

Edgar Filing: NORTH EUROPEAN OIL ROYALTY TRUST - Form 10-Q

NORTH EUROPEAN OIL ROYALTY TRUST  
Form 10-Q  
February 26, 2009

SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

Quarterly report pursuant to Section 13 or 15(d) of the  
Securities Exchange Act of 1934

For the quarterly period ended January 31, 2009 or  
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Transition report pursuant to Section 13 or 15(d) of the  
Securities Exchange Act of 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_ .

Commission file number 1-8245

NORTH EUROPEAN OIL ROYALTY TRUST

-----  
(Exact name of registrant as specified in its charter)

Delaware

22-2084119

-----  
(State of organization)

-----  
(I.R.S. Employer I.D. No.)

Suite 19A, 43 West Front Street, Red Bank, New Jersey 07701

-----  
(Address of principal executive offices)

(732) 741-4008

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(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes X No  
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Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer	-----	Accelerated filer	X	-----
Non-accelerated filer	-----	Smaller reporting company		-----

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

Class	Outstanding at January 31, 2008
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Units of Beneficial Interest	9,190,590

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PART I -- FINANCIAL INFORMATION

Item 1. Financial Statements.

STATEMENTS OF ASSETS, LIABILITIES AND TRUST CORPUS (NOTE 1)

JANUARY 31, 2009 AND OCTOBER 31, 2008

	2009	2008
	(unaudited)	
Current assets - - Cash and cash equivalents (Note 1)	\$ 9,904,690	\$ 9,524,529
Producing gas and oil royalty rights, net of amortization (Notes 1 and 2)	1	1
Total Assets	<u>\$ 9,904,691</u>	<u>\$ 9,524,530</u>
Current liabilities - - Distributions to be paid to unit owners, paid February 2009 and November 2008	\$ 9,742,025	\$ 9,466,308
Trust corpus (Notes 1 and 2)	1	1
Undistributed earnings	162,665	58,221
Total Liabilities and Trust Corpus	<u>\$ 9,904,691</u>	<u>\$ 9,524,530</u>

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

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STATEMENTS OF REVENUE COLLECTED AND EXPENSES PAID (NOTE 1)

FOR THE THREE MONTHS ENDED JANUARY 31, 2009 AND 2008

	2009	2008
	(unaudited)	
German gas, sulfur and oil royalties received	\$10,180,979	\$ 7,215,083
Interest income	9,451	33,355
Trust expenses	( 343,961)	( 269,113)
Net income	\$ 9,846,469	\$ 6,979,325
Net income per unit	\$1.07	\$ .76
Distributions per unit to be paid to unit owners	\$1.06	\$ .76

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

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STATEMENTS OF UNDISTRIBUTED EARNINGS (NOTE 1)  
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 FOR THE THREE MONTHS ENDED JANUARY 31, 2009 AND 2008  
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	2009	2008
	-----	-----
	(unaudited)	
Balance, beginning of period	\$ 58,221	\$ 30,642
Net income	9,846,469	6,979,325
	-----	-----
	9,904,690	7,009,967
Less:		
Current year distributions paid or to be paid to unit owners	9,742,025	6,984,848
	-----	-----
Balance, end of period	\$ 162,665	\$ 25,119
	=====	=====

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

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STATEMENTS OF CHANGES IN CASH AND CASH EQUIVALENTS (NOTE 1)

FOR THE THREE MONTHS ENDED JANUARY 31, 2009 AND 2008

	2009	2008
	(unaudited)	
Sources of cash and cash equivalents:		
German gas, sulfur and oil royalties	\$10,180,979	\$ 7,215,083
Interest income	9,451	33,355
	-----	-----
	10,190,430	7,248,438
	-----	-----
Uses of cash and cash equivalents:		
Payment of Trust expenses	343,961	269,113
Distributions paid	9,466,308	5,881,978
	-----	-----
	9,810,269	6,151,091
	-----	-----
Net increase (decrease) in cash and cash equivalents during the period	380,161	1,097,347
Cash and cash equivalents, beginning of period	9,524,529	5,912,620
	-----	-----
Cash and cash equivalents, end of period	\$ 9,904,690	\$ 7,009,967
	=====	=====

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

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NORTH EUROPEAN OIL ROYALTY TRUST

NOTES TO FINANCIAL STATEMENTS

(Unaudited)

(1) Summary of significant accounting policies:

Basis of Accounting -

The accompanying financial statements of North European Oil Royalty Trust ("the Trust") present financial statement balances and financial results on a modified cash basis of accounting, which is a comprehensive basis of accounting other than accounting principles generally accepted in the United States ("GAAP basis"). On a modified cash basis revenue is earned when cash is received and expenses are incurred when cash is paid. GAAP basis financial statements disclose revenue as earned and expenses as incurred, without regard to receipts or payments. The modified cash basis of accounting is utilized to permit the accrual for distributions to be paid to unit owners (those distributions approved by the Trustees for the Trust). The Trust's distributable income represents royalty income received by the Trust during the period plus interest income less any expenses incurred by the Trust, all on a cash basis. In the opinion of the Trustees, the use of the modified cash basis of accounting provides a more meaningful presentation to unit owners of the results of operations of the Trust.

Producing gas and oil royalty rights -

The rights to certain gas and oil royalties in Germany were transferred to the Trust at their net book value by North European Oil Company (the "Company") (see Note 2). The net book value of the royalty rights has been reduced to one dollar (\$1) in view of the fact that the remaining net book value of royalty rights is de minimis relative to annual royalties received and distributed by the Trust and does not bear any meaningful relationship to the fair value of such rights or the actual amount of proved producing reserves.

Federal income taxes -

The Trust, as a grantor trust, is exempt from federal income taxes under a private letter ruling issued by the Internal Revenue Service.

Cash and cash equivalents -

Included in cash and cash equivalents are amounts deposited in bank accounts and amounts invested in certificates of deposit and U. S. Treasury bills with original maturities of three months or less from the date of purchase.

Since December 10, 2008, all funds deposited in the Trust's bank accounts have been fully covered under the FDIC's Temporary Liquidity Guarantee Program.

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Net income per unit -  
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Net income per unit is based upon the number of units outstanding at the end of the period. As of both January 31, 2009 and 2008, there were 9,190,590 units of beneficial interest outstanding.

(2) Formation of the Trust:  
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The Trust was formed on September 10, 1975. As of September 30, 1975, the Company was liquidated and the remaining assets and liabilities of the Company, including its royalty rights, were transferred to the Trust. The Trust, on behalf of the owners of beneficial interest in the Trust, holds overriding royalty rights covering gas and oil production in certain concessions or leases in the Federal Republic of Germany. These rights are held under contracts with local German exploration and development subsidiaries of ExxonMobil Corp. and the Royal Dutch/Shell Group of Companies. Under these contracts, the Trust receives various percentage royalties on the proceeds of the sales of certain products from the areas involved. At the present time, royalties are received for sales of gas well gas, oil well gas, crude oil, condensate and sulfur.

(3) Related party transactions:  
-----

John R. Van Kirk, the Managing Director of the Trust, provides office space and office services to the Trust at cost. For such office space and office services, the Trust reimbursed the Managing Director \$5,778 and \$8,922 in the first quarter of fiscal 2009 and 2008, respectively.

As of January 1, 2007, Lawrence A. Kobrin, a Trustee of the Trust, was named Senior Counsel at Cahill Gordon & Reindel LLP which serves as counsel to the Trust. Prior to such time, Mr. Kobrin was a partner at Cahill Gordon & Reindel LLP. For the first quarter of fiscal 2009 and 2008, the Trust paid Cahill Gordon & Reindel LLP \$33,029 and \$56,692 for legal services, respectively.

As of November 1, 2006, John H. Van Kirk, the former Managing Trustee of the Trust and the father of John R. Van Kirk, was named to the position of Founding Trustee Emeritus. For his service in such capacity, he earned \$2,500 in the first quarter of fiscal 2009 and 2008.

(4) Employee Benefit Plan:  
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As of January 1, 2008, the Trust established a savings incentive match plan for employees (SIMPLE IRA) that is available to all employees of the Trust, including the Managing Director. The Trustees have authorized the Trust to make contributions to the accounts of the employees, on a matching basis, of up to 3% of cash compensation paid to each employee effective for the 2009 calendar year.



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

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Executive Summary  
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The Trust is a passive fixed investment trust which holds overriding royalty rights, receives income under those rights from certain operating companies, pays its expenses and distributes the remaining net funds to its unit owners. The Trust does not engage in any business or extractive operations of any kind in the areas over which it holds royalty rights and is precluded from any such involvement by the Trust Agreement. There are no requirements, therefore, for capital resources with which to make capital expenditures or investments in order to continue the receipt of royalty revenues by the Trust.

The properties of the Trust, which the Trust and Trustees hold pursuant to the Trust Agreement on behalf of the unit owners, are overriding royalty rights on sales of gas, sulfur and oil under certain concessions or leases in the Federal Republic of Germany. The actual leases or concessions are held either by Mobil Erdgas-Erdol GmbH ("Mobil Erdgas"), a German operating subsidiary of the ExxonMobil Corp. ("ExxonMobil"), or by Oldenburgische Erdolgesellschaft ("OEG"). In 2002, Mobil Erdgas and BEB Erdgas und Erdol GmbH ("BEB"), a joint venture of ExxonMobil and the Royal Dutch/Shell Group of Companies, formed a company ExxonMobil Production Deutschland GmbH ("EMPG") to carry out all exploration, drilling and production activities. All sales activities are still handled by the operating companies, either Mobil Erdgas or BEB.

The operating companies pay monthly royalties to the Trust based on their sales of natural gas, sulfur and oil. Of these three products, natural gas provides approximately 98% of the total royalties. The amount of royalties paid to the Trust is based on four primary factors: the amount of gas sold, the price of that gas, the area from which the gas is sold and the exchange rate. The Oldenburg concession is the primary area from which the natural gas, sulfur and oil are extracted and provides nearly 100% of all the royalties received by the Trust. The Oldenburg concession (1,398,000 acres) covers virtually the entire former Principality of Oldenburg and is located in the federal state of Lower Saxony.

Under one set of rights covering the western part of the Oldenburg concession (approximately 662,000 acres), the Trust receives a royalty payment of 4% on gross receipts from sales by Mobil Erdgas of gas well gas, oil well gas, crude oil and condensate (the "Mobil Agreement"). Under the Mobil Agreement, there is no deduction of costs prior to the calculation of royalties from gas well gas and oil well gas, which together account for approximately 99% of all the royalties under this agreement. Historically, the Trust has received significantly greater royalty payments under the Mobil Agreement due to the higher royalty rate specified by that agreement.

The Trust is also entitled under the Mobil Agreement to receive a 2% royalty on gross receipts of sales of sulfur obtained as a by-product of sour gas produced from the western part of Oldenburg. The payment of the sulfur royalty is conditioned upon sales of sulfur by Mobil Erdgas at a selling price above an agreed upon base price. This base price is adjusted annually by an inflation index. The Trust had received no sulfur royalties under this

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agreement for over ten years until the second quarter of fiscal 2008.

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From that point forward, the average selling price for sulfur again exceeded the indexed base price and the payment of sulfur royalties under the Mobil Agreement resumed. In the first quarters of fiscal 2009 and 2008, the Trust received \$244,874 and \$0, respectively. The reason behind this sudden resumption in payments has been the substantial increase in sulfur commodity prices. The Trust is unable to determine how long sulfur prices will remain above the threshold price level and thus how long these sulfur royalties may continue.

Under another set of rights covering the entire Oldenburg concession and pursuant to the agreement with OEG, the Trust receives royalties at the rate of 0.6667% on gross receipts from sales by BEB of gas well gas, oil well gas, crude oil, condensate and sulfur (removed during the processing of sour gas) less a certain allowed deduction of costs (the "OEG Agreement"). Under the OEG Agreement, 50% of the field handling, treatment and transportation costs, as reported for state royalty purposes, are deducted from the gross sales receipts prior to the calculation of the royalty to be paid to the Trust. NV Nederlandse Gasunie (the state owned Dutch gas distribution company) has completed the purchase of BEB's North German gas distribution and transmission network. Preliminary informal discussions with OEG personnel indicate that the pipeline sale should not affect the method of royalty calculation. The Trust is seeking a formal confirmation that the sale will not affect the method of royalty calculation.

The Trust also receives small amounts of royalties from a private lease area, Grosses Meer, outside the Oldenburg concession. The German authorities have requested that the operating companies conduct a reservoir analysis to determine whether the royalties are being properly allocated based on the locations of the gas reserves. Until such time as this issue is settled, the payment of royalties from Grosses Meer has been suspended effective as of the second calendar quarter of 2008. In the first quarters of fiscal 2009 and 2008, the Trust received \$0 and \$37,612 in royalties from Grosses Meer, respectively.

The gas is sold to various distributors under long-term contracts which delineate, among other provisions, the timing, manner, volume and price of the gas sold. The pricing mechanisms contained in these contracts include a delay factor of three to six months and use the price of light heating oil in Germany as one of the primary pricing components. Since Germany must import a large percentage of its energy requirements, the U.S. dollar price of oil on the international market has a significant impact on the price of light heating oil and a delayed impact on the price of gas. The Trust does not have access to the specific sales contracts under which gas from the Oldenburg concession is sold. Working under a confidentiality agreement with the operating companies, the Trust's German auditor reviews these contracts periodically on behalf of the Trust to verify the correctness of application of the Agreement formulas for the computation of royalty payments.

For unit owners, changes in the value of the Euro have both an immediate and long-term impact. The immediate impact is from the exchange rate that is applied at the time the royalties, paid to the Trust in Euros, are converted into dollars at the time of their transfer from Germany to the United States. A higher exchange rate would yield more dollars and a lower exchange rate fewer dollars. The long-term impact relates to the mechanism of gas pricing. Since oil on the international market is priced in dollars, a weaker Euro would mean that oil imported into Germany is more expensive. A stronger Euro would mean that oil imported into Germany is less expensive. These changes in the price of oil in Germany are subsequently reflected in

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the price of light heating oil, which is used as a component in the

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calculation of gas prices in the contracts under which the gas is sold. The changes in German domestic light heating oil prices are in turn reflected in gas prices with a built-in delay of three to six months.

Seasonal demand factors affect the income from royalty rights insofar as they relate to energy demands and increases or decreases in prices, but on average they are not material to the regular annual income received under the royalty rights.

The Trust has no means of ensuring continued income from overriding royalty rights at their present level or otherwise. The Trust's consultant in Germany provides general information to the Trust on the German and European economies and energy markets. This information provides a context in which to evaluate the actions of the operating companies. In his position as consultant, he receives reports from the operating companies with respect to current and planned drilling and exploration efforts. However, the unified exploration and production venture, EMPG, which provides the reports to the Trust's consultant, continues to limit the information flow to that which is required by German law.

The relatively low level of administrative expenses of the Trust limits the effect of inflation on its financial prospects. Continued price inflation, which would be reflected in sales prices, along with sales volumes form the basis on which the royalties paid to the Trust are computed. The impact of inflation or deflation on energy prices in Germany is delayed by the use, in certain long-term gas sales contracts, of a delay factor of three to six months prior to the application of any changes in light heating oil prices to gas prices.

As mandated by the Trust Agreement, distributions of income are made on a quarterly basis. These distributions, as determined by the Trustees, constitute substantially all the funds on hand after provision is made for Trust expenses then anticipated.

Results: First Quarter Fiscal 2009 Versus First Quarter Fiscal 2008

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For the first quarter of fiscal 2009, the Trust's net income was \$9,846,469, an increase of 41.08% from the net income of \$6,979,325 for the first quarter of fiscal 2008. Gross royalties received for the first quarter of fiscal 2009 were \$10,180,979, an increase of 41.11% as compared to \$7,215,083 for the first quarter of fiscal 2008. These royalties were derived from sales of gas, sulfur and oil from the Trust's overriding royalty areas in Germany during the fourth calendar quarter of 2008. A distribution of \$1.06 per unit was paid on February 25, 2009 to owners of record as of February 13, 2009.

The amount of royalties paid to the Trust is based on four primary factors: the amount of gas sold, the price of that gas, the area from which the gas is sold and the exchange rate. Gas sales are measured in billion cubic feet ("Bcf"). Gas prices are reported in Euro cents per Kilowatt hour ("Ecents/Kwh") and dollars per thousand cubic feet ("\$/Mcf"). The primary factor affecting royalty revenue for the quarter just ended was the increase in gas prices under both the Mobil and the OEG Agreements. In addition, in comparison to the first quarter of fiscal 2008, the lower average value of the Euro relative to the dollar reduced the number of dollars received when the royalties paid in Euros were converted to dollars at the time of their

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transfers to the U.S. The increase in gas prices more than offset the lower average value of the Euro and the decline in gas sales under both royalty agreements.

### Factors Affecting Royalties Paid under the Mobil Agreement

	First Fiscal Qtr. Ended 1/31/2009	First Fiscal Qtr. Ended 1/31/2008	Percentage Change
Gas Sales (Bcf)	13.699	14.251	- 3.87%
Gas Prices (Ecents/Kwh)	3.1861	2.0876	+52.62%
Gas Prices (\$/Mcf)	\$12.30	\$ 8.83	+39.35%
Average Euro Value	\$1.3404	\$1.4693	- 8.77%

If we exclude the effects of differences in prices and average exchange rates, the combination of royalty rates on gas sold from western Oldenburg results in an effective royalty rate approximately seven times higher than the royalty rate on gas sold from eastern Oldenburg. This is of particular significance to the Trust since gas sold from western Oldenburg provides the bulk of royalties paid to the Trust. For the quarter just ended, gas sales from western Oldenburg accounted for only 39.88% of all gas sales. However, royalties on these gas sales provided approximately 81.93% or \$7,896,998 out of a total of \$9,638,306 in Oldenburg royalties attributable to gas.

### Factors Affecting Royalties Paid under the OEG Agreement

	First Fiscal Qtr. Ended 1/31/2009	First Fiscal Qtr. Ended 1/31/2008	Percentage Change
Gas Sales (Bcf)	34.351	34.716	- 1.05%
Gas Prices (Ecents/Kwh)	3.4411	2.1921	+56.98%
Gas Prices (\$/Mcf)	\$12.93	\$ 9.06	+42.66%
Average Euro Value	\$1.3382	\$1.4697	- 8.95%

Interest income was lower reflecting the decline in interest rates applicable during the period. For the quarter just ended, Trust interest income decreased 71.67% to \$9,451 from \$33,355 in the first quarter of fiscal 2008. Trust expenses for the first quarter of fiscal 2009 increased 27.81% or \$74,848 to \$343,961 in comparison to the prior year(s) equivalent period. The increase in costs reflects various legal matters related to the examination of the German operating companies' royalty payments that is made every two years, higher Trustees fees calculated based upon the provisions of the Trust Agreement and variations in the timing of the receipt of invoices for payment.

The current Statement of Assets, Liabilities and Trust Corpus of the Trust at January 31, 2009, compared to that at fiscal year-end (October 31, 2008), shows an increase in assets due to the higher royalty receipts during the first quarter of fiscal 2009.

This report on Form 10-Q contains forward looking statements concerning business, financial performance and financial condition of the Trust. Many of these statements are based on information provided to the Trust by the operating companies or by consultants using public information sources. These statements are subject to certain risks and uncertainties that could cause actual results to differ materially from those anticipated in any forward looking statements. These include uncertainties concerning levels of gas production and gas prices, general economic conditions and currency exchange rates and the risks described in Item 1A, "Risk Factors," in the Trust's Annual Report on Form 10-K for the fiscal year ended October 31, 2008. Actual results and events may vary significantly from those discussed in the forward looking statements.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.  
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The Trust does not engage in any trading activities with respect to possible foreign exchange fluctuations. The Trust does not use any financial instruments to hedge against possible risks related to foreign exchange fluctuations. The market risk is negligible because standing instructions at its German bank require the bank to process transfers of royalty payments as soon as possible following their receipt. The Trust does not engage in any trading activities with respect to possible commodity price fluctuations.

Item 4. Controls and Procedures.  
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The Trust maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed by the Trust is recorded, processed, summarized, accumulated and communicated to its management, which consists of the Managing Director, to allow timely decisions regarding required disclosure, and reported within the time periods specified in the Securities and Exchange Commission's rules and forms.

The Managing Director has performed an evaluation of the effectiveness of the design and operation of the Trust's disclosure controls and procedures as of January 31, 2009. Based on that evaluation, the Managing Director concluded that the Trust's disclosure controls and procedures were effective as of January 31, 2009.

There have been no changes in our internal control over financial reporting identified in connection with the evaluation described above that occurred during the first quarter of fiscal 2009 that have materially affected or are reasonably likely to materially affect our internal control over financial reporting.

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PART II -- OTHER INFORMATION

Item 5. Submission of Matters to a Vote of Security Holders.

The Annual Meeting of Unit Owners was held on February 10, 2009. The following persons were elected as Trustees of the Trust to serve until the next Annual Meeting of Unit Owners:

Robert P. Adelman	(7,647,626 votes for; 228,415 withheld)
Samuel M. Eisenstat	(7,683,044 votes for; 192,997 withheld)
Lawrence A. Kobrin	(7,582,767 votes for; 293,274 withheld)
Willard B. Taylor	(7,709,647 votes for; 166,394 withheld)
Rosalie J. Wolf	(7,687,812 votes for; 188,229 withheld)

Item 6. Exhibits.

- Exhibit 31. Certification of Chief Executive Officer  
Chief Financial Officer pursuant to Section 302  
of the Sarbanes-Oxley Act of 2002
- Exhibit 32. Certification of Chief Executive Officer and  
Chief Financial Officer pursuant to Section 906  
of the Sarbanes-Oxley Act of 2002

SIGNATURE

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

NORTH EUROPEAN OIL ROYALTY TRUST

(Registrant)

/s/ John R. Van Kirk

John R. Van Kirk  
Managing Director

Dated: February 26, 2009