

NOTES TO FINANCIAL STATEMENTS

1. Trust Organization and Provisions

The Permian Basin Royalty Trust (“Trust”) was established as of November 1, 1980. Southwest Bank (“Trustee”) is Trustee for the Trust. The net overriding royalties conveyed to the Trust include (1) a 75% net overriding royalty in Southland Royalty Company’s fee mineral interest in the Waddell Ranch in Crane County, Texas (the “Waddell Ranch properties”) and (2) a 95% net overriding royalty carved out of Southland Royalty Company’s major producing royalty properties in Texas (the “Texas Royalty properties”). The net overriding royalty for the Texas Royalty properties is subject to the provisions of the lease agreements under which such royalties were created. The net overriding royalties above are collectively referred to as the “Royalties.”

On November 3, 1980, Units of Beneficial Interest (“Units”) in the Trust were distributed to the Trustee for the benefit of Southland Royalty Company’s shareholders of record as of November 3, 1980, who received one Unit in the Trust for each share of Southland Royalty Company common stock held. The Units are traded on the New York Stock Exchange.

Burlington Resources Oil & Gas Company LP (“BROG”), a subsidiary of ConocoPhillips, is the interest owner for the Waddell Ranch properties and Riverhill Energy Corporation (“Riverhill Energy”), formerly a wholly owned subsidiary of Riverhill Capital Corporation (“Riverhill Capital”) and formerly an affiliate of Coastal Management Corporation (“CMC”), is the interest owner for the Texas Royalty properties. BROG currently conducts all field, technical and accounting operations on behalf of BROG with regard to the Waddell Ranch properties. Riverhill Energy currently conducts the accounting operations for the Texas Royalty properties.

In February 1997, BROG sold its interest in the Texas Royalty properties to Riverhill Energy.

The Trustee was advised that in the first quarter of 1998, Schlumberger Technology Corporation (“STC”) acquired all of the shares of stock of Riverhill Capital. Prior to such acquisition by STC, CMC and Riverhill Energy were wholly owned subsidiaries of Riverhill Capital. The Trustee was further advised that in connection with STC’s acquisition of Riverhill Capital, the shareholders of Riverhill Capital acquired ownership of all of the shares of stock of Riverhill Energy. Thus, the ownership in the Texas Royalty properties referenced above remained in Riverhill Energy, the stock ownership of which was acquired by the former shareholders of Riverhill Capital.

On January 9, 2014, Bank of America N.A. (as successor to The First National Bank of Fort Worth) gave notice to Unit holders that it would be resigning as trustee of the Trust subject to certain conditions that included the appointment of Southwest Bank as successor trustee. At a Special Meeting of Trust Unit holders, the Unit holders approved the appointment of Southwest Bank as successor trustee of the Trust once the resignation of Bank of America N.A. took effect and also approved certain amendments to the Trust Indenture. The effective date of Bank of America N.A.’s resignation and the effective date of Southwest Bank’s appointment as successor trustee was August 29, 2014. The defined term “Trustee” as used herein shall refer to Bank of America N.A. for periods prior to August 29, 2014, and shall refer to Southwest Bank for periods on or after August 29, 2014.

The terms of the Trust Indenture provide, among other things, that:

- the Trust shall not engage in any business or commercial activity of any kind or acquire any assets other than those initially conveyed to the Trust;
- the Trustee may not sell all or any part of the Royalties unless approved by holders of 75% of all Units outstanding in which case the sale must be for cash and the proceeds promptly distributed;
- the Trustee may establish a cash reserve for the payment of any liability which is contingent or uncertain in amount;
- the Trustee is authorized to borrow funds to pay liabilities of the Trust; and
- the Trustee will make monthly cash distributions to Unit holders (see Note 3).

2. Accounting Policies

The financial statements of the Trust are prepared on the following basis:

- Royalty income recorded for a month is the amount computed and paid to the Trustee on behalf of the Trust by the interest owners. Royalty income consists of the amounts received by the owners of the interest burdened by the Royalties from the

sale of production less accrued production costs, development and drilling costs, applicable taxes, operating charges and other costs and deductions multiplied by 75% in the case of the Waddell Ranch properties and 95% in the case of the Texas Royalty properties.

- Trust expenses, consisting principally of routine general and administrative costs, recorded are based on liabilities paid and cash reserves established out of cash received or borrowed funds for liabilities and contingencies.
- Distributions to Unit holders are recorded when declared by the Trustee.
- Royalty income is computed separately for each of the conveyances under which the Royalties were conveyed to the Trust. If monthly costs exceed revenues for any conveyance (“excess costs”), such excess costs cannot reduce royalty income from other conveyances, but is carried forward with accrued interest to be recovered from future net proceeds of that conveyance.

The financial statements of the Trust differ from financial statements prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) because revenues are not accrued in the month of production and certain cash reserves may be established for contingencies which would not be accrued in financial statements prepared in accordance with GAAP. Amortization of the Royalties calculated on a unit-of-production basis is charged directly to trust corpus. This comprehensive basis of accounting other than GAAP corresponds to the accounting permitted for royalty trusts by the U.S. Securities and Exchange Commission as specified by Staff Accounting Bulletin Topic 12:E, Financial Statements of Royalty Trusts.

Use of Estimates

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

Impairment

The Trustee routinely reviews its royalty interests in oil and gas properties for impairment whenever events or circumstances indicate that the carrying amount of an asset may not be recoverable. If an impairment event occurs and it is determined that the carrying value of the Trust’s royalty interests may not be recoverable, an impairment will be recognized as measured by the amount by which the carrying amount of the royalty interests exceeds the fair value of these assets, which would likely be measured by discounting projected cash flows. There was no impairment of the assets as of December 31, 2015.

Contingencies

Contingencies related to the Underlying Properties that are unfavorably resolved would generally be reflected by the Trust as reductions to future royalty income payments to the Trust with corresponding reductions to cash distributions to Unit holders.

Distributable Income Per Unit

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

New Accounting Pronouncements

There are no new accounting pronouncements that are expected to have a significant impact on the Trust’s financial statements.

3. Net Overriding Royalty Interests and Distribution to Unit Holders

The amounts to be distributed to Unit holders (“Monthly Distribution Amounts”) are determined on a monthly basis. The Monthly Distribution Amount is an amount equal to the sum of cash received by the Trustee during a calendar month attributable to

the Royalties, any reduction in cash reserves and any other cash receipts of the Trust, including interest, reduced by the sum of liabilities paid and any increase in cash reserves. If the Monthly Distribution Amount for any monthly period is a negative number, then the distribution will be zero for such month. To the extent the distribution amount is a negative number, that amount will be carried forward and deducted from future monthly distributions until the cumulative distribution calculation becomes a positive number, at which time a distribution will be made. Unit holders of record will be entitled to receive the calculated Monthly Distribution Amount for each month on or before 10 business days after the monthly record date, which is generally the last business day of each calendar month.

The cash received by the Trustee consists of the amounts received by owners of the interest burdened by the Royalties from the sale of production less the sum of applicable taxes, accrued production costs, development and drilling costs, operating charges and other costs and deductions, multiplied by 75% in the case of the Waddell Ranch properties and 95% in the case of the Texas Royalty properties.

The initial carrying value of the Royalty Interests \$10,975,216 represented Southland Royalty Company's historical net book value at the date of the transfer to the Trust. Accumulated amortization as of December 31, 2015 and 2014 was \$10,294,530 and \$10,252,269, respectively.

4. Federal Income Taxes

For federal income tax purposes, the Trust constitutes a fixed investment trust that is taxed as a grantor trust. A grantor trust is not subject to tax at the trust level. The Unit holders are considered to own the Trust's income and principal as though no trust were in existence. The income of the Trust is deemed to have been received or accrued by each Unit holder at the time such income is received or accrued by the Trust and not when distributed by the Trust. The Trust has on file technical advice memoranda confirming the tax treatment described above.

Some Trust Units are held by middlemen, as such term is broadly defined in U.S. Treasury Regulations (and includes custodians, nominees, certain joint owners, and brokers holding an interest for a customer in street name, collectively referred to herein as "middlemen"). Therefore, the Trustee considers the Trust to be a non-mortgage widely held fixed investment trust ("WHFIT") for U.S. federal income tax purposes. Southwest Bank, EIN: 75-1105980, 2911 Turtle Creek Boulevard, Suite 850, Dallas, Texas 75219, telephone number (855) 588-7839, email address trustee@pbt-permian.com, is the representative of the Trust that will provide tax information in accordance with applicable U.S. Treasury Regulations governing the information reporting requirements of the Trust as a WHFIT. Tax information is also posted by the Trustee at www.pbt-permian.com. Notwithstanding the foregoing, the middlemen holding Trust Units on behalf of Unit holders, and not the Trustee of the Trust, are solely responsible for complying with the information reporting requirements under the U.S. Treasury Regulations with respect to such Trust Units, including the issuance of IRS Forms 1099 and certain written tax statements. Unit holders whose Trust Units are held by middlemen should consult with such middlemen regarding the information that will be reported to them by the middlemen with respect to the Trust Units.

Because the Trust is a grantor trust for federal tax purposes, each Unit holder is taxed directly on his proportionate share of income, deductions and credits of the Trust consistent with each such Unit holder's taxable year and method of accounting and without regard to the taxable year or method of accounting employed by the Trust. The income of the Trust consists primarily of a specified share of the proceeds from the sale of oil and gas produced from the Underlying Properties. During 2015, the Trust also earned interest income on funds held for distribution and the cash reserve maintained for the payment of contingent and future obligations of the Trust.

The deductions of the Trust consist of severance taxes and administrative expenses. In addition, each Unit holder is entitled to depletion deductions because the Royalties constitute "economic interests" in oil and gas properties for federal income tax purposes. Each Unit holder is entitled to amortize the cost of the Units through cost depletion over the life of the Royalties or, if greater, through percentage depletion equal to 15 percent of gross income. Unlike cost depletion, percentage depletion is not limited to a Unit holder's depletable tax basis in the Units. Rather, a Unit holder is entitled to a percentage depletion deduction as long as the applicable Underlying Properties generate gross income. Percentage depletion is allowed on proven properties acquired after October 11, 1990. For Units acquired after such date, Unit holders would normally compute both percentage depletion and

cost depletion from each property and claim the larger amount as a deduction on their income tax returns. The Trustee has estimated the cost depletion for January through December 2015, and it appears that percentage depletion will exceed cost depletion for some of the Unit holders.

If a taxpayer disposes of any "Section 1254 property" (certain oil, gas, geothermal or other mineral property), and if the adjusted basis of such property includes adjustments for deductions for depletion under Section 611 of the Internal Revenue Code (the "Code"), the taxpayer generally must recapture the amount deducted for depletion as ordinary income (to the extent of gain realized on the disposition of the property). This depletion recapture rule applies to any disposition of property that was placed in service by the taxpayer after December 31, 1986. Detailed rules set forth in Sections 1.1254-1 through 1.1254-6 of the U.S. Treasury Regulations govern dispositions of property after March 13, 1995. The Internal Revenue Service likely will take the position that a Unit holder who purchases a Unit subsequent to December 31, 1986, must recapture depletion upon the disposition of that Unit.

Individuals may incur expenses in connection with the acquisition or maintenance of Trust Units. These expenses may be deductible as "miscellaneous itemized deductions" only to the extent that such expenses exceed 2 percent of the individual's adjusted gross income.

The classification of the Trust's income for purposes of the passive loss rules may be important to a Unit holder. Royalty income generally is treated as portfolio income and does not offset passive losses. Therefore, in general, it appears that Unit holders should not consider the taxable income from the Trust to be passive income in determining net passive income or loss. Unit holders should consult their tax advisors for further information.

Unit holders of record will continue to receive an individualized tax information letter for each of the quarters ending March 31, June 30 and September 30, 2016, and for the year ending December 31, 2016. Unit holders owning Units in nominee may obtain monthly tax information from the Trustee upon request. See discussion above regarding certain reporting requirements imposed upon middlemen under U.S. Treasury Regulations because the Trust is considered a WHIFT for federal income tax purposes.

Under current law, the highest marginal U.S. federal income tax rate applicable to ordinary income of individuals is 39.6%, and the highest marginal U.S. federal income tax rate applicable to long-term capital gains (generally, gains from the sale or exchange of certain investment assets held for more than one year) and qualified dividends of individuals is 20%. Such marginal tax rates may be effectively increased by up to 1.2% due to the phaseout of personal exemptions and the limitations on itemized deductions. The highest marginal U.S. federal income tax rate applicable to corporations is 35%, and such rate applies to both ordinary income and capital gains.

Section 1411 of the Code imposes a 3.8% Medicare tax on certain investment income earned by individuals, estates, and trusts for taxable years beginning after December 31, 2012. For these purposes, investment income generally will include a Unit holder's allocable share of the Trust's interest and royalty income plus the gain recognized from a sale of Trust Units. In the case of an individual, the tax is imposed on the lesser of (i) the individual's net investment income from all investments, or (ii) the amount by which the individual's modified adjusted gross income exceeds specified threshold levels depending on such individual's federal income tax filing status. In the case of an estate or trust, the tax is imposed on the lesser of (i) undistributed net investment income, or (ii) the excess adjusted gross income over the dollar amount at which the highest income tax bracket applicable to an estate or trust begins.

The tax consequences to a Unit holder of the ownership and sale of Units will depend in part on the Unit holder's tax circumstances. Unit holders should consult their tax advisors about the federal tax consequences relating to owning the Units in the Trust.

Pursuant to the Foreign Account Tax Compliance Act (commonly referred to as "FATCA"), distributions from the Trust to "foreign financial institutions" and certain other "non-financial foreign entities" may be subject to U.S. withholding taxes. Specifically, certain "withholdable payments" (including certain royalties, interest and other gains or income from U.S. sources) made to a foreign financial institution or non-financial foreign entity will generally be subject to the withholding tax unless the foreign financial institution or non-financial foreign entity complies with certain information reporting, withholding, identification, certification and related requirements imposed by FATCA. Foreign financial institutions located in jurisdictions that have an intergovernmental agreement with the United States governing FATCA may be subject to different rules.

The Treasury Department issued guidance providing that the FATCA withholding rules described above generally will only apply to qualifying payments made after June 30, 2014. Foreign Unit holders are encouraged to consult their own tax advisors regarding the possible implications of these withholding provisions on their investment in Trust Units.

5. Proved Oil and Gas Reserves (Unaudited)

Reserve Quantities

Information regarding estimates of the proved oil and gas reserves attributable to the Trust are based on reports prepared by Cawley, Gillespie & Associates, Inc., independent petroleum engineering consultants. Estimates were prepared in accordance with the guidelines established by the FASB and the Securities and Exchange Commission. Certain information required by this guidance is not presented because that information is not applicable to the Trust due to its passive nature.

Oil and gas reserve quantities (all located in the United States) are estimates based on information available at the time of their preparation. Such estimates are subject to change as additional information becomes available. Reserves actually recovered, and the timing of the production of those reserves, may differ substantially from original estimates. The following schedule presents changes in the Trust's total proved reserves (in thousands):

	Total	
	Oil (Bbls)	Gas (Mcf)
January 1, 2013	6,429	18,276
Extensions, discoveries, and other additions	74	120
Revisions of previous estimates	(11)	(3,330)
Production	<u>(370)</u>	<u>(727)</u>
December 31, 2013	6,122	14,339
Extensions, discoveries, and other additions	216	1,048
Revisions of previous estimates	(509)	(1,279)
Production	<u>(453)</u>	<u>(931)</u>
December 31, 2014	5,376	13,177
Extensions, discoveries, and other additions	65	201
Revisions of previous estimates	(486)	(3,682)
Production	<u>(345)</u>	<u>(650)</u>
December 31, 2015	<u>4,610</u>	<u>9,046</u>

Estimated quantities of proved developed reserves of oil and gas as of the dates indicated were as follows (in thousands):

	Oil (Barrels)	Gas (Mcf)
Proved Developed Reserves:		
January 1, 2013	6,122	16,848
December 31, 2013	5,769	13,177
December 31, 2014	5,160	12,129
December 31, 2015	4,610	9,046

Disclosure of a Standardized Measure of Discounted Future Net Cash Flows

The following is a summary of a standardized measure (in thousands) of discounted future net cash flows related to the Trust's total proved oil and gas reserve quantities. Information presented is based upon valuation of proved reserves by using discounted cash flows based upon average oil and gas prices (\$50.28 per bbl and \$2.59 per MMBtu, respectively) during the 12-month period prior to the fiscal year-end, determined as an unweighted arithmetic average of the first-day-of-the-month price for

each month within such period, unless prices are defined by contractual arrangements, excluding escalations based upon future conditions and severance and ad valorem taxes, if any, and economic conditions, discounted at the required rate of 10 percent. As the Trust is not subject to taxation at the trust level, no provision for income taxes has been made in the following disclosure. Trust prices may differ from posted NYMEX prices due to differences in product quality and property location. The impact of changes in current prices on reserves could vary significantly from year to year. Accordingly, the information presented below should not be viewed as an estimate of the fair market value of the Trust's oil and gas properties nor should it be viewed as indicative of any trends.

<u>December 31,</u>	<u>2015</u>	<u>2014</u>	<u>2013</u>
Future net cash inflows	\$ 237,703	\$ 538,738	\$ 615,626
Discount of future net cash flows @ 10%	(111,598)	(236,456)	(281,988)
Standardized measure of discounted future net cash inflows	<u>\$ 126,105</u>	<u>\$ 302,282</u>	<u>\$ 333,638</u>

The change in the standardized measure of discounted future net cash flows for the years ended December 31, 2015, 2014 and 2013 is as follows (in thousands):

	<u>Total</u>		
	<u>2015</u>	<u>2014</u>	<u>2013</u>
January 1	\$ 302,282	\$333,638	\$354,060
Extensions, discoveries, and other additions	0	12,519	3,041
Accretion of discount	30,229	33,364	35,406
Revisions of previous estimates and other	(188,610)	(30,296)	(17,123)
Royalty income	(17,796)	(49,011)	(41,746)
December 31	<u>\$ 126,105</u>	<u>\$302,282</u>	<u>\$333,638</u>

Subsequent to year end, the price of both oil and gas continued to fluctuate, giving rise to a correlating adjustment of the respective standardized measure of discounted future net cash flows. As of March 1, 2016, NYMEX posted oil prices were approximately \$34.39 per barrel, which compared to the posted price of \$50.28 per barrel, used to calculate the worth of future net revenue of the Trust's proved developed reserves, would result in a smaller standardized measure of discounted future net cash flows for oil. As of March 1, 2016, NYMEX posted gas prices were \$1.57 per million British thermal units. The use of such price, as compared to the posted price of \$2.59 per million British thermal units, used to calculate the future net revenue of the Trust's proved developed reserves would result in a smaller standardized measure of discounted future net cash flows for gas.

6. Quarterly Schedule of Distributable Income (Unaudited)

The following is a summary of the unaudited quarterly schedule of distributable income for the two years ended December 31, 2015 (in thousands, except per Unit amounts):

<u>2015</u>	<u>Royalty Income</u>	<u>Distributable Income</u>	<u>Distributable Income and Distribution Per Unit</u>
First Quarter	\$ 4,630	\$ 4,184	\$.089768
Second Quarter	4,122	3,521	.075927
Third Quarter	5,882	5,494	.117872
Fourth Quarter	3,162	2,851	.061163
Total	<u>\$17,796</u>	<u>\$16,050</u>	<u>\$.344730</u>

<u>2014</u>	<u>Royalty Income</u>	<u>Distributable Income</u>	<u>Distributable Income and Distribution Per Unit</u>
First Quarter	\$12,135	\$11,700	\$.251032
Second Quarter	14,607	14,125	.303064
Third Quarter	15,233	15,039	.322672
Fourth Quarter	7,036	6,853	.147013
Total	<u>\$49,011</u>	<u>\$47,717</u>	<u>\$1.023781</u>

7. State Tax Considerations

All revenues from the Trust are from sources within Texas, which has no individual income tax. Texas imposes a franchise tax at a rate of .75% on gross revenues less certain deductions, as specifically set forth in the Texas franchise tax statutes. Entities subject to tax generally include trusts and most other types of entities that provide limited liability protection, unless otherwise exempt. Trusts that receive at least 90% of their federal gross income from designated passive sources, including royalties from mineral properties and other non-operated mineral interest income, and do not receive more than 10% of their income from operating an active trade or business, generally are exempt from the Texas franchise tax as “passive entities.” The Trust has been and expects to continue to be exempt from Texas franchise tax as a passive entity. Because the Trust should be exempt from Texas franchise tax at the Trust level as a passive entity, each Unit holder that is considered a taxable entity under the Texas franchise tax will generally be required to include its portion of Trust revenues in its own Texas franchise tax computation. This revenue is sourced to Texas under provisions of the Texas Administrative Code providing that such income is sourced according to the principal place of business of the Trust, which is Texas.

Unit holders should consult their tax advisors regarding Trust tax compliance matters.

8. Commitments and Contingencies

Contingencies related to the Underlying Properties that are unfavorably resolved would generally be reflected by the Trust as reductions to future royalty income payments to the Trust with corresponding reductions to cash distributions to Unit holders.

On May 2, 2011, ConocoPhillips, as the parent company of BROG, the operator of the Waddell Ranch properties, notified the Trustee that as a result of inaccuracies in ConocoPhillips’ accounting and record keeping relating to the Trust’s interest in proceeds from the gas plant production since January 2007, ConocoPhillips overpaid the Trust approximately \$5.9 million initially. ConocoPhillips withheld \$4.5 million from the proceeds for 2011 pending completions to the corrections of the accounting procedures. Beginning with the October 2012 distribution, previously withheld proceeds of \$4.5 million were reimbursed by ConocoPhillips to the Trust (\$4.0 million and \$0.5 million in 2013 and 2012, respectively). ConocoPhillips has adjusted the monthly royalty payments to the Trust since October 2012 by the related reimbursed amounts to reflect ConocoPhillips’ ongoing correction of past and current production and royalty allocations and the payment of the previously withheld proceeds. These adjustments were completed in the first quarter of 2014. The Trust’s reported royalty income for the years ended December 31, 2015, 2014 and 2013 was not significantly impacted by these offsetting amounts. The Trustee is continuing to evaluate the matter.

9. General and Administrative Expenses

General and administrative expenses for the years ended December 31, were as follows:

	<u>2015</u>	<u>2014</u>	<u>2013</u>
Trustee’s fee	\$ 84,798	\$ 80,084	\$ 65,292
Professional fees	274,265	281,365	296,746
Unit holders’ services fees	886,800	931,969	864,894
Other (reserve for expenses)	500,000	—	—
Total General and Administrative Expenses	<u>\$1,745,863</u>	<u>\$1,293,418</u>	<u>\$1,226,932</u>

10. Subsequent Events

Subsequent to December 31, 2015, the Trust declared the following distributions:

<u>Monthly Record Date</u>	<u>Payment Date</u>	<u>Distribution per Unit</u>
January 29, 2016	February 12, 2016	\$.014734
February 29, 2016	March 14, 2016	\$.021680

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