accordance with the provisions of the Trust Indenture.

After funds are disbursed on the Distribution Date, an analysis will be made by the Trustee of the disbursement account or accounts and a credit for funds as calculated under the practice as it exists in the Trustee bank at the time and, from time to time, will be applied to reduce the administrative fee described in paragraph A above charged by the Trustee at the next administrative fee payment date. In no event shall the credit exceed the administrative fee.

CAWLEY, GILLESPIE & ASSOCIATES, INC.

PETROLEUM CONSULTANTS

302 FORT WORTH CLUB BUILDING

FORT WORTH, TEXAS 76102

(817) 336-2461

METRO 429-6751

July 25, 1980

**Southland Royalty Company
1000 Fort Worth Club Tower
Fort Worth, Texas 76102**

**Re: Appraisal
Permian Basin Royalty Trust
As of December 31, 1979**

Gentlemen:

A reserve study of the proved oil and gas reserves for Southland's Waddell Ranch properties, referred to as "properties", located in Crane County, Texas has been made by Cawley, Gillespie & Associates, Inc., independent petroleum engineering consultants. The interest appraised is a net overriding royalty equivalent to a 75 percent net profit interest of the total Southland net reserves and future net revenue for the properties. The 75 percent net profit interest is proposed for transfer to the Permian Basin Royalty Trust, referred to as "Trust".

Data from wells drilled and completed prior to the effective date of December 31, 1979 have been used in the reserve study. Wells drilling on December 31, 1979 were not included. There have been no events subsequent to December 31, 1979 which have caused significant change in estimated reserves.

The reserve quantity and economic forecast are estimates based on interpretations and information, including the extent and character of ownership, obtained from Southland Royalty Company, referred to as "Southland", which has been accepted as represented. These estimates represent our best judgment based on the information available at the time of preparation. It should be recognized that much of the data used in the estimation of reserves are arrived at by the use of estimates and that reserve estimates are subject to continuing change as additional information becomes available. Reserve estimates which presently appear to be correct may require substantial revision as time passes and new information becomes available. The reserves actually recovered, the revenues derived therefrom and actual costs could be more or less than the estimated amounts.

A field examination of the facilities and operation of the properties was not considered necessary. The data used in the preparation of this report were obtained from the records of Southland, the Texas Railroad Commission and the operator, Gulf Oil Corporation. The data are retained in our files for review by authorized parties.

Preparation of the report was in adherence with Cawley, Gillespie & Associates, Inc.'s understanding of the Securities and Exchange Commission's definitions and regulations governing estimation of reserves and economics. Estimated reserves were classified as proved developed and proved undeveloped as of December 31, 1979. Methods employed in the determination of reserve estimates were production performance and analogy. The estimates relying on analogy were based on experience and judgment supported by observation of similar reservoir performances in other fields.

Proved oil and gas reserves are the estimated quantities of crude oil, natural gas and natural gas liquids which geological and engineering data demonstrate with reasonable certainty to be recoverable in future years from known reservoirs under existing economic and operating conditions; i.e., prices and costs as of the date the estimate is made. Prices include consideration of changes in existing prices provided by contractual arrangements, but not escalations based upon future conditions.

Proved developed reserves are those that can be expected to be recovered by existing wells, equipment and operating methods. Proved undeveloped reserves are those to be recovered from new wells on undrilled acreage or from existing wells requiring a relatively major expenditure for recompletions or new facilities for fluid injection.

Estimates of reserves and future net revenues for the properties were determined by (1) applying current oil and gas prices to estimated future production and (2) using current costs for development drilling and operating expenditures. Since the evaluation was made as of December 31, 1979, current prices and costs are those in effect at that time. Consideration of changes in existing economic and operating conditions, or actions of governmental regulatory agencies affecting prices were not incorporated into this study. It was assumed that development of primary and secondary reserves would follow the operating plans prescribed by Southland.

Reserves and net revenue estimates for the Trust were calculated from the projection of estimated reserves and revenue for the total Southland interest. Reserves attributable to the Trust were estimated by allocating a portion of the total Southland net reserves based on future revenue. The formula used to estimate the Trust reserves for the properties is as follows:

$$\text{Trust Reserves} = \frac{\text{Trust Future Net Revenue}}{\text{Total Southland Future Gross Revenue}} \times \text{Total Southland Net Proved Reserves}$$

We estimated the net proved reserves and future net revenue for the Trust as of December 31, 1979 to be as follows:

	Oil (Bbls)	Gas (Mcf)	Future Net Revenue	
			Undiscounted	Discounted @ 10%
Proved Developed	18,291,000	75,636,000	\$605,089,000	\$267,028,000
Proved Undeveloped	9,252,000	55,449,000	338,708,000	150,405,000
Total	<u>27,543,000</u>	<u>131,085,000</u>	<u>\$943,797,000</u>	<u>\$417,433,000</u>

Revenue estimates are expressed in terms of the estimated future net revenue and present worth using a discount factor of 10 percent. Future net revenue attributable to the Trust was calculated annually from the projection of estimated total Southland future net revenue. The total Southland net revenue values were calculated by deducting operating expenses, drilling costs and production and ad valorem taxes from future gross revenue. In addition to well operating costs, an overhead charge was applied in the amount of \$75.00 per month for a gross producing and injection well (a dual completion being one well). Charges for extraction plant processing were taken into account by adjusting gas prices. A summary of the estimated future net revenue from proved reserves as of December 31, 1979 is as follows:

	Net Proved	
	Developed and Undeveloped	Developed
1980	\$ 45,073,000	\$ 42,399,000
1981	50,000,000	37,378,000
1982	55,807,000	35,387,000
Remainder	792,917,000	489,925,000
Total	<u>\$943,797,000</u>	<u>\$605,089,000</u>

Oil revenue from estimated future production was based on oil prices received during December 1979. Prices were not escalated nor were the crude oil decontrol regulations applied. For a producing property with lower and upper tier oil, a volumetric weighted average of the current prices was applied. Production from properties qualifying as marginal or stripper received applicable December prices. The effect of the "windfall profits" tax is not considered in the estimates.

Gas production is sold as plant residue to purchasers; i.e., HT Gathering Company for intrastate sales and El Paso Natural Gas Company ("El Paso") for interstate sales. Gas volumes, at standard conditions for the area, relate to unprocessed or wellhead volume in the study, for such volumes are customarily used in analyzing reservoir performance. Condensate reserves are those to be recovered with standard field separation.

Gas revenue from intrastate sales was based on the contract price as of January 1, 1980. Prices were adjusted for contractual terms, plant charges, as well as shrinkage, fuel and other losses and applied on the basis of an unprocessed volume unit. Prices were escalated in accordance with existing gas contracts and within the ceilings established by the Natural Gas Policy Act of 1978 ("NGPA"). It was assumed that undeveloped gas reserves sold intrastate would receive prices in accordance with existing contracts and regulatory restrictions. Revenue from interstate sales was based on the price being taken in as income by Southland. Interstate price was not escalated since it was understood that changes in existing prices were not provided in a contractual agreement. It was assumed that undeveloped reserves sold interstate would receive the same price as developed gas reserves sold interstate.

Southland and El Paso are involved in settlement proceedings before the Federal Energy Regulatory Commission ("FERC") regarding differences as to the prices for gas sold in interstate commerce since July 25, 1975 and applicable to future sales to El Paso. It was understood that Southland and El Paso have entered into a gas contract which will be effective upon final approval of the settlement by the FERC. The settlement and contract terms provide for payment of the small producer replacement contract price provided by the NGPA, or higher price authorized by the NGPA. The interstate price used in the study was equivalent to the small producer replacement contract rate.

Yours very truly,

CLARKE B. GILLESPIE

CAWLEY, GILLESPIE & ASSOCIATES, INC.

EXHIBIT IV

RAYMOND F. KRAVIS AND ASSOCIATES, INC.
PETROLEUM CONSULTANTS
 1705 FIRST PLACE
 TULSA, OKLAHOMA 74103

July 11, 1980

Southland Royalty Company
 1000 Fort Worth Club Tower
 Fort Worth, Texas 76102

Dear Sirs:

Pursuant to your request, we have reviewed all available data concerning certain producing royalty interests of Southland Royalty Company (hereinafter referred to as the "Company") in order to estimate as of December 31, 1979, the future proved net oil and gas reserves and revenue to be received therefrom.

The estimates included herein represent a 95% net overriding royalty in 117 producing royalty interests in the State of Texas that the Company proposes to transfer to the Permian Basin Royalty Trust (hereinafter referred to as the "Trust"), and this report has been prepared using Securities and Exchange Commission requirements for reporting on oil and gas reserves of publicly owned companies at this date. The following table summarizes our estimates:

	Net Reserves As of 12/31/79		Future Net Revenue	
	Natural Gas MCF	Crude Oil Barrels	Before Discount Note (1)	Present Worth Note (2)
Proved Developed	26,324,000	12,023,000	\$202,468,000	\$97,213,000

Note (1) Before allowance for depletion or income taxes.

Note (2) Discounted at ten percent (10%), compounded semi-annually, according to Securities and Exchange Commission requirements. Present worth is not considered to be the fair market value of the properties.

Proved oil and gas reserves included herein are the estimated quantities of crude oil and natural gas which geological and engineering data demonstrate with reasonable certainty are to be recovered in future years from known reservoirs under existing economic and operating conditions, i.e., prices and costs as of the date the estimate was made, including the consideration of changes in existing prices provided only by contractual arrangements but not including escalations based upon future conditions. All of the reserves herein are classified as proved developed and are those which are normally expected to be recovered through existing wellbores with little or no additional development expense.

We have prepared annual estimates of the remaining reserves of the properties for the past eleven years as a part of our reporting on reserves of all of the Company's royalty interests and all of its leasehold interests except those in the Waddell Ranch and the San Juan Basin. In this connection, pertinent data concerning these properties were assembled from the Company's records and from our files. Access was given to all such records, accounts, and reports as were requested. Representation of the management as to the character and extent of property ownership, as well as certain

information related to gas contracts, processing agreements, and production and accounting data, have been accepted by us. No field inspection of the properties was deemed necessary.

At your request and using Securities and Exchange Commission requirements for publicly owned companies, we have prepared this report using the following pricing and escalation parameters:

1. *Crude Oil* – December 1979 prices with no escalations. Classification changes from lower and upper tier prices to stripper oil prices are not included herein because of a lack of gross production and well count statistics necessary for the determination of classification changes.

2. *Gas* – Starting with December 1979 prices, we have escalated only those gas prices that we deem to qualify for the fixed and determinable escalation provisions of the Natural Gas Policy Act of 1978 (NGPA). No indefinite escalations have been included herein. Fixed and determinable escalations have been applied for gas qualifying as “New Gas” under Section 102 of NGPA and escalations of four cents (4¢) per year were applied after the year 1995 for that gas (Section 103 of NGPA) meeting and joining the former fixed gas price escalations of Federal Energy Regulatory Commission Order No. 770A.

Net reserves were estimated for each royalty interest, based on analysis of past net production history and extrapolated to an estimated economic limit for the operating interests. In instances where production has been curtailed or production decline trends have not been well established, remaining reserves were estimated after considering all available engineering and geological data, including the history of older wells producing under similar conditions from the same areas.

Reserves attributable to the Trust properties were estimated using the following formula:

$$\text{Trust Reserves} = \frac{\text{Trust Properties Future Net Revenue}}{\text{Total Future Gross Revenue}} \times \text{Total Net Reserves}$$

Future net revenue has been calculated by multiplying future net reserves by the pricing procedures noted above and subtracting therefrom production and ad valorem taxes. To the extent that our evaluations depend upon an interpretation of governmentally controlled oil and gas pricing structures, our evaluations have been based upon current understanding of these governmental controls. In this regard, it should be understood that, because of possible future changes and/or additions to current regulations, these future changes may necessitate a revision, either upward or downward, of the dollar amounts expressed in this report.

The following table summarizes our estimates of future net revenue, by years for three years and in total thereafter, from the Proved Developed Reserves estimated in this report:

	<u>Future Net Revenue</u>
1980	\$ 17,524,000
1981	15,893,000
1982	14,400,000
Subtotal	<u>\$ 47,817,000</u>
Remainder	154,651,000
Total	<u><u>\$202,468,000</u></u>

The preceding summarization is taken from our projections of net production over the estimated remaining life of each of the royalties. We recognize the limitations in the accuracy of such lengthy projections, because of possible unforeseen changes in reservoir performance, operating method, or market demand; however, we believe these projections are reasonable and in keeping with the facts known about the properties at this time. While we do not intend to qualify the reserves estimated herein, we do wish to point out that future information and its reinterpretation may indicate the need for reserve revisions, either upward or downward, and that future reserve adjustments may be in order.

Submitted,

RAYMOND F. KRAVIS AND ASSOCIATES,
INC.

By W. C. SOUTHMAYD
W. C. Southmayd — *President*

EXHIBIT V

H. J. GRUY AND ASSOCIATES, INC.

PETROLEUM CONSULTANTS

150 WEST JOHN CARPENTER FREEWAY

IRVING, TEXAS 75062

(IN THE DALLAS-FORT WORTH METROPLEX)

CARPENTER FREEWAY AT O'CONNOR ROAD
IN LAS COLINAS

TELEPHONE (214) 659-3200
TELEX: 730833 GRUY DAL

July 14, 1980

Southland Royalty Company
1000 Fort Worth Club Tower
Fort Worth, Texas 76102

Gentlemen:

As requested, we have made estimates as of December 31, 1979 of reserves and future revenue attributable to a 75 percent net overriding royalty interest in certain Southland Royalty Company ("Southland") oil and gas properties located in Northwest New Mexico. These are properties Southland proposes to transfer to the San Juan Basin Royalty Trust ("Trust").

We estimate the net proved reserves of the Trust properties as of December 31, 1979 to be:

<u>Category</u>	<u>Estimated Net Reserves</u>		<u>Estimated Future Net Revenue</u>	
	<u>Oil or Condensate (Barrels)</u>	<u>Gas (MCF)</u>	<u>Undiscounted</u>	<u>Discounted at 10%</u>
Proved Developed	1,503,000	371,670,000	\$1,469,402,000	\$339,256,000
Proved Undeveloped	478,000	91,990,000	553,541,000	95,692,000
Total Proved	1,981,000	463,660,000	\$2,022,943,000	\$434,948,000

Gas volumes are at 60 degrees Fahrenheit and at the standard pressure bases used in the areas in which the reserves are located. Condensate reserves are those to be obtained from normal separator recovery. Estimated future net revenues are after deduction of severance and ad valorem taxes, direct operating expenses and required capital expenditures to develop the proved undeveloped reserves. The discounted revenue figures were calculated to show the present worth of future revenues and are not estimates of fair market values.

A summary projection of estimated future net revenue for the Trust properties as of December 31, 1979 is:

<u>Year</u>	<u>Estimated Future Net Revenue</u>	
	<u>Total Proved Reserves</u>	<u>Developed Reserves</u>
1980	\$ 38,423,000	\$ 43,300,000
1981	43,080,000	40,993,000
1982	42,893,000	39,200,000
Subtotal	\$ 124,396,000	\$ 123,493,000
Remainder	1,898,547,000	1,345,909,000
Total	\$2,022,943,000	\$1,469,402,000

Our reserve estimates and future revenue projections are based on a detailed study of the Trust properties. During the study, we consulted freely with officers and employees of Southland and were given access to needed records and data. In the preparation of this report we have relied, without independent verification, on information furnished by Southland with respect to property interests to be transferred to the Trust, production from the properties, current costs of operation and development and current prices received for production as of December 31, 1979, agreements relating to current and future operations and sale of production and various other information and data. It was not considered necessary to make a field examination of the physical condition and operation of the Trust properties.

Reserves and revenue figures included in this report were estimated from annual projections of reserves and revenue attributable to the total Southland interest in the properties. Reserves attributable to the Trust properties were estimated by allocation using the following formula:

$$\text{Trust Reserves} = \frac{\text{Trust Properties Future Net Revenue}}{\text{Total Future Gross Revenue}} \times \text{Total Net Reserves}$$

The total Southland future net revenue figures were calculated by deducting estimated operating costs, severance and ad valorem taxes, and required capital expenditures from projected future gross revenues to Southland and Trust properties interests. These figures were then reduced by an overhead charge furnished by Southland of \$165 per well completion per month for properties operated by Southland. Overhead charges were proportionately reduced for partial working interests operated by Southland. No overhead charges were applied to non-operated properties or royalty interests. The 75 percent "net profits" factor was then applied to the adjusted revenue to arrive at the Trust properties future net revenue. Present worth of future net revenue was calculated by discounting the future net revenue at the rate of ten percent per year compounded semi-annually over the expected period of realization.

Prices for oil, condensate and natural gas effective December 31, 1979 were furnished by Southland. These prices were used for the life of the properties with no escalation except that gas prices were escalated using fixed and determinable escalations in accordance with existing gas contracts and within ceilings established by the Natural Gas Policy Act of 1978 using only the real growth factor escalation component.

Petroleum reserves included in this report are classified as proved reserves and are judged to be economically producible in future years from known reservoirs under existing economic and operating conditions and assuming continuation of current regulatory practices using conventional methods and equipment. In the analyses of production-decline curves, reserves were estimated only to the limit of economic rates of production under existing economic and operating conditions, i.e., prices and costs as of the date the estimate is made, including consideration of changes in existing prices provided only by contractual arrangements but not including escalations based on future conditions. The reserves are further classified as follows:

1. Developed reserves are those reserves which are normally expected to be recovered through an existing wellbore with little or no additional development expense.
2. Undeveloped reserves are those reserves which will require a new wellbore or substantial expenditure on an existing wellbore in order to obtain their recovery.

In our opinion, the information relating to estimated proved reserves, estimated future net revenue from proved reserves, and present worth of estimated future net revenue from proved reserves of oil, condensate, and gas contained in this report has been prepared in accordance with Rules 3-18(a)(1)-(13) and 3-18(k)(5)-(6) of Regulation S-X promulgated by the Securities and Exchange Commission (the "Commission") in Accounting Series Release No. 253 (August 31, 1978), as amended by the Commission in Accounting Series Releases Nos. 257 (December 19, 1978) and 258 (December 19, 1978);

Item 2(b)(1) of Regulation S-K, as amended by the Commission in Securities Act Release No. 33-6008 (December 19, 1978); paragraphs 50-56 of Statement of Financial Accounting Standards No. 19 (December 1977) promulgated by the Financial Accounting Standards Board, as amended by its Statement of Financial Accounting Standards No. 25 (February 1979); and paragraph 7 of said Statement of Financial Accounting Standards No. 25.

To the extent the above-enumerated rules, regulations and statements require determinations of an accounting or legal nature, we are necessarily unable to express an opinion as to whether the above-described information was prepared in accordance therewith.

Yours very truly,

H. J. GRUY AND ASSOCIATES, INC.

H. J. GRUY AND ASSOCIATES, INC.

CAWLEY, GILLESPIE & ASSOCIATES, INC.

PETROLEUM CONSULTANTS

302 FORT WORTH CLUB BUILDING

FORT WORTH, TEXAS 76102

(817) 336-2461

METRO 429-6751

July 25, 1980

Southland Royalty Company
1000 Fort Worth Club Tower
Fort Worth, Texas 76102

Re: Appraisal
Remaining Southland Interest
As of December 31, 1979

Gentlemen:

A reserve study of the proved oil and gas reserves for Southland's Waddell Ranch properties, referred to as "properties", located in Crane County, Texas has been made by Cawley, Gillespie & Associates, Inc., independent petroleum engineering consultants. The interest appraised is the remaining interest after the proposed transfer to the Permian Basin Royalty Trust, referred to as "Trust", of a net overriding royalty interest equivalent to a 75 percent net profit interest in the properties. The appraised remaining Southland interest is referred to as the "Remaining Southland Interest."

Data from wells drilled and completed prior to the effective date of December 31, 1979 have been used in the reserve study. Wells drilling on December 31, 1979 were not included. There have been no events subsequent to December 31, 1979 which have caused significant change in estimated reserves.

The reserve quantity and economic forecast are estimates based on interpretations and information, including the extent and character of ownership obtained from Southland Royalty Company, referred to as "Southland", which has been accepted as represented. These estimates represent our best judgment based on the information available at the time of preparation. It should be recognized that much of the data used in the estimation of reserves are arrived at by the use of estimates and that reserve estimates are subject to continuing change as additional information becomes available. Reserve estimates which presently appear to be correct may require substantial revision as time passes and new information becomes available. The reserves actually recovered, the revenues derived therefrom and actual costs could be more or less than the estimated amounts.

A field examination of the facilities and operation of the properties was not considered necessary. The data used in the preparation of this report were obtained from the records of Southland, the Texas Railroad Commission and the operator, Gulf Oil Corporation. The data are retained in our files for review by authorized parties.

Preparation of the report was in adherence with Cawley, Gillespie & Associates, Inc.'s understanding of the Securities and Exchange Commission's definitions and regulations governing estimation of reserves and economics. Estimated reserves were classified as proved developed and proved undeveloped as of December 31, 1979. Methods employed in the determination of reserve estimates were production performance and analogy. The estimates relying on analogy were based on experience and judgment supported by observations of similar reservoir performances in other fields.

Proved oil and gas reserves are the estimated quantities of crude oil, natural gas and natural gas liquids which geological and engineering data demonstrate with reasonable certainty to be recoverable

in future years from known reservoirs under existing economic and operating conditions; i.e., prices and costs as of the date the estimate is made. Prices include consideration of changes in existing prices provided by contractual arrangements, but not escalations based upon future conditions.

Proved developed reserves are those that can be expected to be recovered by existing wells, equipment and operating methods. Proved undeveloped reserves are those to be recovered from new wells on undrilled acreage or from existing wells requiring a relatively major expenditure for recompletions or new facilities for fluid injection.

Estimates of reserves and future net revenue for the properties were determined by (1) applying current oil and gas prices to estimated future production and (2) using current costs for development drilling and operating expenditures. Since the evaluation was made as of December 31, 1979, current prices and costs are those in effect at that time. Consideration of changes in existing economic and operating conditions or actions of governmental regulatory agencies were not incorporated into this study. It was assumed that development of primary and secondary reserves would follow the operating plans prescribed by Southland.

Reserve and revenue estimates for the Remaining Southland Interest were calculated from the projection of estimated reserves and income for the total Southland interest. Reserves attributable to the Trust were estimated by allocating a portion of the total Southland net reserves based on future net revenues. The formula used to estimate the Trust reserves for the properties is as follows:

$$\text{Trust Reserves} = \frac{\text{Trust Future Net Revenue}}{\text{Total Southland Future Gross Revenue}} \times \text{Total Southland Net Proved Reserves}$$

The estimated Trust reserves and future net revenue were subtracted from the total Southland reserves and future net revenue to arrive at those for the Remaining Southland Interest. We estimate the future revenue for the Remaining Southland Interest as of December 31, 1979 to be as follows:

	Oil (Bbls)	Gas (Mcf)	Future Net Revenue	
			Undiscounted	Discounted @ 10%
Proved Developed	20,457,000	38,837,000	\$201,696,000	\$ 89,009,000
Proved Undeveloped	9,762,000	27,864,000	112,903,000	50,135,000
Total	<u>30,219,000</u>	<u>66,701,000</u>	<u>\$314,599,000</u>	<u>\$139,144,000</u>

Revenue estimates are expressed in terms of the estimated future net revenue and present worth using a discount factor of 10 percent. Future net revenue attributable to the Remaining Southland Interest was calculated annually from the projection of estimated total Southland future net revenue. The total Southland net revenue values were calculated by deducting operating expenses, drilling costs and production and ad valorem taxes from future gross revenue. In addition to well operating costs, an overhead charge was applied in the amount of \$75.00 per month for a gross producing and injection well (a dual completion being one well). Charges for extraction plant processing were taken into account by adjusting gas prices. A summary of the estimated future net revenue for the Remaining Southland Interest from proved reserves as of December 31, 1979 is as follows:

	Net Proved	
	Developed and Undeveloped	Developed
1980	\$ 15,024,000	\$ 14,133,000
1981	16,667,000	12,459,000
1982	18,602,000	11,796,000
Remainder	264,306,000	163,308,000
Total	<u>\$ 314,599,000</u>	<u>\$ 201,696,000</u>

Oil revenue from estimated future production was based on oil prices received during December 1979. Prices were not escalated nor were the crude oil decontrol regulations applied. For a producing property with lower and upper tier oil, a monthly volumetric weighted average of the current prices was applied. Production from properties qualifying as marginal or stripper received applicable December prices. The effect of the "windfall profits" tax is not considered in the estimates.

Gas production is sold as plant residue to purchasers; i.e., HT Gathering Company for intrastate sales and El Paso Natural Gas Company ("El Paso") for interstate sales. Gas volumes, at standard conditions for the area, relate to unprocessed or wellhead volume in the study, for such volumes are customarily used in analyzing reservoir performance. Condensate reserves are those to be recovered with standard field separation.

Gas revenue from intrastate sales was based on the contract price as of January 1, 1980. Prices were adjusted for contractual terms, plant charges, as well as shrinkage, fuel and other losses and applied on the basis of an unprocessed volume unit. Prices were escalated in accordance with existing gas contracts and within the ceilings established by the Natural Gas Policy Act of 1978 ("NGPA"). It was assumed that undeveloped gas reserves sold intrastate would receive prices in accordance with existing contracts and regulatory restrictions. Revenue from interstate sales was based on the price being taken in as income by Southland. Interstate price was not escalated since it was understood that changes in existing prices were not provided in a contractual agreement. It was assumed that undeveloped reserves sold interstate would receive the same price as developed gas reserves sold interstate.

Southland and El Paso are involved in settlement proceedings before the Federal Energy Regulatory Commission ("FERC") regarding differences as to the prices for gas sold in interstate commerce since July 25, 1975 and applicable to future sales to El Paso. It was understood that Southland and El Paso have entered into a gas contract which will be effective upon final approval of the settlement by the FERC. The settlement and contract terms provide for payment of the small producer replacement contract price provided by the NGPA, or higher price authorized by the NGPA. The interstate price used in the study was equivalent to the small producer replacement contract rate.

Yours very truly,

CLARKE B. GILLESPIE

CAWLEY, GILLESPIE & ASSOCIATES, INC.

EXHIBIT VII

H. J. GRUY AND ASSOCIATES, INC.

PETROLEUM CONSULTANTS

150 WEST JOHN CARPENTER FREEWAY

IRVING, TEXAS 75062

(IN THE DALLAS-FORT WORTH METROPLEX)

CARPENTER FREEWAY AT O'CONNOR ROAD
IN LAS COLINAS

TELEPHONE (214) 659-3200
TELEX: 730833 GRUY DAL

July 14, 1980

Southland Royalty Company
1000 Fort Worth Club Tower
Fort Worth, Texas 76102

Gentlemen:

As requested, we have made estimates as of December 31, 1979 of reserves and future revenue attributable to Southland Royalty Company ("Southland") interests in certain oil and gas properties in Northwest New Mexico, Colorado and Utah after deduction of a 75 percent net overriding royalty interest in the Northwest New Mexico properties which Southland proposes to transfer to the San Juan Basin Royalty Trust ("Trust").

We estimate the net proved reserves of the Southland properties as of December 31, 1979 to be:

Category	Estimated Net Reserves		Estimated Future Net Revenue	
	Oil or Condensate (Barrels)	Gas (MCF)	Undiscounted	Discounted at 10%
Proved Developed	5,692,000	226,892,000	\$524,905,000	\$132,066,000
Proved Undeveloped	1,707,000	84,016,000	191,299,000	32,542,000
Total Proved	<u>7,399,000</u>	<u>310,908,000</u>	<u>\$716,204,000</u>	<u>\$164,608,000</u>

Gas volumes are at 60 degrees Fahrenheit and at the standard pressure bases used in the areas in which the reserves are located. Condensate reserves are those to be obtained from normal separator recovery. Estimated future net revenues are after deduction of severance and ad valorem taxes, direct operating expenses and required capital expenditures to develop the proved undeveloped reserves. The discounted revenue was calculated to show the present worth of future revenue and is not an estimate of fair market value.

A summary projection of estimated future net revenue for the Southland properties as of December 31, 1979 is:

Year	Estimated Future Net Revenue	
	Total Proved Reserves	Developed Reserves
1980	\$ 12,965,000	\$ 17,947,000
1981	15,475,000	16,860,000
1982	18,474,000	15,973,000
Subtotal	<u>\$ 46,914,000</u>	<u>\$ 50,780,000</u>
Remainder	669,290,000	474,125,000
Total	<u>\$716,204,000</u>	<u>\$524,905,000</u>

Our reserve estimates and future revenue projections are based on a detailed study of the Trust properties. During the study, we consulted freely with officers and employees of Southland and were given access to needed records and data. In the preparation of this report we have relied, without independent verification, on information furnished by Southland with respect to property interests to be transferred to the Trust, production from the properties, current costs of operation and development, current prices received for production as of December 31, 1979, agreements relating to current and future operations and sale of production and various other information and data. It was not considered necessary to make a field examination of the physical condition and operation of the Trust properties.

Reserves and revenue figures included in this report were estimated from annual projections of reserves and revenue attributable to the total Southland interest in the properties. Reserves attributable to the Trust properties were estimated by allocation using the following formula:

$$\text{Trust Reserves} = \frac{\text{Trust Properties Future Net Revenue}}{\text{Total Future Gross Revenue}} \times \text{Total Net Reserves}$$

The total Southland future net revenue figures were calculated by deducting estimated operating costs, severance and ad valorem taxes, and required capital expenditures from projected future gross revenues to Southland and Trust properties interests. These figures were then reduced by an overhead charge furnished by Southland of \$165 per well completion per month for properties operated by Southland. Overhead charges were proportionately reduced for partial working interests operated by Southland. No overhead charges were applied to non-operated properties or royalty interests. The 75 percent "net profits" factor was then applied to the adjusted revenue to arrive at the Trust properties future net revenue. Present worth of future net revenue was calculated by discounting the future net revenue at the rate of ten percent per year compounded semi-annually over the expected period of realization.

Prices for oil, condensate and natural gas effective December 31, 1979 were furnished by Southland. These prices were used for the life of the properties with no escalation except that gas prices were escalated using fixed and determinable escalations in accordance with existing gas contracts and within ceilings established by the Natural Gas Policy Act of 1978 using only the real growth factor escalation component.

Petroleum reserves included in this report are classified as proved reserves and are judged to be economically producible in future years from known reservoirs under existing economic and operating conditions and assuming continuation of current regulatory practices using conventional methods and equipment. In the analyses of production-decline curves, reserves were estimated only to the limit of economic rates of production under existing economic and operating conditions, i.e., prices and costs as of the date the estimate is made, including consideration of changes in existing prices provided only by contractual arrangements but not including escalations based on future conditions. The reserves are further classified as follows:

1. Developed reserves are those reserves which are normally expected to be recovered through an existing wellbore with little or no additional development expense.
2. Undeveloped reserves are those reserves which will require a new wellbore or substantial expenditure on an existing wellbore in order to obtain their recovery.

In our opinion, the information relating to estimated proved reserves, estimated future net revenue from proved reserves, and present worth of estimated future net revenue from proved reserves of oil, condensate, and gas contained in this report has been prepared in accordance with Rules 3-18(a) (1)-(13) and 3-18(k) (5)-(6) of Regulation S-X promulgated by the Securities and Exchange Commission (the "Commission") in Accounting Series Release No. 253 (August 31, 1978), as amended by the

Commission in Accounting Series Releases Nos. 257 (December 19, 1978) and 258 (December 19, 1978); Item 2(b)(1) of Regulation S-K, as amended by the Commission in Securities Act Release No. 33-6008 (December 19, 1978); paragraphs 50-56 of Statement of Financial Accounting Standards No. 19 (December 1977) promulgated by the Financial Accounting Standards Board, as amended by its Statement of Financial Accounting Standards No. 25 (February 1979); and paragraph 7 of said Statement of Financial Accounting Standards No. 25.

To the extent the above-enumerated rules, regulations and statements require determinations of an accounting or legal nature, we are necessarily unable to express an opinion as to whether the above-described information was prepared in accordance therewith.

Yours very truly,

H. J. GRUY AND ASSOCIATES, INC.

H. J. GRUY AND ASSOCIATES, INC.

EXHIBIT VIII

RAYMOND F. KRAVIS AND ASSOCIATES, INC.
 PETROLEUM CONSULTANTS
 1705 FIRST PLACE
 TULSA, OKLAHOMA 74103

July 11, 1980

Southland Royalty Company
 1000 Fort Worth Club Tower
 Fort Worth, Texas 76102

Dear Sirs:

Pursuant to your request, we have reviewed all of the information available to us concerning certain oil and gas properties of Southland Royalty Company (hereinafter referred to as the "Company") in order to estimate the future proved net reserves and revenue to be received therefrom as of December 31, 1979.

The properties included in this report consist of certain properties of the Company remaining after the proposed transfer of a 95% net overriding royalty in certain producing royalty interests to the Permian Basin Royalty Trust (hereinafter referred to as the "Trust"). Excluded from our report are those properties in the Waddell Ranch area where term leases reverted to the Company in 1975, those San Juan Basin properties obtained in the acquisition of Aztec Oil & Gas Company in 1976, and certain other properties obtained in recent acquisitions. This report has been prepared using Securities and Exchange Commission requirements for reporting on oil and gas reserves of publicly owned companies at this date. The following table summarizes our estimates:

	Net Reserves As of 12/31/79		Future Net Revenue	
	Natural Gas MCF	Crude Oil and Condensate Barrels	Before Discount Note (1)	Present Worth Note (2)
Proved Developed	257,574,000	43,580,000	\$1,057,594,000	\$588,756,000
Proved Undeveloped	18,584,000	3,968,000	145,058,000	55,759,000
Total Proved	276,158,000	47,548,000	\$1,202,652,000	\$644,515,000

Note (1) – Before allowance for depreciation, depletion, income taxes, or salvage value of producing equipment.

Note (2) – Discounted at ten percent (10%), compounded semi-annually, according to Securities and Exchange Commission requirements. Present worth is not considered to be the fair market value of the properties.

Proved oil and gas reserves included herein are the estimated quantities of crude oil, natural gas, and natural gas liquids which geological and engineering data demonstrate with reasonable certainty are to be recovered in future years from known reservoirs under existing economic and operating conditions, i.e., prices and costs as of the date the estimate was made, including the consideration of changes in existing prices provided only by contractual arrangements but not including escalations based upon future conditions. The reserves are further classified herein as proved developed and proved undeveloped. The developed reserves are those that can be expected to be recovered through existing wells with little or no additional development expense and the undeveloped reserves are

those that are expected to be recovered from new wells on undrilled acreage, or from existing wells where a relatively major expenditure is required for recompletion.

We have prepared annual estimates of the reserves of the properties for the past eleven years as a part of our reporting on reserves of all of the Company's royalty interests and all of its leasehold interests except those in the Waddell Ranch and the San Juan Basin. In this connection, pertinent data concerning these properties were assembled from the Company's records and from our files. Access was given to all such records, accounts, and reports as were requested. Representation of the management as to the character and extent of property ownership, as well as certain information related to gas contracts, processing agreements, and production and accounting data, have been accepted by us. No field inspection of the properties was deemed necessary.

At your request and using Securities and Exchange Commission requirements for publicly owned companies, we have prepared this report with the following pricing and escalation parameters for leasehold interests:

1. *Crude Oil* – December 1979 prices with no escalation except where properties producing currently with upper or lower tier prices are projected to become qualified for stripper oil pricing under current Department of Energy regulations. At that time, current stripper prices were applied.

2. *Condensate* – December 1979 prices with no escalation.

3. *Gas* – Starting with December 1979 prices, we have escalated gas prices where permitted by contract. On other gas prices, we have escalated only those gas prices that we deem to qualify for the fixed and determinable escalation provisions of the Natural Gas Policy Act of 1978 (NGPA), namely that qualifying as "New Gas" and "Stripper Gas" under Sections 102 and 108 of NGPA. No indefinite escalations have been included herein. A definitive escalation of four cents (4¢) per year was applied after the year 1995 for that gas (Section 103 of NGPA) meeting and joining with the former fixed gas price escalations of Federal Energy Regulatory Commission Order No. 770A. Upon contract expiration, gas prices on qualified properties were applied at the current price (without escalations) as provided under various sections of the NGPA.

With regard to mineral and royalty interests, December 1979 prices have been used throughout the projections except where those projections have been associated with leasehold interests that are permitted to escalate or where the fixed and determinable gas price escalations are allowed as indicated in the discussion above covering pricing for the leasehold interests. The application of stripper oil and gas prices are precluded because of a lack of gross production and well count statistics for the royalty interests.

Future operating costs for individual leases have been based on the analysis of past operating costs. The most recent operating cost statements available were those through October of 1979. In this report, operating costs have been projected at a constant rate, without escalation except where there are anticipated changes in methods of operating which we estimate will cause changes in operating costs. Development costs and workover expenses have been provided for as needed. All future projected Canadian income and expenses have been converted to U.S. dollars.

Reserves were estimated for each leasehold interest property, by formation. Where past history permitted, reserves were estimated with the aid of decline curves extrapolated to an economic limit calculated on the basis of current operating costs, with adjustments for anticipated changes in operating conditions or methods. Prices used in calculating these economic limits are those considered to be in effect at the end of economic production, allowing for changes to "stripper" oil price and fixed and determinable gas price increases, as allowed by Securities and Exchange Commission guidelines. In instances where production has been curtailed or production trends have not been well established, gross ultimate recovery was estimated by volumetric analysis after considering the producing formation and all available engineering and geological data, including the history of older wells producing under similar conditions from the same formation. In estimating remaining gas reserves,

past pressure, production, and deliverability history of the wells were analyzed and used to confirm volumetric estimates or to supersede them when the weight of well performance data so warranted. Casinghead gas reserves were estimated for only those properties that were marketing the gas at September 30, 1979. All gas volume calculations are at the pressure and temperature bases provided under law for the particular areas wherein the properties are located or the special terms of the contracts where variances are known to exist.

Future net revenue has been calculated by multiplying future net reserves by the pricing procedures noted above and subtracting therefrom estimated costs to produce the reserves, including future workover, development, and equipment expense.

To the extent that our evaluations depend upon an interpretation of governmentally controlled oil and gas pricing structures, our evaluations have been based upon our current understanding of these governmental controls. In this regard, it should be understood that, because of possible future changes and/or additions to current regulations, these future changes may necessitate a revision, either upward or downward, of the dollar amounts expressed in this report.

The following table summarizes our estimates of future net revenue, by years for three years and in totals thereafter, from the proved reserves estimated in this report:

	Future Net Revenue	
	Total Proved Reserves	Total Developed Reserves
1980	\$ 126,122,000	\$ 129,233,000
1981	117,221,000	111,070,000
1982	107,411,000	102,558,000
Subtotal	\$ 350,754,000	\$ 342,861,000
Remainder	851,898,000	714,733,000
Total	<u>\$1,202,652,000</u>	<u>\$1,057,594,000</u>

The above summarization is taken from our projections of production over the estimated remaining life of each of the leases. We recognize the limitations in the accuracy of such lengthy projections, because of possible unforeseen changes in reservoir performance, operating method, or market demand; however, we believe these projections are reasonable and in keeping with the facts known about the properties at this time. While we do not intend to qualify the reserves estimated herein, we do wish to point out that future information and its re-interpretation may indicate the need for reserve revisions, either upward or downward, and that future reserve adjustments may be in order.

Submitted,

RAYMOND F. KRAVIS AND ASSOCIATES,
INC.

By W. C. SOUTHMAYD

W. C. Southmayd — *President*

**SOUTHLAND ROYALTY COMPANY
1980 STOCK INCENTIVE PLAN**

1. *Purpose.* This "Southland Royalty Company 1980 Stock Incentive Plan" ("Plan") is intended to provide additional incentives for executive and other key employees of Southland Royalty Company ("Company") and its subsidiaries to promote the success of Company and to afford Company better opportunities to secure and hold the services of outstanding executives and other key personnel.

2. *Units Subject to Grant.* Units granted pursuant to this Plan ("Units") will consist of a stock purchase option ("Option") as described in Paragraph 3 and a stock appreciation right ("SAR") as described in Paragraph 4. Subject to the provisions of Paragraph 5, the aggregate number of Units which may be granted under this Plan is 1,500,000. The number of Units granted during any calendar year will not exceed 400,000, and the number of Units granted to any one employee during any calendar year will not exceed 75,000. Each grant will be in multiples of 10 Units. If a previously granted Unit expires or terminates for any reason without having been exercised, such Unit will be added to the Units then otherwise available under this Plan.

3. *Option.* Each Unit will entitle the person to whom it is granted to purchase one share of Company's common stock, par value \$.125 per share ("Common Stock"). Such shares may consist in whole or in part, as the board of directors of Company ("Board") from time to time determines, of authorized but unissued shares or once issued shares since reacquired by Company. The purchase price ("Option Price") of the share covered by each Unit will be 100% of the fair market value of a share of Common Stock at the time of the grant ("Grant Date") of the Unit. The fair market value of the Common Stock on the Grant Date will be the mean between the high and low sale prices of the Common Stock on the New York Stock Exchange, Inc. ("Exchange") on the Grant Date or, if no shares of Common Stock are sold on the Exchange on the Grant Date, on the last preceding day on which shares of Common Stock were sold on the Exchange.

If at any time while Units are outstanding or may be granted under this Plan the Common Stock is not listed on the Exchange, the Board may provide such alternative provisions as it deems appropriate for determining the "fair market value" of the Common Stock for purposes of this Paragraph 3 and of Paragraph 4. Any such action by the Board will be conclusive and binding on all parties and will not constitute an amendment of this Plan for purposes of Paragraph 18.

4. *Stock Appreciation Right.* Each Unit will also entitle its holder to receive upon exercise of the Option included in the Unit a cash payment equal to the amount, if any, by which the fair market value of the Common Stock on the date of exercise exceeds the Option Price. The fair market value of the Common Stock on the date of exercise will be the mean between the high and the low sale prices of the Common Stock on the Exchange on the date the Option is exercised or, if no shares of Common Stock are sold on the Exchange on such day, on the last preceding day on which shares of Common Stock were sold on the Exchange.

5. *Changes in Capital Structure.* If the outstanding shares of Common Stock are hereafter increased or decreased or converted into or exchanged for a different number or kind of shares or other securities of Company by reason of any reorganization, merger or consolidation in which Company is the surviving corporation or any reclassification, stock split, stock dividend or similar event affecting outstanding shares of Common Stock, the Board will appropriately adjust the number of Units and the number and kind of shares to be purchased under Option in Units which may thereafter be granted under this Plan. In addition, the Board will appropriately adjust the number and kind of shares as to which outstanding Units may thereafter be exercised so that the grantee's proportionate interest will be maintained as before such event. Any such adjustment in outstanding Units will be made without change in the total Option Price applicable to unexercised Units and

with a corresponding adjustment in the Option Price per share. All adjustments made by the Board in accordance with this Paragraph 5 will be conclusive and binding upon all parties.

6. *Administration of Plan.* The Board will administer this Plan. To carry out the purposes of this Plan, and subject to its provisions, the Board will have full authority, in its discretion, to determine which eligible employees, if any, are to be granted Units and the time or times at which Units are granted. All questions as to the interpretation and application of this Plan and as to Units are to be determined by the Board, and the determination of the Board will be conclusive and binding upon all parties.

7. *Employees to Whom Units may be Granted.* Any executive employee of Company or of any Subsidiary, from time to time, of Company on the Grant Date will be eligible for selection by the Board to receive Units. For the purposes of this Plan, (i) the term "executive employee" includes only fulltime employees who are officers, key professional or technical employees or supervisors, and (ii) the term "Subsidiary" means any corporation of which at least 50% of the voting securities are owned by Company directly or through one or more other corporations, each of which is also a Subsidiary.

Members of the Board who are not employed on a fulltime basis by Company or a Subsidiary are not eligible to receive Units. Members of the Board who are otherwise eligible may be granted Units only if a majority of the Board and a majority of the members acting in regard to such grant are "disinterested persons." The term "disinterested persons" as used in this Plan means directors who are not at the time they exercise discretion in administering the Plan eligible and have not at any time within one year prior thereto been eligible for selection as persons to whom Units may be granted under this Plan or any other plan of the Company entitling the participants therein to acquire stock, stock options or stock appreciation rights of Company.

8. *Term of Plan.* This Plan will terminate (i) when all Units (as adjusted pursuant to Paragraph 5) granted under it have been exercised or (ii) if it is earlier terminated by the Board as provided below.

9. *Unit Agreement.* Each Unit will be evidenced by an agreement between Company and the grantee in such form consistent with this Plan as the Board from time to time approves. Each such agreement must specify the number of Units covered by it, the Option Price and the exercise period and will otherwise incorporate by reference all the other terms, conditions and provisions of this Plan. Each such agreement will further provide that, with respect to the calendar year in which the Units which it represents are exercised, the grantee will include in his gross income for federal income tax purposes (i) the amount, if any, by which the fair market value of the Common Stock as determined in Paragraph 4 exceeds the Option Price and (ii) the cash payment representing any SAR. Each grantee, by accepting a Unit, will acknowledge and agree (i) that the grant of Units to him is special incentive compensation which is not to be taken into account as "wages" or "salary" in determining payments or benefits to the grantee under any pension, thrift, stock or deferred compensation plan of Company and (ii), on behalf of his beneficiary, that such grant will not affect any life insurance coverage available to such beneficiary under any life insurance plan covering employees of Company or any Subsidiary.

10. *No Employment Commitment.* Neither any grant of Units nor the execution of an agreement as contemplated hereby by Company is to be interpreted or construed as imposing upon Company any obligation to retain the services of a grantee for any period of time, and such employment will continue to be at the pleasure of Company and at such compensation as Company determines from time to time.

11. *Exercise of Units.* Units may be exercised only upon the following terms and conditions:

(a) On the second anniversary of the Grant Date, 40% of the Units granted on such Grant Date will become exercisable, and on each of the next three anniversaries of the Grant Date, 20% of the Units granted on such Grant Date will become exercisable. The right to exercise Units

will be cumulative, except that any Units which remain unexercised on the tenth anniversary after the Grant Date will expire and such Units will be added to the Units otherwise then available for grant under this Plan.

(b) If a Unit is otherwise exercisable under the provisions of the preceding Paragraph 11(a) and the closing sales price of the Common Stock on the Exchange exceeds twice the Option Price related to such Unit for ten consecutive trading days, Company will so notify the grantee and the Unit will expire unless the grantee exercises the Unit on or before the end of the next Exercise Period (as defined in Paragraph 11(g)) beginning after the date such notice is given to the grantee. Such expired Units will be eligible to be granted again pursuant to the provisions of Paragraph 2.

(c) A grant must be exercised in multiples of 10% of the Units to which it applies.

(d) Except as provided in Paragraph 15 below, no Unit may be exercised at any time unless its holder has been continuously employed by Company or a Subsidiary from the Grant Date until the Unit is exercised. For purposes of this Plan, an employee will be considered to be continuously employed by Company during a leave of absence if the leave of absence is authorized by Company under Company's standard personnel practices and the employee returns within the period specified in the authorized leave of absence.

(e) No Unit may be exercised unless at the date of exercise an appropriate registration statement under the Securities Act of 1933 is in effect and the Board has been advised by counsel for Company that all other applicable legal requirements for such exercise (including any related issuance of securities) have been complied with. Company will use its best efforts to effect such registration and satisfy all other applicable legal requirements for issuance as promptly as practicable after approval of this Plan by Company's stockholders and to maintain such registration and the satisfaction of all other applicable legal requirements so long as Units are exercisable.

(f) No Unit may be exercised unless at the date of exercise all shares of Common Stock covered thereby are effectively listed on each stock exchange on which the Common Stock is listed.

(g) Each Unit may be exercised only during the period ("Exercise Period") beginning on the third business day following the date of release of a statement of Company's quarterly or annual sales and earnings and ending on the twelfth business day following such date.

12. *Method of Exercise.* Units may be exercised only by payment to Company at its principal offices in Fort Worth, Texas, of the full amount of the purchase price for the shares being purchased upon such exercise with such payment to be at the sole option of the grantee, either in cash or in shares of the Company's Common Stock owned by the grantee at the time of exercise of the Units or by a combination thereof. To the extent payment is made in shares of the Company's Common Stock, the value of such shares shall be determined in accordance with the provisions of Paragraph 4. Company will thereupon (a) without transfer or issue tax to the grantee, deliver to the grantee at the principal office of Company in Fort Worth, Texas, one or more certificates for such purchased shares and (b) pay the entire cash proceeds from the SAR's of such exercised Units to the proper taxing authorities to be credited toward state and/or federal withholding taxes on behalf of the grantee.

13. *Non-Transferability.* No Unit will be transferable or assignable by the grantee except by will (but with no requirement for specific reference to same) or by the laws of descent and distribution. During the life of a grantee, his Units may be exercised only by him or by his guardian or legal representative.

14. *Rights as a Stockholder.* A holder of Units will have no rights as a stockholder with respect to any shares covered by his Units until the date of issuance of a stock certificate for such shares. No adjustment will be made for dividends whose record date is prior to the date such stock certificate is issued.

15. Termination of Employment. If a grantee ceases to be an employee of Company or a Subsidiary for any reason other than death, retirement (including early retirement as defined below) or disability, all his Units remaining unexercised (whether then exercisable or not) will terminate as of the date the grantee ceases to be an employee, and such Units will be added to the Units then otherwise available for grant under this Plan.

In the event of termination of employment by reason of the retirement (including early retirement) of a grantee while an employee of Company, such grantee may exercise all of his Units remaining unexercised (regardless of the provisions of Paragraph 11(a)) on or before the end of the next Exercise Period beginning after the date of such termination, but in no event after the tenth anniversary of the Grant Date. The terms "retirement" and "early retirement" as used in this Plan will have the same meaning as in the "Southland Royalty Company Employees' Retirement Plan" on the date of such retirement.

In the event of (i) the death or disability of a grantee while he is an employee of Company or a Subsidiary, (ii) the death of a grantee on or before the end of the next Exercise Period beginning after the termination of employment by reason of retirement (including early retirement) or (iii) the death of a grantee within two Exercise Periods beginning after termination of employment by reason of disability, any Units remaining unexercised at the date of such disability or death may be exercised (regardless of the provisions of Paragraph 11(a)) by the grantee or his personal representatives, heirs or legatees at any time within the two Exercise Periods beginning after the date of such disability or death, but in no event after the 10th anniversary of the Grant Date. The term "disability" as used in this Plan means a condition of physical or mental health which incapacitates the grantee to continue normal employment and which results in the termination of his employment. All determinations as to whether employment is terminated by reason of disability, or otherwise, are to be made by the Board and its decision will be conclusive and binding upon all parties.

16. Effectiveness of Plan. This Plan, which was adopted by the Board on August 21, 1980, will be subject to (i) the approval by the holders of a majority of the shares of Common Stock represented in person or by proxy at a special meeting of stockholders to be held at such time, date and place during 1980 as the Board determines and (ii) the consummation of the distribution to holders of Common Stock of units of beneficial interest in the San Juan Basin Royalty Trust and the Permian Basin Royalty Trust, which is to be voted upon at such special meeting.

17. Termination of Plan. Notwithstanding approval of this Plan by the stockholders of Company, the Board may terminate this Plan at any time. Such termination will not affect those rights and obligations theretofore granted and then in effect.

18. Amendment of Plan. The Board may at any time amend the Plan, except that (i) without approval of stockholders there will be no increase in the total number of Units, no change in the class of employees eligible to receive Units, no reduction in the Option Price and no extension of the latest date upon which Units may be exercised and (ii) no amendment may affect any outstanding Unit in any manner adverse to the holder thereof.

19. Use of Proceeds. The proceeds from the sale of Common Stock pursuant to Units will constitute general funds of Company.

20. Merger and Other Events. If (i) Company merges or consolidates with any other corporation (other than a wholly-owned Subsidiary) and is not the surviving corporation, (ii) Company sells all or substantially all its assets to any other corporation (other than a wholly-owned Subsidiary) or (iii) Company is dissolved, all Units will terminate upon the effective date of such merger, consolidation, sale of assets or dissolution, but each grantee will in such event have the right for ten days immediately prior to the effective date of such transaction to exercise his Units in whole or in part without regard to the provisions of Paragraph 11 of this Plan. If any person or entity (together with all persons or entities controlling, controlled by or under common control with such person or entity) acquires or gains ownership or control of (including without limitation power to vote) a majority of the Common Stock then outstanding, all outstanding Units will immediately become, and

will continue to be unless terminated in accordance with this Plan, immediately exercisable without regard to the provisions of Paragraph 11 of this Plan.

The undersigned, as secretary of Southland Royalty Company, hereby certifies that the above Southland Royalty Company 1980 Stock Incentive Plan was adopted by the Board of Directors of such Company on August 21, 1980, was approved by the stockholders of such Company on _____, 1980 and has not been amended to date.

SOUTHLAND ROYALTY COMPANY

Corporate Seal:

By: _____

Secretary