LEGG MASON INC
Form 10-K
May 29, 2008
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

(Mark One)

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended March 31, 2008

or

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to

Commission File No. 1-8529

LEGG MASON, INC.

(Exact name of registrant as specified in its charter)

Maryland	**52-1200960**

(State or other jurisdiction of	**(I.R.S. Employer**
incorporation or organization)	**Identification No.)**
100 Light Street	
Baltimore, Maryland	**21202**
(Address of principal executive offices)	**(Zip Code)**

Registrant s telephone number, including area code: (410) 539-0000

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

Title of each class	**Name of each exchange on which registered**
Common Stock, $.10 par value	New York Stock Exchange
Equity Units	New York Stock Exchange (Registration Pending)

Securities registered pursuant to Section 12(g) of the Act: NONE

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

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

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 ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405) is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

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

Large accelerated filer x	Accelerated filer ¨
Non-accelerated filer ¨	Smaller reporting company ¨

(Do not check if smaller reporting company)

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

As of September 30, 2007, the aggregate market value of the registrant s voting stock, consisting of the registrant s common stock and the exchangeable shares discussed below, held by non-affiliates was $10,957,853,155.

As of May 23, 2008, the number of shares outstanding of the registrant s common stock was 139,158,325. In addition, on that day, a subsidiary of the registrant had outstanding 1,971,122 exchangeable shares that are convertible on a one-for-one basis at any time into shares of common stock of the registrant.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant s definitive proxy statement for its Annual Meeting of Stockholders to be held on July 22, 2008 are incorporated by reference into Part III of this Report.

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PART I

ITEM 1. BUSINESS.

General

Legg Mason is a global asset management company. Acting through our subsidiaries, we provide investment management and related services to institutional and individual clients, company-sponsored mutual funds and other pooled investment vehicles. We offer these products and services directly and through various financial intermediaries. We divide our business into three divisions: Managed Investments, Institutional, and Wealth Management. Within each of our divisions, we provide our services through a number of asset managers, each of which is an individual business that generally markets its products and services under its own brand name.

Legg Mason, Inc. was incorporated in Maryland in 1981 to serve as a holding company for its various subsidiaries. The predecessor companies to Legg Mason trace back to Legg & Co., a Maryland-based broker-dealer formed in 1899. Our subsequent growth has occurred primarily through internal expansion and the acquisition of asset management and broker-dealer firms. In December 2005, Legg Mason completed a transaction in which it sold its broker-dealer businesses to concentrate on the asset management industry.

Additional information about Legg Mason is available on our website at *http://www.leggmason.com*. We make available, free of charge, our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and our proxy statements. Investors can find this information under the Investor Relations section of our website. These reports are available through our website as soon as reasonably practicable after we electronically file the material with, or furnish it to, the Securities and Exchange Commission (SEC). In addition, the Legg Mason, Inc. Corporate Governance Principles, our Code of Conduct for all employees and directors and the charters for the committees of our Board of Directors are also available on our corporate website at *http://www.leggmason.com* under the Investor Relations and the Investor Relations-Board Committees sections. A copy of any of these materials may also be obtained, free of charge, by sending a written request to Corporate Secretary, Legg Mason, Inc., 100 Light Street, Baltimore, Maryland 21202. Within the time frames required by the SEC or the New York Stock Exchange (NYSE), we will post on our website any amendments to the Code of Conduct and any waiver of the Code of Conduct applicable to any executive officer, director, chief financial officer, principal accounting officer or controller. The information on our website is not incorporated by reference into this Report.

Unless the context otherwise requires, all references in this Report to we, us, our and Legg Mason include Legg Mason, Inc. and its predecessors and subsidiaries, and the term asset managers refers to the asset management businesses operated by our subsidiaries.

Business Developments During the Fiscal Year Ended March 31, 2008

During fiscal year 2008, in addition to the normal course operation of our business, we transitioned to a new Chief Executive Officer, provided support to liquidity funds managed by our asset managers, raised $1.25 billion in additional capital and sold several businesses that did not fit into our core business strategy.

On January 28, 2008, our Board of Directors elected Mark R. Fetting Chief Executive Officer and President of Legg Mason, Inc. Mr. Fetting had been serving as Senior Executive Vice President of the company. Raymond A. Mason, who had served as Chief Executive Officer since Legg Mason, Inc. was formed, remains with the company as non-executive Chairman of the Board of Directors.

During much of fiscal year 2008 and continuing thereafter, the fixed income markets have endured substantial turmoil. One effect of this turmoil was that liquidity in the markets for many types of asset backed commercial paper and medium term notes issued by structured investment vehicles (SIVs) became substantially reduced.

This led to us entering into several transactions during the fiscal year to provide support to liquidity funds that are managed by our asset managers that had invested in SIV-issued securities. These transactions resulted in aggregate non-cash charges during the fiscal year of $608.3 million. See Note 18 of Notes to Consolidated Financial Statements in Item 8 below and Management s Discussion and Analysis of Financial Condition and Results of Operations Liquidity in Item 7 below.

In January 2008 we raised $1.25 billion through the sale of 2.5% convertible senior notes to an affiliate of, and providers of financing to, Kohlberg Kravis Roberts & Co. We used a portion of the proceeds to purchase and retire shares of our Series A Non-Voting Convertible Preferred Stock that were convertible into 2.5 million shares of our common stock and will use the rest for general corporate purposes.

In fiscal year 2008, we entered into agreements to sell several businesses that did not fit into our core strategy. Two of the businesses were small Wealth Management subsidiaries, Berkshire Asset Management and our Bingham Legg Advisors joint venture with a law firm. Another business that we sold was our asset management business in Chile, although we retained an international fund distribution business in that country. Finally, we entered into an agreement to sell most of the business of Legg Mason Private Portfolio Group, our retail separately managed accounts implementation and overlay services provider (although our other asset managers will continue to provide sub-advisory services to most of the accounts that Legg Mason Private Portfolio Group serviced). This last disposition closed immediately after the end of the fiscal year.

See Item 8. Financial Statements and Supplementary Data for the revenues, net income and assets of the company, which operates in a single reportable business segment. See Note 19 of Notes to Consolidated Financial Statements in Item 8 of this Report for our revenues and pre-tax earnings generated in, and our long-lived assets (consisting of intangible assets and goodwill) located in, each of the principal geographic areas in which we conduct business.

Business Overview

Acting through our subsidiaries, we provide investment management and related services to institutional and individual clients, company-sponsored investment funds and retail separately managed account programs. Operating from asset management offices primarily located in the United States, but also located in a number of countries worldwide, our businesses provide a broad array of investment management products and services. We offer these products and services directly and through various financial intermediaries. Our investment advisory services include discretionary and non-discretionary management of separate investment accounts in numerous investment styles for institutional and individual investors. Our investment products include proprietary mutual funds ranging from money market and other liquidity products to fixed income and equity funds managed in a wide variety of investment styles, other domestic and offshore funds offered to both retail and institutional investors and funds-of-hedge funds. We believe that our asset managers diversification across asset classes, investment styles and distribution channels may help to mitigate our exposure to the risks created by changing market environments.

Our subsidiary asset managers primarily earn revenues by charging fees for managing the investment assets of clients. Fees are typically calculated as a percentage of the value of assets under management and vary with the type of account managed, the asset manager and the type of client. Accordingly, the fee income of each of our asset managers will typically increase or decrease as its average assets under management increases or decreases. We may also earn performance fees from certain accounts if the investment performance of the assets in the account meets or exceeds a specified benchmark during a measurement period. For the fiscal years ended March 31, 2008, 2007 and 2006, $132.7 million, $142.2 million and $101.6 million, respectively, of our $3.9 billion, $3.6 billion and $2.2 billion in investment advisory revenues represented performance fee revenues. Increases in assets under management generally result from inflows of additional assets from new and existing clients and from appreciation in the value of client assets (including investment income earned on the client assets). Conversely, decreases in assets under management generally result from client redemptions and withdrawals and from asset value depreciation. Our assets under management may also increase as a result of acquisitions, or decrease as a result of dispositions.

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As of March 31 of each of the last three years, we had the following aggregate assets under management (in billions, except percents):

	Assets Under Management	Equity Assets	% of Total in Equity Assets	Fixed Income Assets	% of Total in Fixed Income Assets	Liquidity Assets	% of Total in Liquidity Assets
2008	$ 950.1	$ 271.6	28.6%	$ 508.2	53.5%	$ 170.3	17.9%
2007	$ 968.5	$ 338.0	34.9%	$ 470.9	48.6%	$ 159.6	16.5%
2006	$ 867.6	$ 324.9	37.5%	$ 410.6	47.3%	$ 132.1	15.2%

Over a ten year period, our asset management business has grown substantially. During that period, our assets under management have grown from $71.0 billion, including assets under management in businesses that were subsequently sold, to $950.1 billion and our investment advisory fee revenues have grown from $295.6 million, including revenues generated by businesses that were subsequently sold, to $3.9 billion. This growth in our business has occurred through both internal growth and strategic acquisitions of asset management businesses. During that ten-year period, the percentages of our revenues and profits generated by our asset management business also increased steadily, and since December 1, 2005, asset management has been our sole business. We have also emphasized our international business, and, as a result, $327.4 billion, or 34%, of our assets under management at March 31, 2008 were managed on behalf of clients domiciled outside the United States. In reporting our assets managed on behalf of clients domiciled outside the United States, assets in funds are categorized based on the domicile of the funds. It is our strategy to continue to grow our business through both internal growth and, from time to time, acquisitions of asset management businesses.

We believe that market conditions and our investment performance will be critical elements in our attempts to grow our assets under management and business. When securities markets are strong and increasing, our assets under management will tend to increase because of market growth, resulting in increased asset management revenues. Similarly, if we can produce strong investment results, our assets under management will tend to increase as a result of the investment performance. In addition, strong market conditions or strong relative investment performance can result in increased inflows in assets from existing and new clients. Conversely, in periods when securities markets are weak or declining, or when we have produced poor investment performance, absolute or relative, it is likely to be more difficult to grow our assets under management and business and, in such periods, our assets under management and business are more likely to decline.

We generally manage the accounts of our clients pursuant to written investment management or sub-advisory contracts between one of our asset managers and the client (or a financial intermediary acting on behalf of the client). These contracts usually specify the management fees to be paid to the asset manager and the investment strategy for the account, and are generally terminable by either party on relatively short notice. Typically, investment management contracts may not be assigned (including as a result of transactions, such as a direct or indirect change of control of the asset manager, that would constitute an assignment under the Investment Advisers Act of 1940) without the prior consent of the client. When the asset management client is a registered mutual fund or closed-end fund (whether or not one of our asset managers has sponsored the fund), the fund s board of directors generally must annually approve the investment management contract, and any material changes to the contract or assignment of the contract (including as a result of transactions that would constitute an assignment under the Investment Company Act of 1940) must be approved by the investors in the fund.

We conduct our business primarily through 13 asset managers. Our asset managers are individual businesses, each of which generally focuses on a portion of the asset management industry in terms of the types of assets managed (primarily equity or fixed income), the types of products and services offered, the investment styles utilized, the distribution channels used, and the types and geographic locations of its clients. Each asset manager is housed in one or more different subsidiaries, the voting stock of all of which, except for the joint venture discussed below, is directly or indirectly wholly owned by Legg Mason. Each of our asset managers is generally operated as a separate business, in many cases with certain administrative and distribution functions being provided by the parent company and other affiliates, that typically markets its products and services under its own brand name. Consistent with this approach, we

have in place revenue sharing agreements with Legg Mason Capital Management; Royce & Associates; Western Asset Management Company; Brandywine Global Investment Management; Batterymarch Financial Management; Private Capital Management; Barrett Associates; Bartlett & Co.; and Permal Group and/or certain of their key officers. Pursuant to these revenue sharing agreements, a specified percentage of the asset manager s revenues (or, in certain cases, net revenues) is required to be distributed to us and the balance of the revenues (or net revenues) is retained to pay operating expenses, including salaries and bonuses, but excluding certain non-cash expenses such as amortization of acquired intangible assets, with specific compensation allocations being determined by the asset manager s management, subject to corporate management approval. Although the revenue sharing agreements impede our ability to increase the profit margins of these businesses, we believe the agreements are important because they provide management of the businesses with incentives to (i) grow the asset managers revenues, since management is able to participate in the revenue growth through the portion that is retained; and (ii) control operating expenses, which will increase the portion of the retained revenues that is available to fund growth initiatives and for incentive compensation.

We divide our business into three divisions: Managed Investments, Institutional and Wealth Management. Managed Investments includes our asset managers that are primarily engaged in providing investment advisory services to proprietary investment funds and to retail separately managed account programs, and the proprietary fund management operations of our other asset managers (except Permal). Our Institutional managers are our asset managers that primarily focus on providing asset management services to institutional clients. Our Wealth Managers are our asset managers that primarily focus on providing asset management services (either directly or through funds-of-hedge funds) to high net worth individuals and families and endowments. One of our Managed Investments managers, Legg Mason Capital Management, also provides asset management services to institutions, and the managed assets and revenues of this portion of its business are included in our Institutional division. There is overlap among the three groups of asset managers as many of our Wealth Managers and Institutional asset managers, particularly Western Asset Management, manage proprietary funds that are part of the Managed Investments division. In addition, each asset manager may also provide asset management services to other types of clients, and the managed assets and revenues for these services are included in the asset manager s division. For example, many of our Wealth Managers provide asset management services to institutional clients as well as individuals, families and endowments.

Our assets under management by division (in billions) as of March 31 of each of the three years indicated below were as follows:

	2008	2007	2006
Managed Investments	$ 376.6	$ 403.2	$ 356.5
Institutional	511.4	496.3	444.8
Wealth Management	62.1	69.0	66.3
Total	$ 950.1	$ 968.5	$ 867.6

Managed Investments includes all assets in our proprietary investment funds (except funds managed by Permal), all assets in retail separately managed account programs managed by ClearBridge Advisors and all assets in separate accounts managed by Royce & Associates and ClearBridge Advisors. Institutional includes all assets managed by our Institutional managers (other than assets in proprietary funds) and assets managed by the institutional business of Legg Mason Capital Management. Wealth Management includes all assets managed by our Wealth Managers (other than assets in proprietary funds) and fund assets managed by Permal.

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For the fiscal years ended March 31, 2008, 2007 and 2006, our aggregate operating revenues were $4.6 billion, $4.3 billion and $2.6 billion, respectively. Our operating revenues by division (in millions) in each of those fiscal years were as follows:

	2008	2007	2006
Managed Investments	$ 2,538.4	$ 2,444.4	$ 1,364.0
Institutional	1,024.5	970.0	717.6
Wealth Management	1,071.2	929.3	563.6
Total	$ 4,634.1	$ 4,343.7	$ 2,645.2

In reporting our operating revenues by division, we include in each division all revenues of the asset managers within the division, except that revenues earned for providing investment advisory services to proprietary funds by all managers other than Permal are included in our Managed Investments division. Revenues from Legg Mason Capital Management are divided so that the revenues from their mutual funds business are credited to the Managed Investments division and the revenues from their institutional business are credited to the Institutional division. The Managed Investments division also includes revenues for certain administrative, marketing, sales and distribution services provided to proprietary mutual funds.

Managed Investments Division

In our Managed Investments division, we sponsor and manage domestic and international equity, fixed income and money market mutual funds, as well as closed-end funds and other proprietary funds. Our Managed Investments division includes the following asset managers: ClearBridge Advisors, Legg Mason Capital Management (excluding its institutional business) and Royce & Associates. This division also includes the proprietary funds operations of our other asset managers (except Permal Group), particularly Western Asset Management, and our U.S. mutual fund and international fund administrative and distribution activities. This division sponsors and manages various groups of U.S. mutual funds, including the Legg Mason Partners Funds (which, for purposes of this Report, include the mutual and closed-end funds that we began to manage as part of the 2005 acquisition of the Citigroup Asset Management (CAM) business regardless of whether the names of the funds have been changed to Legg Mason Partners), the Legg Mason Funds, The Royce Funds and the Western Asset Funds. This division also provides investment advisory services to a number of retail separately managed account programs, and sponsors and distributes funds that are domiciled outside the United States. For the fiscal years ended March 31, 2008, 2007 and 2006, our Managed Investments division generated aggregate revenues of $2.5 billion, $2.4 billion and $1.4 billion, respectively.

As of March 31, 2008 and 2007, our Managed Investments division managed assets with a value of $376.6 billion and $403.2 billion, respectively. As of March 31, 2008, 58% of the assets managed by this division were in fixed income and liquidity funds managed by Western Asset Management, 23% of the assets managed by this division were managed by ClearBridge Advisors, 8% were managed by Royce & Associates and 6% were managed by Legg Mason Capital Management. Approximately 87% of the reduction in assets managed by this division during fiscal year 2008 resulted from aggregate net client cash outflows, and the remainder resulted from asset depreciation and dispositions of non-core businesses. Of the assets managed by this division at March 31, 2008, approximately 65% was in U.S. mutual funds, approximately 20% was in international and other funds and approximately 10% was in retail separately managed accounts. The remaining assets managed by this division were in other products, primarily institutional separate accounts.

United States Mutual Funds

Our mutual funds business primarily consists of four groups of proprietary mutual and closed-end funds, the Legg Mason Partners Funds, the Legg Mason Funds, The Royce Funds and the Western Asset Funds. The Legg Mason Partners Funds and the Legg Mason Funds invest in a wide range of domestic and international equity and fixed income securities utilizing a number of different investment styles. The Legg Mason Partners Funds also include several money market funds. The Royce Funds invest primarily in small-cap company stocks using a value investment approach. The Western Asset Funds invest primarily in fixed income securities.

The Legg Mason Partners Funds include 102 mutual funds and 22 closed-end funds in the United States, almost all of which are managed by our subsidiary asset managers. The mutual and closed-end funds within the Legg Mason Partners Funds include 48 equity funds (including balanced funds) that invest in a wide spectrum of equity securities utilizing numerous investment styles, including large-and mid-cap growth funds, international funds and sector funds. The fixed income and liquidity mutual and closed-end funds within the Legg Mason Partners Funds include 80 funds that offer a similarly wide variety of investment strategies and objectives, including income funds, investment grade funds and municipal securities funds. Many of our asset managers provide investment advisory services to the Legg Mason Partners Funds. As of March 31, 2008 and 2007, the Legg Mason Partners Funds included $168.4 billion and $163.0 billion in assets, respectively, in their mutual funds and closed-end funds, of which approximately 23% and 31%, respectively, were equity assets, approximately 11% and 13%, respectively, were fixed income assets and approximately 66% and 56%, respectively, were liquidity assets.

The Legg Mason Funds consist of 14 mutual funds, all of which are managed by our subsidiary asset managers. Of these funds, eight invest primarily in domestic equity securities; two invest primarily in international equity securities; three invest primarily in domestic taxable or tax-exempt fixed income securities, and one invests primarily in global fixed income securities. Investment objectives for the Legg Mason Funds range from capital appreciation to current income. Equity investment strategies may emphasize large-cap, mid-cap or small-cap investing. In addition to Legg Mason Capital Management and the joint venture discussed below, our other asset managers that manage Legg Mason Funds are Western Asset Management Company (2 funds), Legg Mason Investment Counsel (1 fund), Batterymarch Financial Management (3 funds) and Brandywine Global Investment Manager (3 funds). As of March 31, 2008 and 2007, the Legg Mason Funds included $24.5 billion and $36.1 billion in assets, respectively, of which approximately 96% were equity assets and approximately 4% were fixed income assets.

The Royce Funds consist of 24 mutual funds and three closed-end funds, most of which invest primarily in smaller company stocks. Each of these funds seeks long-term appreciation of capital using a value approach. The funds differ in their approaches to investing in small or micro-cap companies and the universe of securities from which they can select. As of March 31, 2008 and 2007, The Royce Funds included $27.5 billion and $30.3 billion in assets, respectively, substantially all of which were equity assets. The Royce Funds are primarily distributed through non-affiliated fund supermarkets, non-affiliated wrap programs, and direct distribution. In addition, two of the portfolios in The Royce Funds are distributed only through insurance companies.

Our mutual funds business also includes the Western Asset Funds, a proprietary family of nine U.S. mutual funds that are marketed primarily to institutional investors and retirement plans primarily through our institutional funds marketing group. Western Asset Management Company manages these funds using a team approach under the supervision of Western Asset s investment committee. The funds primarily invest in fixed income securities. As of March 31, 2008 and 2007, the Western Asset Funds included $24.2 billion and $21.5 billion in assets, respectively.

Retail Separately Managed Account Programs

We are a leading provider of asset management services to retail separately managed account products, such as wrap programs. Although we have sold a majority of the business of Legg Mason Private Portfolio Group, our subsidiary that provides implementation and overlay services to retail separately managed account programs, our other

asset managers continue to provide services to most of the programs that were serviced by this business. These programs typically allow securities brokers or other financial intermediaries to offer their clients the opportunity to choose from a number of asset management services pursuing different investment strategies provided by one or more asset managers, and generally charge an all-inclusive fee that covers asset management, trade execution, asset allocation and custodial and administrative services. We provide investment management services to a number of retail separately managed account programs. Our retail separately managed account services are distributed through programs sponsored by Citigroup s distributors as well as other financial institutions. Certain of our asset managers that are not part of this division, including several of our Institutional managers, also provide investment advisory services to retail separately managed account programs. The assets and revenues of our separately managed account program services are included in the division containing the asset manager that provides the services.

International Funds

Our Managed Investments division also includes numerous proprietary funds that are domiciled outside the United States. These funds are domiciled in countries around the world, including Ireland, Luxembourg, the United Kingdom, Poland, Hong Kong, Singapore, Japan, Australia, Brazil, Canada, the Cayman Islands and the Netherlands Antilles. Our non-U.S. funds include equity, fixed income, liquidity and balanced funds that are primarily managed or sub-advised by Legg Mason Capital Management, Legg Mason International Equities, ClearBridge Advisors, Western Asset Management, Batterymarch Financial Management, Royce & Associates, Private Capital Management and Brandywine. These funds are primarily offered for sale only outside of the United States to non-U.S. persons and are a means of making our asset management capabilities available to investors around the world. We sponsor and manage more than 200 of these non-U.S. funds, which, as of March 31, 2008 and 2007, had an aggregate of approximately $74.5 billion and $83.0 billion in assets, respectively.

Distribution

Our Managed Investments distribution groups distribute and support our U.S. mutual funds, international funds and our retail separately managed account program business. These distribution groups also support our closed-end funds. In general, our Managed Investments distributors are housed in separate subsidiaries from our asset managers and are managed by different officers.

Our Managed Investments division includes our U.S. mutual fund support and distribution operations. These operations support and distribute the Legg Mason Partners Funds and the Legg Mason Funds, and include our mutual fund wholesalers and our institutional funds marketing group. Our mutual fund wholesalers distribute the Legg Mason Partners Funds and the Legg Mason Funds through a number of third party distributors. The Legg Mason Partners Funds are principally distributed to retail investors through Citigroup s distribution businesses, primarily its retail brokerage business. The Legg Mason Funds, which prior to the closing of the strategic transaction with Citigroup were principally distributed by our former private client business, are also currently primarily distributed to retail investors by Citigroup s distribution businesses. Pursuant to a Global Distribution Agreement we entered with Citigroup, Citigroup has agreed to distribute certain of our asset management products and services, including the Legg Mason Funds and the Legg Mason Partners Funds, through its various distribution businesses, and we have agreed that, subject to a few exceptions, Citigroup s retail securities brokerage will be the exclusive retail distributor of the Legg Mason Funds that are managed by Legg Mason Capital Management for a period of up to three years. The majority of the assets managed by our Managed Investments division were distributed through Citigroup s various distribution businesses. Our institutional funds marketing group distributes institutional share classes of the Legg Mason Partners Funds, the Legg Mason Funds and the Western Asset Funds to institutional clients and also distributes variable annuity sub-advisory services provided by our asset managers to insurance companies. Our institutional liquidity funds are primarily distributed by Western Asset s distributors. The Royce Funds are distributed primarily by Royce & Associates and not by our wholesaling group.

Our distributors also distribute and provide administrative support to our international funds. Much of our international distribution is conducted under the Legg Mason Investments brand name.

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In addition to distributing funds, our wholesalers also support our retail separately managed account services. These services are provided through programs sponsored by Citigroup s distributors as well as other financial institutions.

Asset Managers In this Division

ClearBridge Advisors is an equity asset management firm based in New York, New York that also has an office in San Francisco, California. ClearBridge Advisors provides asset management services to 25 of the equity funds (including balanced funds) in the Legg Mason Partners Funds, to retail separately managed account programs and, primarily through separate accounts, to institutional clients. ClearBridge also sub-advises domestic mutual funds that are sponsored by third parties. ClearBridge offers a diverse array of investment styles and disciplines, designed to address a range of investment objectives. Significant ClearBridge investment styles include large cap growth and core equity management. In managing assets, ClearBridge generally utilizes a bottom-up, primary research intensive, fundamental approach to security selection that seeks to identify companies with the potential to provide solid economic returns relative to their risk-adjusted valuations.

Legg Mason Capital Management is an equity asset management business based in Baltimore, Maryland that manages both institutional separate accounts and mutual funds. Legg Mason Capital Management manages the four largest Legg Mason Funds and one fund in the Legg Mason Partners Funds family. Legg Mason Capital Management also sub-advises the mutual fund managed by the joint venture described below and investment products sponsored by our other subsidiaries. Applying the principles of value investing, Legg Mason Capital Management s investment process uses a variety of techniques to develop an estimate of the worth of a business over the long term. The objective is to identify companies where the intrinsic value of the business is significantly higher than the current market value.

We and one of our employees each own 50% of a consolidated joint venture subsidiary that serves as investment manager of one equity fund, Legg Mason Opportunity Trust, within the Legg Mason Funds family. All of the assets managed by this joint venture, $5.7 billion at March 31, 2008, are included in our assets under management.

Royce & Associates, LLC is investment advisor to all of The Royce Funds. In addition, Royce & Associates also manages other pooled and separate accounts, primarily institutional. Royce & Associates generally invests in smaller company stocks, using a value approach. Royce & Associates stock selection process seeks to identify companies with strong balance sheets and the ability to generate free cash flow. Royce & Associates pursues securities that are priced below its estimate of the company s current worth.

In addition to these asset managers, a number of our Institutional asset managers and Wealth Managers also advise proprietary funds that are part of this division. In particular, Western Asset Management Company, one of our Institutional managers, operates a large mutual and other proprietary fund business. Western Asset manages the fixed income and liquidity funds in the Legg Mason Partners Funds, manages two of the Legg Mason Funds and manages the Western Asset Funds.

Institutional Division

Our Institutional division includes our asset managers that primarily provide asset management services to institutional clients and the institutional business of Legg Mason Capital Management. These asset managers manage a wide range of domestic, international and global equity, balanced, fixed income and cash management portfolios for their domestic and international institutional clients. Our domestic and international institutional clients include pension and other retirement plans, corporations, insurance companies, endowments and foundations and governments. All of these asset managers also manage proprietary funds that are included in our Managed Investments division. For the fiscal years ended March 31, 2008, 2007 and 2006, the asset managers in our Institutional division generated aggregate revenues of $1.0 billion, $970.0 million and $717.6 million, respectively, excluding revenues generated by these managers for managing proprietary funds.

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As of March 31, 2008 and 2007, our Institutional asset managers managed assets with a value of $511.4 billion and $496.3 billion, respectively (excluding assets with a value of approximately $256 billion and $250 billion, respectively, in proprietary funds managed by these asset managers). Almost 81% of these assets were in fixed income or liquidity accounts managed by Western Asset, 9% were managed by Brandywine and 4% were managed by Legg Mason Capital Management. Approximately 83% of the growth in these assets during the fiscal year resulted from net asset appreciation and the remainder primarily resulted from aggregate net client cash inflows.

United States Institutional Managers

Western Asset Management Company is a leading global fixed income asset manager for institutional clients. Western Asset operates globally; its United States operations are discussed in this section and its international operations are discussed below. Headquartered in Pasadena, California, Western Asset also has investment operations in New York City. Western Asset offers a broad range of products spanning the yield curve and encompassing the world s major bond markets, including a suite of limited duration and core products, emerging market and high yield portfolios, municipal portfolios and a variety of sector-oriented and global products. Among the services Western Asset provides are management of separate accounts and management of mutual funds, closed-end funds and other structured investment products that are included in our Managed Investments division.

Brandywine Global Investment Management, LLC manages equity and fixed income, including global and international fixed income, portfolios for institutional and, through wrap accounts, high net worth individual clients. Brandywine, based in Philadelphia, Pennsylvania, pursues a value investing approach in its management of both equity and fixed income assets. We have announced our intention to transfer the international and global equity investment team that is currently part of Brandywine to a newly-organized subsidiary named Global Currents Investment Management, LLC. Global Currents has commenced operations, and it is expected that the bulk of the assets managed by this international and global equity team will be transferred to Global Currents on or about July 1, 2008.

Legg Mason Capital Management is an equity asset management business based in Baltimore, Maryland that manages both institutional separate accounts and mutual funds. Legg Mason Capital Management generally uses the same style and approach in managing both institutional accounts and mutual funds.

Batterymarch Financial Management, Inc. manages U.S., international and emerging markets equity portfolios for institutional clients. Based in Boston, Massachusetts, Batterymarch primarily uses a quantitative approach to asset management. The firm s investment process for U.S. and international portfolios, other than emerging market portfolios, is designed to enhance the fundamental investment disciplines by using quantitative tools to process fundamental data.

Legg Mason Real Estate Investors, Inc. primarily sponsors and manages private investment vehicles that invest debt and equity in commercial real estate. Legg Mason Real Estate Investors is located in Los Angeles, California and currently manages three investment vehicles.

International Institutional Managers

Western Asset Management Company has asset management offices in the United Kingdom, Japan, Brazil, Australia, Singapore and Hong Kong. Western Asset s international fixed income business includes management of liquidity products and Asian, Japanese, Brazilian, European and United Kingdom local currency fixed income securities.

Legg Mason International Equities is an international equity manager. Legg Mason International Equities has investment management capabilities in London, New York, Hong Kong, Singapore and Sao Paulo. Legg Mason International Equities investment expertise spans the global emerging markets, Asia (including China and Japan), Central Europe and South America. We have spun out of Legg Mason International Equities our asset management businesses located in Melbourne and Warsaw, which are currently operated as separate businesses.

Each of our Institutional asset managers has one or more marketing groups. These marketers distribute the business services to potential clients, both directly and through consultants. Consultants play a large role in the institutional asset management business by helping clients select and retain asset managers. Institutional asset management clients and their consultants tend to be highly sophisticated and investment performance-driven.

Wealth Management Division

Our Wealth Management asset managers provide customized discretionary, investment management services and products to high net worth individuals and families, endowments, foundations and institutions. Our Wealth Managers seek to provide these services in a manner that is tailored to meet our clients particular needs and objectives. In addition, this division includes Permal Group, a global funds-of-hedge funds manager. For the fiscal years ended March 31, 2008, 2007 and 2006, our Wealth Managers generated aggregate revenues of $1.1 billion, $929.3 million and $563.6 million, respectively, excluding revenues generated by these managers (other than Permal) for managing proprietary funds.

As of March 31, 2008 and 2007, our Wealth Managers managed assets with a value of $62.1 billion and $69.0 billion, respectively (excluding assets with a value of approximately $757 million and $900 million, respectively, in proprietary funds managed by these asset managers other than Permal). As of March 31, 2008, 63% of these assets were managed by Permal, 17% were managed by Private Capital Management and 15% were managed by Legg Mason Investment Counsel & Trust Company and its two subsidiaries. During the fiscal year, growth in assets managed by Permal was more than offset by a reduction in the aggregate assets managed by the other asset managers in this division, particularly Private Capital Management. The reduction in assets managed by the asset managers in this division during the fiscal year (excluding assets in proprietary funds managed by these asset managers other than Permal) primarily resulted from aggregate net client cash outflows.

Traditional Wealth Managers

Private Capital Management, L.P. manages equity assets for high net worth individuals and families, institutions, endowments and foundations in separate accounts and through limited partnerships. Based in Naples, Florida, Private Capital Management s value-focused investment philosophy is based on an analysis of a company s free cash flow. In executing this philosophy, Private Capital Management seeks to build an all-cap portfolio consisting primarily of securities of mid-cap companies that possess several basic elements, including significant free cash flow, a substantial resource base and a management team with the ability to correct problems that Private Capital Management believes have been excessively or inappropriately discounted by the public markets.

Legg Mason Investment Counsel & Trust Company, National Association is a national banking association with authority to exercise trust powers. Headquartered in Baltimore, Maryland, Legg Mason Investment Counsel & Trust Company provides services as a trustee for trusts established by our individual and employee benefit plan clients and manages fixed income and equity assets. Through a number of our asset managers, we provide asset management services for a significant portion of the assets held in Legg Mason Investment Counsel & Trust Company s accounts.

Legg Mason Investment Counsel & Trust has two subsidiary asset managers. Legg Mason Investment Counsel, LLC manages equity, fixed income and balanced portfolios for high net worth individual and institutional clients and several of our proprietary mutual funds. Legg Mason Investment Counsel is headquartered in Baltimore, Maryland and operates out of offices in New York, Chicago, Cincinnati, Philadelphia, and Bryn Mawr, Pennsylvania. Legg Mason Investment Counsel & Trust s other asset management subsidiary is Barrett Associates, Inc., an equity asset manager for high net worth individuals and families, endowments and foundations that is based in New York, New York. Barrett delivers services through separately managed portfolios for individuals and institutions as well as through two proprietary mutual funds that are part of our Managed Investments division.

Bartlett & Co. manages balanced, equity and fixed income portfolios for high net worth individual and institutional clients and follows a value investment philosophy. Bartlett is based in Cincinnati, Ohio. Bartlett s research and stock selection criteria emphasize a variety of fundamental factors, and Bartlett seeks to invest in companies that generally possess some combination of the following characteristics: financial strength, potential for growth of earnings and dividends, attractive profitability characteristics, sustainable competitive advantage and shareholder-oriented management.

Each of our traditional wealth managers retains its own investment style and operations, seeking to generate ongoing growth in its core business through direct new business efforts. These asset managers distribute their services through their own marketing efforts directly to high net worth investors and indirectly through financial intermediaries.

Funds-of-Hedge Funds Business

Permal Group Ltd. is a leading global funds-of-hedge funds management firm. Permal s products include both directional and absolute return strategies, and are available through multi-manager and single manager funds, separately managed accounts and structured products sponsored by several large financial institutions. Permal selects from among thousands of investment managers and investment firms in designing portfolios that are intended to meet a wide variety of specific investment objectives, including global, regional, class and sector specific offerings. In managing its directional offerings, Permal s objective is to participate significantly in strong markets, preserve capital in down or volatile markets and outperform market indices over a full market cycle with reduced risk and volatility. In managing its absolute return strategies, Permal seeks to achieve positive investment returns in all market conditions with low correlation to the overall equity markets.

Permal s products and services are sold primarily outside the United States to non-U.S. high net worth investors through a network of financial intermediaries. Permal s relationships with its financial intermediaries has resulted in wide international distribution of Permal s products and services.

Employees

At March 31, 2008, we had approximately 4,220 employees. None of our employees is covered by a collective bargaining agreement. We consider our relations with our employees to be satisfactory. However, competition for experienced asset management personnel is intense and from time to time we may experience a loss of valuable personnel. We recognize the importance to our business of hiring, training and retaining skilled professionals.

Competition

We are engaged in an extremely competitive business and are subject to substantial competition in all aspects of our business. Our competition includes, with respect to one or more aspects of our business, numerous international and domestic asset management firms and broker-dealers, mutual fund complexes, hedge funds, commercial banks, insurance companies, other investment companies and other financial institutions. Many of these organizations offer products and services that are similar to, or compete with, those we offer, and many of these organizations have substantially more personnel and greater financial resources than we have. Some of these competitors have proprietary products and distribution channels that make it more difficult for us to compete with them. In addition, many of our competitors have long-standing and established relationships with distributors and clients. The principal competitive factors relating to our business are the quality of advice and services provided to investors, the performance records of that advice and service, the reputation of the company providing the services, the price of the services, the products and services offered and distribution relationships and compensation offered to distributors.

Competition in our business periodically has been affected by significant developments in the asset management industry. See Item 1A. Risk Factors Competition in the Asset Management Industry Could Reduce our Revenues and Net Income.

Regulation

The asset management industry in the United States is subject to extensive regulation under both federal and state laws. The SEC is the federal agency charged with administration of the federal securities laws. Our distribution activities also may be subject to regulation by self-regulatory authorities and state securities commissions in those states in which we conduct business. In addition, asset management firms may be subject to regulation by various foreign governments, securities exchanges, central banks and regulatory bodies, particularly in those countries where they have established offices. Due to the extensive laws and regulations to which we are subject, we must devote substantial time, expense and effort to legal and regulatory compliance issues.

Our U.S. asset managers are registered as investment advisors with the SEC, as are several of our international asset managers, and are also required to make notice filings in certain states. Virtually all aspects of the asset management business are subject to various federal and state laws and regulations. These laws and regulations are primarily intended to protect the asset management clients and generally grant supervisory agencies and bodies broad administrative powers, including the power to limit or restrict an investment advisor from conducting its asset management business in the event that it fails to comply with such laws and regulations. Possible sanctions that may be imposed include the suspension of individual employees, the imposition of limitations on engaging in the asset management business for specified periods of time, the revocation of licenses or registrations, and imposition of censures and fines. A regulatory proceeding, regardless of whether it results in a sanction, can require substantial expenditures and can have an adverse effect on our reputation or business. Regulators also have available a variety of informal enforcement mechanisms that could have a significant impact on our business.

During prior years, abuses by certain participants in the mutual fund industry, including activities relating to market timing, late trading and selective disclosure of portfolio holdings, prompted legislative and regulatory scrutiny of a wide range of fund-related activities. This scrutiny has resulted in the adoption or proposal of a number of new regulatory rules and legislative initiatives to increase regulatory oversight of the mutual fund and asset management industries. Over time, the cumulative effect of these actions may result in increased fund expenses, or lower management or other fees, and therefore adversely affect the revenues or profitability of mutual fund businesses.

Our asset managers also may be subject to the Employee Retirement Income Security Act of 1974, as amended (ERISA), and related regulations, particularly insofar as they act as a fiduciary under ERISA with respect to benefit plan clients. ERISA and related provisions of the Internal Revenue Code impose duties on persons who are fiduciaries under ERISA, and prohibit certain transactions involving the assets of ERISA plan clients and certain transactions by the fiduciaries (and several other related parties) to the plans. In addition, Legg Mason Investment Counsel & Trust Company is regulated by the Office of the Comptroller of the Currency.

In our international business we have subsidiaries domiciled in the United Kingdom, Luxembourg, Poland, Brazil, Japan, Hong Kong, Taiwan, Singapore, Canada and Australia that are subject to the laws of, and to supervision by governmental authorities in, each of these jurisdictions. Our international subsidiaries are also authorized or licensed to offer their products and services in several other countries around the world and thus are subject to the laws of, and to supervision by governmental authorities in, these additional countries. In addition, a subsidiary of Permal is a Bahamas bank regulated by the Central Bank of the Bahamas. Our offshore proprietary funds are subject to the laws and regulatory bodies of the jurisdictions in which they are domiciled and, for funds listed on exchanges, to the rules of the applicable exchanges. Certain of our funds domiciled in Ireland and Luxembourg are also registered for public sale in several countries around the world and are subject to the laws of, and supervision by the governmental authorities of, those countries. All of these non-U.S. governmental authorities generally have broad supervisory and disciplinary powers, including, among others, the power to set minimum capital requirements, to temporarily or permanently revoke the authorization to carry on regulated business, to suspend registered employees, and to invoke censures and fines for both the regulated business and its registered employees.

Our broker-dealer subsidiaries are subject to regulations that cover all aspects of the securities business. Much of the regulation of broker-dealers has been delegated to self-regulatory authorities, principally the Financial Industry Regulatory Authority. These self-regulatory organizations conduct periodic examinations of member broker-dealers in

accordance with rules they have adopted and amended from time to time, subject to approval by the SEC. The SEC, self-regulatory authorities and state securities commissions may conduct administrative proceedings that can result in censure, fine, suspension or expulsion of a broker-dealer, its officers or employees. These administrative proceedings, whether or not resulting in adverse findings, can require substantial expenditures and can have an adverse impact on the reputation or business of a broker-dealer. The principal purpose of regulation and discipline of broker-dealers is the protection of customers and the securities markets, rather than protection of creditors and stockholders of the regulated entity.

Net Capital Requirements

Our broker-dealer subsidiaries are subject to net capital rules that mandate that they maintain certain levels of capital. In addition, certain of our subsidiaries that operate outside the United States are subject to net capital or liquidity requirements in the jurisdictions in which they operate. For example, in addition to requirements in other jurisdictions, our United Kingdom-based subsidiaries and our Singapore-based subsidiaries are subject to the net capital requirements of the Financial Services Authority and the Monetary Authority of Singapore, respectively.

ITEM 1A. RISK FACTORS.

Our business, and the asset management industry in general, is subject to numerous risks, uncertainties and other factors that could negatively affect our business or results of operations. These risks, uncertainties and other factors, including the ones discussed below and those discussed elsewhere herein and in our other filings with the SEC, could cause actual results to differ materially from any forward-looking statements that we or any of our employees may make.

Our Leverage May Affect our Business and May Restrict our Operating Results

At March 31, 2008, on a consolidated basis, we had approximately $2.8 billion in total indebtedness and total stockholders equity of $6.6 billion, and our goodwill and other intangible assets were $2.5 billion and $4.1 billion, respectively. As of March 31, 2008, after giving effect to the sale on May 6, 2008 of our Equity Units, we would have had an aggregate consolidated indebtedness outstanding of approximately $3.9 billion. As of May 6, 2008, we had $440 million of additional borrowing capacity available under our various credit agreements, subject to certain conditions. As a result of this substantial indebtedness, we are required to use a significant portion of our cash flow to service principal and interest on our debt, which will limit the cash flow available for other business opportunities. In addition, these servicing obligations would increase in the future if we incur additional indebtedness and, in this regard, we have available credit facilities that are not currently being utilized.

Our ability to make scheduled payments of principal of, to pay interest on, or to refinance our indebtedness and to satisfy our other debt obligations will depend upon our future operating performance, which may be affected by general economic, financial, competitive, legislative, regulatory, business and other factors beyond our control and by a variety of factors specific to our business.

The level of our indebtedness could:

- limit our ability to obtain additional debt financing in the future or to borrow under our existing credit facilities (our principal debt facilities require that (i) our ratio of total debt to Consolidated EBITDA (as defined therein) not exceed 2.5 to 1 and (ii) our ratio of Consolidated EBITDA to total cash interest payments on certain Indebtedness (as defined therein) exceeds 4 to 1);

- limit cash flow available for general corporate purposes due to the ongoing cash flow requirements for debt service;

- limit our flexibility, including our ability to react to competitive and other changes in the industry and economic conditions generally and our ability to provide support, should we elect to do so, to funds that our subsidiaries manage; and

- place us at a competitive disadvantage compared to our competitors that have less debt.

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Upon the occurrence of various events, such as a change of control, some or all of our outstanding debt obligations may come due prior to their maturity date. In addition, we have outstanding $425 million of 6.75% senior notes that mature on July 2, 2008.

Support We Have Provided to Liquidity Funds Has, and Will Continue to, Affect Our Financial Position and Results of Operations

As has been widely publicized, since late July 2007, there has been substantial disruption in the worldwide fixed income markets, including, specifically, the market for commercial paper. This disruption has included a dramatic reduction in buyers of commercial paper, particularly asset backed commercial paper securities (ABCP) and medium term notes (MTN) issued by SIVs, which has adversely affected the liquidity in the market. ABCP refer generally to commercial paper that is collateralized by a pool of assets, such as receivables, loans or securities, and includes commercial paper issued by SIVs. The MTN in which these funds invest are generally similarly collateralized. ABCP and MTN are typically over-collateralized when initially issued, although the securities do not always remain over-collateralized. A SIV is a special purpose entity created solely to issue securities, including ABCP and MTN, and use the proceeds to acquire the collateral that secures its securities. As a result of these liquidity constraints and, for certain issuers, credit concerns, a number of ABCP and MTN securities have been, or currently are, placed on credit watch or downgraded by ratings agencies and certain ABCP and MTN issuers have defaulted on their obligations under their securities and become the subject of restructuring negotiations or insolvency proceedings, and additional issuers may become so in the future. Liquidity asset management funds that are managed by our subsidiaries invest in fixed income securities, including commercial paper, and have been, and may continue to be, affected by these issues, and other types of funds managed by our subsidiaries, including closed-end funds that have issued auction rate preferred securities, have also been affected by these issues.

In response to these issues, we have taken steps to provide contingent support to certain of the liquidity funds that our subsidiaries manage. The steps that we have taken to date include:

- procuring letters of credit from banks in an aggregate amount of $485 million supporting securities held by funds;
- entering into capital support agreements with two funds pursuant to which we have agreed to provide up to $415 million in capital contributions to the funds if they recognize losses from investments in certain ABCP or MTN, including upon the required sale of the underlying securities upon the expiration of one of the agreements;
- purchasing an aggregate of $98 million in principal amount of Canadian conduit securities from a Canadian fund;
- entering into a total return swap transaction with a major bank pursuant to which the bank purchased $890 million in principal amount of ABCP from a liquidity fund and we agreed to be responsible to the bank for any losses it suffers on the investment; and
- purchasing an aggregate of $132 million in principal amount (of which $82 million remained outstanding as of March 31, 2008 and matured and were paid in full in May 2008) of non-bank sponsored SIV-issued securities from a fund.

These steps have resulted in non-cash expenses of $608.3 million in fiscal 2008 ($313.7 million net of compensation adjustments and tax) and $517.2 million in the fourth quarter of fiscal 2008 ($291.0 million net of compensation adjustments and tax). These non-cash expenses are the primary reason we recorded a net loss of $255.5 million in that quarter. We may also incur additional expenses as a result of declines in the value of ABCP or MTN with respect to which we have provided credit support and that could result in reduced earnings, or losses, in future periods, even if we do not undertake further support activities. See Note 18 of Notes to Consolidated Financial Statements in Item 8 below for a further description of the support we have provided.

Each of the letters of credit and capital support agreements that we have put in place to support liquidity funds expires one year from the date on which they became effective. Several of the letters of credit ($335 million in aggregate) must be drawn in full immediately prior to their expiration if the fund continues to hold the underlying

securities. The other letter of credit arrangements and the capital support agreements require that the funds sell the underlying securities immediately prior to the expiration date, and draw upon the support to fund any losses. If the funds continue to hold the underlying securities upon these expiration dates and market conditions have not improved, we will most likely be required to utilize significant amounts of cash to address these obligations.

In the future, we may elect to provide additional credit, liquidity, or other support to products that we manage, particularly liquidity funds, although we are not legally required to do so and there can be no assurance that any support would be sufficient to avoid an adverse impact on any product or investors in any product. A decision to provide support may arise from factors specific to our products or from industry wide factors. The support that we have provided exposes us to the risk of losses on the securities to which the support applies. In addition, if we elect to provide additional support, we could incur losses from the support we provide and incur additional costs, including financing costs, in connection with the support. These losses and additional costs could be material, and could adversely affect our earnings. If we were to take such actions we may also restrict our corporate assets, limiting our flexibility to use these assets for other purposes, and may be required to raise additional capital.

Poor Investment Performance Could Lead to a Loss of Assets Under Management and a Decline in Revenues

We believe that investment performance is one of the most important factors for the maintenance and growth of our assets under management. Poor investment performance, either on an absolute or relative basis, could impair our revenues and growth because:

- existing clients might withdraw funds in favor of better performing products, which would result in lower investment advisory and other fees;

- our ability to attract funds from existing and new clients might diminish; and

- negative absolute investment performance will directly reduce our managed assets.

In addition, in the ordinary course of our business we may reduce or waive investment management fees, or limit total expenses, on certain products or services for particular time periods to manage fund expenses, or for other reasons, and to help retain or increase managed assets. If our revenues decline without a commensurate reduction in our expenses, our net income will be reduced. During the last two years, several of our key equity asset managers have not produced strong investment performance, on a relative basis, and, in some cases, an absolute basis, in certain products or accounts that they manage. These investment performance issues may have hindered the ability of these asset managers to grow their assets under management and revenues and, in some cases, have contributed to a significant reduction in their assets under management and revenues and a reduction in performance fees. There can be no assurance as to when, or if, these investment performance issues, or the resulting effects on the managers assets under management and revenues, will be resolved. Moreover, even if investment performance should improve in the short term, in some cases there may be a lag before that performance produces a positive effect on the managers assets under management or revenues.

Assets Under Management May Be Withdrawn, Which May Reduce our Revenues and Net Income

Our investment advisory and administrative contracts are generally terminable at will or upon relatively short notice, and investors in the mutual funds that we manage may redeem their investments in the funds at any time without prior notice. Institutional and individual clients can terminate their relationships with us, reduce the aggregate amount of assets under management, or shift their funds to other types of accounts with different rate structures for any number of reasons, including investment performance, changes in prevailing interest rates, changes in investment preferences of clients, changes in our reputation in the marketplace, changes in management or control of clients or third party distributors with whom we have relationships, loss of key investment management or other personnel and financial market performance. This risk is underscored by the fact that we have one international client that represents approximately 5% of our total assets under management (although it generates less than 1% of our operating revenues). In addition, in a declining stock market, the pace of mutual fund redemptions and withdrawal of assets from other accounts could accelerate. Poor investment performance generally or relative to other investment

management firms tends to result in decreased purchases of fund shares, increased redemptions of fund shares, and the loss of institutional or individual accounts. During fiscal year 2008, our assets under management decreased from $969 billion at March 31, 2007 to $950 billion at March 31, 2008. One driver of this decrease was $26 billion in net client outflows (of which $44 billion was outflows from equity assets offset, in part, by $18 billion in inflows from fixed income and liquidity assets). During the quarter ended March 31, 2008, our assets under management declined by $48 billion, primarily as a result of market depreciation of $28 billion and net asset client outflows of $19 billion. This decrease in our assets under management reduced our revenues and our operating income.

If We Are Unable to Maintain our Fee Levels or If Our Asset Mix Changes, our Revenues and Margins Could Be Reduced

Our profit margins and net income are dependent in significant part on our ability to maintain current fee levels for the products and services that our asset managers offer. There has been a trend toward lower fees in some segments of the asset management industry, and no assurances can be given that we will be able to maintain our current fee structure. Competition could lead to our asset managers reducing the fees that they charge their clients for products and services. See Competition in the Asset Management Industry Could Reduce our Revenues and Net Income. In addition, our asset managers may be required to reduce their fee levels, or restructure the fees they charge, because of, among other things, regulatory initiatives or proceedings that are either industry-wide or specifically targeted or court decisions. For example, several firms in the mutual fund business agreed to reduce the management fees that they charge registered mutual funds as part of regulatory settlements. A reduction or other change in the fees that our asset managers charge for their products and services will reduce our revenues and could reduce our net income. These factors also could inhibit our ability to increase fees for certain products.

Our assets under management can generate very different revenues per dollar of managed assets based on factors such as the type of asset managed equity assets generally produce greater revenues than fixed income assets, the type of client institutional clients generally pay lower fees than other clients, the type of asset management product or service provided and the fee schedule of the asset manager providing the service. A shift in the mix of our assets under management from higher revenue-generating assets to lower revenue-generating assets may result in a decrease in our revenues even if our aggregate level of assets under management remains unchanged or increases. A decrease in our revenues, without a commensurate reduction in expenses, will reduce our net income. We experienced such a shift in the mix of our assets under management to a modest extent during certain of the quarters in fiscal year 2007. During fiscal year 2008, we experienced such a shift to a greater extent, as our equity assets under management declined from $338 billion (35% of our total assets under management) to $272 billion (29% of our total assets under management). During the quarter ended March 31, 2008, our equity assets under management decreased by 15%, from $321 billion at December 31, 2007 to $272 billion at March 31, 2008.

Our Mutual Fund Management Contracts May Not Be Renewed, Which May Reduce our Revenues and Net Income

A substantial portion of our revenues comes from managing U.S. mutual funds. We generally manage these funds pursuant to management contracts with the funds that must be renewed and approved by the funds boards of directors annually. A majority of the directors of each mutual fund are independent from us. Although the funds boards of directors have historically approved each of our management contracts, there can be no assurance that the board of directors of each fund that we manage will continue to approve the fund s management contract each year, or will not condition its approval on the terms of the management contract being revised in a way that is adverse to us. If a mutual fund management contract is not renewed, or is revised in a way that is adverse to us, it could result in a reduction in our revenues and, if our revenues decline without a commensurate reduction in our expenses, our net income will be reduced.

Unavailability of Appropriate Investment Opportunities Could Hamper our Investment Performance or Growth

An important component of investment performance is the availability of appropriate investment opportunities for new client funds. If any of our asset managers is not able to find sufficient investments for new client assets in a timely manner, the asset manager s investment performance could be adversely affected. Alternatively, if one of our asset managers does not have sufficient investment opportunities for new funds, it may elect to limit its growth by reducing the rate at which it receives new funds. Depending on, among other factors, prevailing market conditions, the asset manager s investment style, regulatory and other limits and the market sectors and types of opportunities in which the asset manager typically invests (such as less capitalized companies and other more thinly traded securities in which relatively smaller investments are typically made), the risks of not having sufficient investment opportunities may increase when an asset manager increases its assets under management, particularly when the increase occurs very quickly. If our asset managers are not able to identify sufficient investment opportunities for new client funds, their investment performance or ability to continue to grow may be reduced.

Changes in Securities Markets and Prices May Affect our Revenues and Net Income

A large portion of our revenues is derived from investment advisory contracts with clients. Under these contracts, the investment advisory fees we receive are typically based on the market value of assets under management. Accordingly, a decline in the prices of securities generally may cause our revenues and income to decline by:

- causing the value of our assets under management to decrease, which would result in lower investment advisory and other fees;
- causing our clients to withdraw funds in favor of investments they perceive offer greater opportunity or lower risk, which would also result in lower investment advisory and other fees; or
- decreasing the performance fees earned by our asset managers.

If our revenues decline without a commensurate reduction in our expenses, our net income will be reduced.

There are substantial fluctuations in price levels in the securities markets. These fluctuations can occur on a daily basis and over longer periods as a result of a variety of factors, including national and international economic and political events, broad trends in business and finance, and interest rate movements. Reduced securities market prices generally may result in reduced revenues from lower levels of assets under management and loss or reduction in incentive and performance fees. Periods of reduced market prices may adversely affect our profitability because fixed costs remain relatively unchanged. Because we operate in one industry, the business cycles of our asset managers may occur contemporaneously. Consequently, the effect of an economic downturn may have a magnified negative effect on our business.

Increases in Interest Rates Could Have Adverse Effects on our Fixed Income and Liquidity Assets Under Management

Increases in interest rates from their present levels may adversely affect the net asset values of our assets under management. In addition, in a rising interest rate environment institutional investors may shift liquidity assets that we manage in pooled investment vehicles to direct investments in the types of assets in which the pooled vehicles invest in order to realize higher yields. Furthermore, increases in interest rates may result in reduced prices in equity markets. Any of these effects could lower our assets under management and revenues and, if our revenues decline without a commensurate reduction in our expenses, our net income will be reduced.

Competition in the Asset Management Industry Could Reduce our Revenues and Net Income

The asset management industry in which we are engaged is extremely competitive and we face substantial competition in all aspects of our business. We compete with numerous international and domestic asset management firms and broker-dealers, mutual fund complexes, hedge funds, commercial banks, insurance companies, other investment companies and other financial institutions. Many of these organizations offer products and services that

are similar to, or compete with, those offered by our asset managers and have substantially more personnel and greater financial resources than we do. Some of these competitors have proprietary products and distribution channels that make it more difficult for us to compete with them. In addition, many of our competitors have long-standing and established relationships with distributors and clients. From time to time, our asset managers also compete with each other for clients and assets under management. Our ability to compete may be adversely affected if, among other things, our asset managers lose key employees or under-perform in comparison to relevant performance benchmarks or peer groups.

A sizable number of new asset management firms and mutual funds have been established in the last fifteen years, increasing our competition. In addition, the asset management industry has experienced consolidation as numerous asset management firms have either been acquired by other financial services firms or ceased operations. In many cases, this has resulted in firms with greater financial resources than we have. In addition, a number of heavily capitalized companies, including commercial banks and foreign entities have made investments in and acquired asset management firms. Access to mutual fund distribution channels has also become increasingly competitive. All of these factors could make it more difficult for us to compete, and no assurance can be given that we will be successful in competing and growing our assets under management and business. If clients and potential clients decide to use the services of competitors, it could reduce our revenues and growth rate, and if our revenues decrease without a commensurate reduction in our expenses, our net income will be reduced. In addition, our asset managers are not typically the lowest cost provider of asset management services. To the extent that we compete on the basis of price in any of our businesses, we may not be able to maintain our current fee structure in that business, which could adversely affect our revenues and net income.

Our sole business is asset management. As a result, we may be more affected by trends and issues affecting the asset management business, such as industry-wide regulatory issues and inquiries, publicity about, and public perceptions of the industry and asset management industry market cycles, than other financial services companies that have more diversified businesses.

We May Engage in Strategic Transactions That Could Create Risks

As part of our business strategy, we regularly review, and from time to time have discussions with respect to potential strategic transactions, including potential acquisitions, dispositions, consolidations, joint ventures or similar transactions, some of which may be material. There can be no assurance that we will find suitable candidates for strategic transactions at acceptable prices, have sufficient capital resources to accomplish our strategy, or be successful in entering into agreements for desired transactions. In addition, these transactions typically involve a number of risks and present financial, managerial and operational challenges, including:

- adverse effects on our reported earnings per share in the event acquired intangible assets or goodwill become impaired;
- existence of unknown liabilities or contingencies that arise after closing; and
- potential disputes with counterparties.

Acquisitions, including completed acquisitions, also pose the risk that any business we acquire may lose customers or employees or could under-perform relative to expectations. We could also experience financial or other setbacks if transactions encounter unanticipated problems, including problems related to execution or integration. Following the completion of an acquisition, we may have to rely on the seller to provide administrative and other support, including financial reporting and internal controls, to the acquired business for a period of time. There can be no assurance that the seller will do so in a manner that is acceptable to us.

The acquisition of the former CAM business gave rise to all of the risks discussed above. In addition, there is no assurance that we will continue to receive the expected benefits of the CAM business acquisition, including expected resulting cost savings. If we are unable to retain key personnel of the former CAM business, or the business client relationships and managed assets, it could adversely affect our business. Any of these risks could reduce our revenues or increase our expenses, which could adversely affect our net income.

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Strategic transactions typically are announced publicly even though they may remain subject to numerous closing conditions, contingencies and approvals and there is no assurance that any announced transaction will actually be consummated. The failure to consummate an announced transaction could have an adverse effect on us. Future transactions may also further increase our leverage or, if we issue equity securities to pay for acquisitions, dilute the holdings of our existing stockholders.

Regulatory Matters May Negatively Affect our Business and Results of Operations

Our business is subject to regulation by various regulatory authorities that are charged with protecting the interests of our clients. We could be subject to civil liability, criminal liability, or sanction, including revocation of our subsidiaries registrations as investment advisers, revocation of the licenses of our employees, censures, fines, or temporary suspension or permanent bar from conducting business, if we violate such laws or regulations. Any such liability or sanction could have a material adverse effect on our financial condition, results of operations, and business prospects. In addition, the regulatory environment in which we operate frequently changes and has seen significant increased regulation in recent years. In particular, we have incurred significant additional costs in recent years as a result of regulatory changes affecting U.S. mutual funds. We may be adversely affected as a result of new or revised legislation or regulations or by changes in the interpretation or enforcement of existing laws and regulations. For example, we note that federal government officials recently have proposed significant changes to the regulatory structure of the financial services industry. Our business and results of operations can also be adversely affected by federal, state and foreign regulatory issues and proceedings.

Our broker-dealer subsidiaries and many of our foreign subsidiaries are subject to net capital or liquidity rules and requirements, which mandate that they maintain certain levels of capital. A significant operating loss or extraordinary charge against net capital may adversely affect the ability of these subsidiaries to expand or even maintain their present levels of business.

If our Reputation Is Harmed, We Could Suffer Losses In our Business, Revenues and Net Income

Our business depends on earning and maintaining the trust and confidence of clients and other market participants, and the resulting good reputation is critical to our business. Our reputation is vulnerable to many threats that can be difficult or impossible to control, and costly or impossible to remediate. Regulatory inquiries, employee misconduct and rumors, among other things, can substantially damage our reputation, even if they are baseless or satisfactorily addressed. Any damage to our reputation could impede our ability to attract and retain clients and key personnel, and lead to a reduction in the amount of our assets under management, any of which could have a material adverse effect on our revenues and net income.

Failure to Properly Address Conflicts of Interest Could Harm our Reputation, Business and Results of Operations

As we have expanded the scope of our businesses and our client base, we must continue to address conflicts between our interests and those of our clients. In addition, the SEC and other regulators have increased their scrutiny of potential conflicts of interest. We have procedures and controls that are reasonably designed to address these issues. However, appropriately dealing with conflicts of interest is complex and difficult and if we fail, or appear to fail, to deal appropriately with conflicts of interest, we could face reputational damage, litigation or regulatory proceedings or penalties, any of which may adversely affect our revenues or net income.

Our Business Involves Risks of Being Engaged in Litigation and Liability That Could Increase our Expenses and Reduce our Net Income

Many aspects of our business involve substantial risks of liability. In the normal course of business, our asset managers have been named as defendants or co-defendants in lawsuits seeking substantial damages. We are also involved from time to time in governmental and self-regulatory agency investigations and proceedings. Similarly, the investment funds that our asset managers manage are subject to lawsuits and governmental and self-regulatory investigations and proceedings, any of which could harm the investment returns or reputation of the applicable fund

or result in our asset managers being liable to the funds for any resulting damages. There has been an increased incidence of litigation and regulatory investigations in the asset management industry in recent years, including customer claims as well as class action suits seeking substantial damages.

In October 2006, we and several of our officers, former officers and directors were named as defendants in two related civil actions filed in the U.S. District Court for the Southern District of New York. The two civil actions were consolidated and on April 16, 2007, the plaintiffs filed an amended complaint in the consolidated action. The amended complaint names only Legg Mason, two of its current officers and the underwriter in a secondary stock offering as defendants. The complaint alleges that the defendants violated the Securities Exchange Act of 1934 and the Securities Act of 1933 by making misleading statements to the public and omitting certain material facts with respect to the acquisition of the CAM business in a prospectus for a secondary stock offering and in other public statements in order to artificially inflate the price of our common stock. The complaint seeks certification of a class of shareholders who purchased our common stock between February 1, 2006 and October 10, 2006 and who purchased stock in a secondary public offering around March 9, 2006 and seeks unspecified damages. On March 17, 2008, the complaint was dismissed. A notice of appeal of this dismissal was filed in the 2nd Circuit Court of Appeals on April 16, 2008.

Insurance May Not Be Available on a Cost Effective Basis to Protect us From Liability

We face the inherent risk of liability related to litigation from clients, third party vendors or others and actions taken by regulatory agencies. To help protect against these potential liabilities, we purchase insurance in amounts, and against risks, that we consider appropriate, where such insurance is available at prices we deem acceptable. There can be no assurance, however, that a claim or claims will be covered by insurance or, if covered, will not exceed the limits of available insurance coverage, that any insurer will remain solvent and will meet its obligations to provide us with coverage or that insurance coverage will continue to be available with sufficient limits at a reasonable cost. Over the last several years, insurance expenses have increased significantly and we expect further increases to be significant going forward. In addition, certain insurance coverage may not be available or may only be available at prohibitive costs. Renewals of insurance policies may expose us to additional costs through higher premiums or the assumption of higher deductibles or co-insurance liability.

Failure to Comply With Contractual Requirements or Guidelines Could Result in Liability and Loss of Assets Under Management, Both of Which Could Cause our Net Income to Decline

The asset management contracts under which we manage client assets, including contracts with investment funds, often specify guidelines or contractual requirements that we are obligated to observe in providing asset management services. A failure to comply with these guidelines or requirements could result in damage to our reputation, liability to the client or the client reducing its assets under our management, any of which could cause our revenues and net income to decline.

Loss of Key Personnel Could Harm our Business

We are dependent on the continued services of a number of our key asset management personnel and our management team, including our Chief Executive Officer. The loss of any of such personnel without adequate replacement could have a material adverse effect on us. Moreover, since certain of our asset managers contribute significantly to our revenues and net income, the loss of even a small number of key personnel at these businesses could have a disproportionate impact on our overall business. Additionally, we need qualified managers and skilled employees with asset management experience in order to operate our business successfully. The market for experienced asset management professionals is extremely competitive and is increasingly characterized by the movement of employees among different firms. Due to the competitive market for asset management professionals and the success of some of our employees, our costs to attract and retain key employees are significant and will likely increase over time. From time to time we may work with key employees to revise revenue sharing and other employment-related terms to reflect current circumstances. In addition, since the investment track record of many of

our products and services is often attributed to a small number of individual employees, and sometime one person, the departure of one or more of these employees could cause the business to lose client accounts or managed assets, which could have a material adverse effect on our results of operations and financial condition. If we are unable to attract and retain qualified individuals or our costs to do so increase significantly, our operations and financial results would be materially adversely affected.

Our Business is Subject to Numerous Operational Risks

We face numerous operational risks related to our business on a day-to-day basis. Among other things, we must be able to consistently and reliably obtain securities pricing information, process client and investor transactions and provide reports and other customer service to our clients and investors. Any failure to keep current and accurate books and records can render us liable to disciplinary action by governmental and self-regulatory authorities, as well as to claims by our clients. If any of our financial, portfolio accounting or other data processing systems do not operate properly or are disabled or if there are other shortcomings or failures in our internal processes, people or systems, we could suffer an impairment to our liquidity, a financial loss, a disruption of our businesses, liability to clients, regulatory problems or damage to our reputation. These systems may fail to operate properly or become disabled as a result of events that are wholly or partially beyond our control, including a disruption of electrical or communications services or our inability to occupy one or more of our buildings. In addition, our operations are dependent upon information from, and communications with, third parties, and operational problems at third parties may adversely affect our ability to carry on our business.

Our operations rely on the secure processing, storage and transmission of confidential and other information in our computer systems and networks. Although we take protective measures and endeavor to modify them as circumstances warrant, our computer systems, software and networks may be vulnerable to unauthorized access, computer viruses or other malicious code, and other events that have a security impact. If one or more of such events occur, it potentially could jeopardize our or our clients or counterparties confidential and other information processed and stored in, and transmitted through, our computer systems and networks, or otherwise cause interruptions or malfunctions in our, our clients , our counterparties or third parties operations. We may be required to spend significant additional resources to modify our protective measures or to investigate and remediate vulnerabilities or other exposures, and we may be subject to litigation and financial losses that are either not insured against fully or not fully covered through any insurance that we maintain.

We depend on our headquarters, the offices of our subsidiaries and our operations centers for the continued operation of our business. A disaster or a disruption in the infrastructure that supports our asset managers, or an event disrupting the ability of our employees to perform their job functions, including terrorist attacks or a disruption involving electrical communications, transportation or other services used by us or third parties with whom we conduct business, directly affecting our headquarters, the offices of our subsidiaries or our operations centers may have a material adverse impact on our ability to continue to operate our business without interruption. Although we have disaster recovery programs in place, there can be no assurance that these will be sufficient to mitigate the harm that may result from such a disaster or disruption. In addition, insurance and other safeguards might only partially reimburse us for our losses.

Potential Impairment of Goodwill and Intangible Assets Could Increase our Expenses and Reduce our Assets

Determining goodwill and intangible assets, and evaluating them for impairment, requires significant management estimates and judgment, including estimating value and assessing life in connection with the allocation of purchase price in the acquisition creating them. Our goodwill and intangible assets may become impaired as a result of any number of factors, including losses of investment management contracts or declines in the value of managed assets. Any impairment of goodwill or intangibles could have a material adverse effect on our results of operations. For example, during the quarter ended March 31, 2008, we took an impairment charge of $151 million ($95 million, net of tax). This charge related to investment management contracts we acquired in the 2001 acquisition of one of our Wealth Management subsidiaries. We have written these contracts down because certain

clients have withdrawn funds under, or terminated, these contracts (thus reducing our cash flows from them). See Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies Intangible Assets and Goodwill.

Performance-Based Fee Arrangements May Increase the Volatility of our Revenues

A portion of our investment advisory and related fee revenues is derived from performance fees. Our asset managers earn performance fees under certain client agreements if the investment performance in the portfolio meets or exceeds a specified benchmark. If the investment performance does not meet or exceed the investment return benchmark for a particular period, the asset manager will not generate a performance fee for that period and, if the benchmark is based on cumulative returns, the asset managers ability to earn performance fees in future periods may be impaired. In particular, recent investment performance issues have had a negative effect on the performance fees we earn. We earned $37.5 million in performance fees in the quarter ended March 31, 2007, $50.8 million in performance fees in the quarter ended December 31, 2007 (due to the periods over which many performance fees are measured, the December quarter is likely to be the highest performance fee quarter) but only $3.3 million in performance fees for the quarter ended March 31, 2008. Our performance fees have generally increased as a result of the November 2005 acquisition of Permal, a fund-of-hedge funds manager that receives performance fees in addition to the fees earned by its underlying hedge fund managers. Performance fees may become more common in our industry. An increase in performance fees, or in performance-based fee arrangements with our clients, could create greater fluctuations in our revenues.

We Are Exposed to a Number of Risks Arising From our International Operations

Our asset managers operate in a number of jurisdictions outside of the United States on behalf of international clients. We have offices in numerous countries and many cross border and local proprietary funds that are domiciled outside the United States. Our international operations require us to comply with the legal requirements of various foreign jurisdictions, expose us to the political consequences of operating in foreign jurisdictions and subject us to expropriation risks, expatriation controls and potential adverse tax consequences which, among other things, make it more difficult to repatriate to the United States the cash that we generate outside the U.S. Our foreign business operations are also subject to the following risks:

- difficulty in managing, operating and marketing our international operations;
- fluctuations in currency exchange rates which may result in substantial negative effects on assets under management and revenues; and
- significant adverse changes in foreign legal and regulatory environments.

We Rely on Third Parties to Distribute our Mutual Funds and Certain Other Products

In the transaction in which we acquired the CAM business, we transferred our retail securities brokerage and capital markets businesses to Citigroup. Prior to the closing of the transaction, our retail securities brokerage business had been the primary retail distributor of the Legg Mason Funds and both our retail brokerage and our capital markets businesses had distributed a number of our other asset management products and services. As a result of the transaction, we have been moving to an open architecture distribution model and now utilize third party distributors for many of our asset management products and services, which may expose us to risks resulting from the fact that we do not control the distributors. For example, we must compensate the distributors for selling our products and services in amounts that are agreed between them and us but which, in many cases, are largely determined by the distributor. In addition, these distributors generally offer their clients various investment products and services, including proprietary products and services, in addition to and in competition with our products and services.

Pursuant to a Global Distribution Agreement we entered into with Citigroup, Citigroup has agreed to distribute certain of our asset management products and services, including the Legg Mason Funds and the Legg Mason Partners Funds, through its various distribution businesses, and we have agreed that, subject to a few exceptions,

Citigroup s retail securities brokerage will be the exclusive retail distributor of the Legg Mason Funds that are managed by Legg Mason Capital Management for a period of up to three years. The former CAM business has historically relied upon Citigroup s distribution businesses to be the primary distributor of its products and services, and we expect this reliance to continue for some time despite the fact that CAM is no longer under common ownership with the distributors. The majority of the aggregate assets managed by our Managed Investments division were distributed through Citigroup s various distribution businesses. While the Citigroup and other distributors are compensated for distributing our products and services, there can be no assurances that we will be successful in distributing the Legg Mason Funds and our other products and services, including those managed or offered by ClearBridge and other former CAM businesses, through Citigroup s distributors, that we will be successful in distributing our products and services through other third party distributors, or that the transfer of our retail securities brokerage and capital markets businesses will not have an adverse effect on our ability to distribute, or the costs of distributing, our products and services. If we are unable to distribute our products and services successfully, it will adversely affect our revenues and net income, and any increase in distribution related expenses could adversely affect our net income.

Distribution fees paid to mutual fund distributors in accordance with Rule 12b-1 promulgated under the Investment Company Act of 1940 (Rule 12b-1) are a critical element in the distribution of a number of the mutual funds that we manage. There have been recent suggestions from regulatory agencies and other industry participants that Rule 12b-1 distribution fees in the mutual fund industry should be reconsidered and, potentially, reduced, eliminated or significantly restructured. We believe that distribution related fees paid to financial advisors will remain a key element in the mutual fund industry. However, an industry-wide reduction or restructuring of Rule 12b-1 distribution fees could have a material adverse effect on our ability to distribute certain of the mutual funds we sponsor and, potentially, on our revenue and net income.

Our Entry into the Funds-of-Hedge Funds Business has Created a Number of Risks

Permal operates in the international funds-of-hedge funds business, a portion of the asset management business in which we had not been engaged before we acquired Permal. The funds-of-hedge funds business and Permal have both grown rapidly over the last several years, and no assurances can be given that this growth will continue or these growth rates will be maintained. The funds-of-hedge funds business typically involves clients being charged fees on two levels at the funds-of-funds level and at the underlying funds level. These fees may include management fees and performance fees. There is no assurance that Permal will not be forced to change its fee structures by competitive or other pressures or that Permal s fee structures will not hamper its growth. In addition, Permal may generate significant performance fees from time to time, which could increase the volatility of our revenues. See Performance-Based Fee Arrangements May Increase the Volatility of our Revenues. Because Permal operates in the funds-of-hedge funds business globally, it is exposed to a number of regulatory authorities and requirements in different jurisdictions.

ITEM 1B. UNRESOLVED STAFF COMMENTS.

None.

ITEM 2. PROPERTIES.

We lease all of our office space. However, we have entered into an agreement under which we expect to purchase the building housing certain of our back office and support operations by the end of fiscal year 2012. Our headquarters and certain other functions are located in an office building in Baltimore, Maryland in which we currently hold under lease approximately 380,000 square feet. We have signed a lease to move our headquarters to a new building that will be built in Baltimore when the term of our current headquarters lease expires in September 2009. In the new headquarters building, we will lease approximately 373,000 square feet.

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Our asset managers and other subsidiaries are housed in office buildings in 35 cities in 17 countries around the world. The largest of the leases include:

ClearBridge Advisors, Western Asset Management and our distribution and administrative services subsidiaries currently occupy approximately 132,000 square feet in an office building located in New York, New York in which we hold under lease approximately 195,000 square feet. The remaining 63,000 square feet will be subleased to a third party commencing in fiscal year 2009;

Our distribution and administrative services subsidiaries occupy approximately 203,000 square feet in an office building located in Stamford, Connecticut; and

Western Asset Management Company s headquarters is housed in an office building in Pasadena, California in which we occupy approximately 194,000 square feet.

See Note 10 of Notes to Consolidated Financial Statements in Item 8 of this Report for a discussion of our lease obligations.

ITEM 3. LEGAL PROCEEDINGS.

Our current and former subsidiaries are the subject of customer complaints, have been named as defendants or co-defendants in various lawsuits alleging substantial damages and have been involved in certain governmental and self-regulatory agency investigations and proceedings. These proceedings arise primarily from asset management, securities brokerage, and investment banking activities. Some of these proceedings relate to public offerings of securities in which one or more of our prior subsidiaries participated as a member of the underwriting syndicate. We are also aware of litigation against certain underwriters of offerings in which one or more of our former subsidiaries was a participant, but where the former subsidiary is not now a defendant. In these latter cases, it is possible that we may be called upon to contribute to settlements or judgments. In the Citigroup transaction, we transferred to Citigroup the subsidiaries that constituted our private client brokerage and capital markets businesses, thus transferring the entities that would have primary liability for most of the customer complaint, litigation and regulatory liabilities and proceedings arising form those businesses. However, as part of that transaction, we agreed to indemnify Citigroup for most customer complaint, litigation and regulatory liabilities of our former private client brokerage and capital markets businesses that result from pre-closing events. In addition, the asset management business we acquired from Citigroup is a defendant in a number of legal actions, including class action litigation, arising from pre-closing asset management activities, some of which seek substantial damages. That business is also involved in certain regulatory matters related to its business activities prior to the closing. Under the terms of the transaction agreement with Citigroup, Citigroup has agreed to indemnify us for certain legal matters, including all currently known pre-closing legal matters, of the former CAM business. While the ultimate resolution of threatened and pending litigation and other matters cannot be currently determined, in the opinion of our management, after consultation with legal counsel, the resolution of these matters will not have a material adverse effect on our financial position. However, our results of operations could be materially affected during any period if liabilities in that period differ from our prior estimates, and our cash flows could be materially impacted during any period in which these matters are resolved. See Note 10 of Notes to Consolidated Financial Statements in Item 8 of this Report.

In October 2006, Legg Mason and several of its officers, former officers and directors were named as defendants in two related civil actions filed in the U.S. District Court for the Southern District of New York. The two civil actions were consolidated and on April 16, 2007, the plaintiffs filed an amended complaint in the consolidated action. The amended complaint names only Legg Mason, two of its current officers and the underwriter in a secondary stock offering as defendants. The complaint alleges that the defendants violated the Securities Exchange Act of 1934 and the Securities Act of 1933 by making misleading statements to the public and omitting certain material facts with respect to the acquisition of the CAM business in a prospectus for a secondary stock offering and in other public statements in order to artificially inflate the price of Legg Mason common stock. The complaint seeks certification of a class of shareholders who purchased Legg Mason common stock between February 1, 2006 and October 10, 2006 and who purchased stock in a secondary public offering around March 9, 2006 and seeks unspecified damages. We intend to defend the action vigorously. On March 17, 2008, the complaint was dismissed

with prejudice. The plaintiffs filed a notice of appeal of that dismissal on April 16, 2008. We cannot accurately predict the eventual outcome of the appeal at this point and there can be no assurance that the action will not have a material adverse effect on Legg Mason.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

None.

ITEM 4A. EXECUTIVE OFFICERS OF THE REGISTRANT.

Information (not included in our definitive proxy statement for the 2008 Annual Meeting of Stockholders) regarding certain of our executive officers is as follows:

Mike Abbaei, age 47, was elected Executive Vice President of Legg Mason in July 2007. Mr. Abbaei is Legg Mason s Chief Information and Operations Officer with primary responsibility for our operations and technology. Since joining us in 1995, Mr. Abbaei has also served as the President of Legg Mason Technology Services, Inc., our wholly owned subsidiary, which provides outsourcing technology and operation services for various asset management firms including our affiliates.

Peter L. Bain, age 49, was elected Senior Executive Vice President of Legg Mason in July 2004 and currently has primary responsibility for the businesses in our Institutional and Wealth Management divisions and directs our corporate marketing and communications department. Mr. Bain became Executive Vice President of Legg Mason in July 2001 and was responsible for our administrative functions from July 2003 through December 2005. Mr. Bain previously served as head of our Wealth Management division from June 2000 through July 2003.

F. Barry Bilson, age 55, was elected Senior Vice President of Legg Mason in October 1998. Mr. Bilson was Vice President-Finance of Legg Mason from June 1984 through October 1998. Mr. Bilson has served in various financial management capacities since joining us in 1981 and presently has responsibility for investor relations and business development projects. Mr. Bilson is a certified public accountant.

Charles J. Daley, Jr., age 45, was elected Chief Financial Officer of Legg Mason in July 2005, and Senior Vice President, Principal Financial Officer and Treasurer of Legg Mason in January 2002. He has served in number of financial management capacities since joining us in 1988, including as Vice President of Legg Mason since July 1999 and as Controller of Legg Mason from July 2001 to July 2002. Mr. Daley is a certified public accountant.

Ronald R. Dewhurst, age 55, was elected Senior Managing Director of Legg Mason in January 2008 and is the head of our International Asset Management business. Mr. Dewhurst served as the Chief Executive Officer of I00F, an investment management company in Australia from 2004 to 2007. From 1993 to 2002, he held various positions at J.P. Morgan Investment Management and J.P. Morgan Fleming Asset Management including Head of Asian Equities, Hong Kong; Head of European Equities, London and Head of the Americas, New York. He was also a member of the J.P. Morgan Global Committee for Private Banking and Asset Management.

PART II

ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES.

Shares of Legg Mason, Inc. common stock are listed and traded on the New York Stock Exchange (symbol LM). As of March 31, 2008, there were approximately 2,010 holders of record of Legg Mason common stock. Information with respect to our dividends and stock prices is as follows:

	Quarter ended			
	Mar. 31	Dec. 31	Sept. 30	June 30
Fiscal 2008				
Cash dividend declared per share	$ 0.24	$ 0.24	$ 0.24	$ 0.24
Stock price range:				
High	74.75	87.04	102.05	105.87
Low	52.72	68.48	77.84	94.15
Fiscal 2007				
Cash dividend declared per share	$ 0.21	$ 0.21	$ 0.21	$ 0.18
Stock price range:				
High	110.17	105.88	102.73	127.47
Low	93.16	84.40	81.05	92.07

We expect to continue paying cash dividends. However, the declaration of dividends is subject to the discretion of our Board of Directors. In determining whether to declare dividends, or how much to declare in dividends, our Board will consider factors it deems relevant, which may include our results of operations and financial condition, our financial requirements, general business conditions and the availability of funds from our subsidiaries, including all restrictions on the ability of our subsidiaries to provide funds to us.

Equity Compensation Plan Information

The following table provides information about our equity compensation plans as of March 31, 2008.

Plan category	(a) Number of securities to be issued upon exercise of outstanding options, warrants and rights	(b) Weighted-average exercise price of outstanding options, warrants and rights	(c) Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))
Equity compensation plans approved by stockholders	6,380,875(1)	65.81(2)	11,280,892(3)(4)
Equity compensation plans not approved by stockholders	17,816(5)	(6)	(7)
Total	6,398,691(1)(5)	65.81(2)(6)	11,280,892(3)(4)(7)

(1) Includes 517,857 shares of Legg Mason Common Stock (Common Stock) that are held in a trust pending distribution of phantom stock units. The phantom stock units, which are converted into shares of Common Stock on a one-for-one basis upon distribution, were granted to plan participants upon their deferral of compensation or dividends paid on phantom stock units. When amounts are deferred, participants receive a number of phantom stock units equal to the deferred amount divided by 90% to 95% of the fair market value of a share of

Common Stock. Also includes 16,193 restricted stock units granted to non-employee directors as equity compensation that are converted into shares of Common Stock on a one-for-one basis upon distribution.

(2) Does not include phantom stock units or restricted stock units that will be converted into Common Stock on a one-for-one basis upon distribution at no additional cost, and were acquired as described in footnote (1).

(3) In addition, an unlimited number of shares of Common Stock may be issued under the Legg Mason & Co, LLC Deferred Compensation/Phantom Stock Plan upon the distribution of phantom stock units that may be acquired in the future as described in footnote (1).

(4) 7,209,136 of these shares may be issued under our omnibus equity plan as stock options, restricted or unrestricted stock grants or any other form of equity compensation. 540,906 of these shares may be issued under the Legg Mason, Inc. Equity Plan for Non-Employee Directors as grants of stock or restricted stock units. 3,530,850 of these shares may be purchased under our employee stock purchase plan, which acquires the shares that are purchased thereunder in the open market.

(5) Includes 2,629 shares of Common Stock that are held in a trust pending distribution of phantom stock units. The phantom stock units, which are converted into shares of Common Stock on a one-for-one basis upon distribution, were granted to plan participants upon their deferral of compensation or dividends paid on phantom stock units or receipt of the right to receive deferred bonuses. When amounts were deferred, participants received a number of phantom stock units equal to the deferred amount divided by the fair market value, or 95% of the fair market value, of a share of Common Stock. Also includes 15,187 shares of Common Stock issuable under the Howard Weil Plan (as defined below).

(6) Phantom stock units are converted into Common Stock on a one-for-one basis upon distribution at no additional cost, and were acquired as described in footnote (5). The Howard Weil Plan provides for the issuance of shares of Common Stock upon the occurrence of certain events at no additional cost to the recipient. However, these rights were acquired upon the recipients deferral of compensation or dividends on rights held with a value equal to the market value of the shares acquirable under the plan.

(7) Effective December 1, 2005, we terminated all of our phantom stock and retention plans that had not been approved by our stockholders and commenced making distributions to participants thereunder. Under the terms of these plans, distributions will be made over a period of 1-3 years. Under the Howard Weil Plan, 15,187 shares of Common Stock are currently held in a trust to be issued under the plan. However, dividends on these shares are reinvested in the right to receive additional shares of Common Stock, which are purchased in the market to fulfill this obligation.

We have three equity compensation plans that have not been approved by our stockholders. Effective December 1, 2005, in connection with the sale of our private client brokerage and capital markets businesses, we terminated all of our phantom stock and retention plans that had not been approved by our stockholders. In connection with this termination, we accelerated the vesting of awards under the plans and commenced distributing shares to participants. Under the terms of these plans, distributions will be made over a period of 1-3 years. For all of these plans, we have issued to a trust shares of our Common Stock that are available for distributions under the plans. Our equity compensation plans that have not been approved by our stockholders are:

- Legg Mason Wood Walker, Incorporated Private Client Group Deferred Compensation Plan;
- Legg Mason Wood Walker, Incorporated Financial Advisor Retention Plan; and
- Howard, Weil, Labouisse, Friedrichs, Inc. Equity Incentive Plan (the Howard Weil Plan).

Set forth below is a brief description of these plans.

Legg Mason Wood Walker, Incorporated Private Client Group Deferred Compensation Plan (PCG Plan) and Financial Advisor Retention Plan (FA Plan)

Under the PCG Plan, financial advisors in our private client brokerage business were eligible to earn deferred bonuses in each calendar year based upon several performance measures. In calendar year 2002, the PCG Plan was replaced with the FA Plan, under which financial advisors in our private client brokerage business were eligible to earn in each calendar year the right to receive future retention bonuses based upon several performance measures. Deferred bonuses under the PCG Plan and future retention bonuses under the FA Plan were deemed invested in either an interest account or a phantom stock account. Amounts deemed invested in phantom stock accounts were credited as a number of phantom stock units based on a unit price equal to the market price for a share of Common Stock. The number of phantom stock units credited to an account will be adjusted until the bonuses are payable to account for any stock dividends, stock splits and similar events. Effective December 1, 2005, we terminated the PCG Plan and FA Plan. In connection with this termination, we accelerated the vesting of all awards under the plans and commenced making distributions or paying deferred bonuses to participants. The majority of participants have received full distributions/deferred bonuses. However, distributions to some participants under the PCG Plan and the FA Plan will be made over a period of three years. Participants in the PCG Plan receive upon distribution a number of shares of Common Stock equal to the number of phantom stock units that are to be distributed, or cash in the amount of the balance of the interest account to be distributed. Participants in the FA Plan receive as payment of retention bonuses a number of shares of Common Stock equal to the number of phantom stock units that are to be distributed, or cash in the amount of the balance of the interest account to be distributed.

Howard, Weil, Labouisse, Friedrichs, Inc. Equity Incentive Plan

Under the Howard Weil Plan, certain employees of Howard, Weil, Labouisse, Friedrichs, Inc. (Howard Weil) were entitled to defer their receipt of compensation. The deferred amounts were deemed invested in Voting Stock of Howard Weil. When we acquired Howard Weil in 1987, the deferred amounts were funded by placing Howard Weil stock into a trust, and the stock in the trust was converted into Legg Mason Common Stock. Since the acquisition, no additional amounts have been deferred under the Howard Weil Plan. However, the Howard Weil Plan governs the distribution of shares from the trust to participants. In addition, dividends paid on the shares held in the trust are used to purchase additional shares of Legg Mason Common Stock in the open market, which are then credited to the accounts of participants. Effective December 1, 2005, the participants in the Howard Weil Plan ceased to be employees of Legg Mason, thus triggering distribution of deferred amounts under the Plan. We expect this distribution to be completed in calendar year 2009.

Purchases of our Common Stock

The following table sets out information regarding our purchases of Common Stock during the quarter ended March 31, 2008

Period	(a) Total number of shares purchased[1]	(b) Average price paid per share	(c) Total number of shares purchased as part of publicly announced plans or programs[2]	(d) Maximum number of shares that may yet be purchased under the plans or programs[2]
January 1, 2008 Through January 31, 2008	498	$ 69.71		3,900,000
February 1, 2008 Through February 29, 2008				3,900,000
March 1, 2008 Through March 31, 2008				3,900,000
Total	498	$ 69.71		3,900,000

(1) All shares were acquired through the surrender of shares by option holders to pay the exercise price of stock options.

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(2) On July 19, 2007, we announced that our Board of Directors authorized Legg Mason to purchase 5.0 million shares of Legg Mason common stock in open-market purchases. There was no expiration date attached to this authorization.

In February, 2008, we purchased and cancelled 2.5 shares of our Series A Non-Voting Convertible Preferred Stock. This preferred stock was convertible into 2.5 million shares of our common stock. The purchase was authorized by the Finance Committee of our Board of Directors on January 8, 2008.

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ITEM 6. SELECTED FINANCIAL DATA

(Dollars in thousands, except per share amounts or unless otherwise noted)

	Years Ended March 31,				
	2008	2007	2006	2005	2004
OPERATING RESULTS[1]					
Operating revenues	**$ 4,634,086**	$ 4,343,675	$ 2,645,212	$ 1,570,700	$ 1,153,076
Operating expenses	**3,583,910**	3,315,377	1,965,482	1,081,583	826,828
Operating income	**1,050,176**	1,028,298	679,730	489,117	326,248
Other income (expense)	**(606,305)**	15,556	35,732	(18,359)	(24,685)
Income from continuing operations before income tax provision and minority interests	**443,871**	1,043,854	715,462	470,758	301,563
Income tax provision	**175,995**	397,612	275,595	175,334	114,223
Income from continuing operations before minority interests	**267,876**	646,242	439,867	295,424	187,340
Minority interests, net of tax	**(266)**	4	(6,160)		
Income from continuing operations	**267,610**	646,246	433,707	295,424	187,340
Income from discontinued operations, net of tax			66,421	113,007	103,943
Gain on sale of discontinued operations, net of tax		572	644,040		6,481
Net income	**$ 267,610**	$ 646,818	$ 1,144,168	$ 408,431	$ 297,764
PER SHARE[2]					
Net income per share:					
Basic					
Income from continuing operations	**$ 1.88**	$ 4.58	$ 3.60	$ 2.86	$ 1.87
Income from discontinued operations			0.55	1.09	1.04
Gain on sale of discontinued operations			5.35		0.06
	$ 1.88	$ 4.58	$ 9.50	$ 3.95	$ 2.97
Diluted					
Income from continuing operations	**$ 1.86**	$ 4.48	$ 3.35	$ 2.56	$ 1.68
Income from discontinued operations			0.51	0.97	0.91
Gain on sale of discontinued operations			4.94		0.06
	$ 1.86	$ 4.48	$ 8.80	$ 3.53	$ 2.65
Weighted average shares outstanding:[2]					
Basic	**142,018**	141,112	120,396	103,428	100,292
Diluted	**143,976**	144,386	130,279	117,074	114,049
Dividends declared	**$ .960**	$ .810	$ .690	$ .550	$ .373
BALANCE SHEET					
Total assets	**$ 11,830,352**	$ 9,604,488	$ 9,302,490	$ 8,219,472	$ 7,282,483
Long-term debt	**2,257,773**	1,112,624	1,202,960	811,164	794,238
Total stockholders equity	**6,620,503**	6,541,490	5,850,116	2,293,146	1,559,610
FINANCIAL RATIOS AND OTHER DATA					
Cash income from continuing operations per diluted share (non-GAAP)[3]	**$ 3.25**	$ 5.86	$ 4.10	$ 3.17	$ 1.98
Profit margin:[4]					
Pre-tax	**9.6%**	24.0%	27.0%	30.0%	26.2%
After-tax	**5.8%**	14.9%	16.6%	18.8%	16.2%
Total debt to total capital[5]	**29.4%**	14.5%	18.0%	26.1%	33.7%
Assets under management *(in millions)*	**$ 950,122**	$ 968,510	$ 867,550	$ 374,529	$ 286,168
Full-time employees	**4,220**	4,030	3,820	5,580	5,250

(1) Reflects results of CAM and Permal since acquisition in fiscal 2006 and discontinued private client, capital markets and mortgage banking and servicing operations, where applicable.

(2) Adjusted to reflect September 2004 stock split, where applicable. Diluted earnings per share and weighted average diluted shares outstanding have been restated as required by EITF 04-8, The Effect of Contingently Convertible Instruments on Diluted Earnings per Share, where applicable.

(3) Cash income from continuing operations is a non-GAAP performance measure we define as income from continuing operations, plus amortization and deferred taxes related to intangible assets. See Supplemental Non-GAAP information in Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations.

(4) Calculated based on income from continuing operations before minority interests.

(5) Calculated based on total debt as a percentage of total capital (total stockholders equity plus total debt) as of March 31.

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ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS
EXECUTIVE OVERVIEW

Legg Mason, Inc., a holding company, with its subsidiaries (which collectively comprise Legg Mason) is a global asset management firm. Acting through our subsidiaries, we provide investment management and related services to institutional and individual clients, company-sponsored mutual funds and other investment vehicles. We offer these products and services directly and through various financial intermediaries. We have operations principally in the United States of America and the United Kingdom and also have offices in Australia, Bahamas, Brazil, Canada, Chile, China, Dubai, France, Germany, Italy, Japan, Luxembourg, Poland, Singapore, Spain and Taiwan.

We operate in one reportable business segment, Asset Management, with three divisions: Managed Investments, Institutional, and Wealth Management. Managed Investments is primarily engaged in providing investment advisory services to proprietary investment funds or to retail separately managed account programs. Institutional focuses on providing asset management services to institutional clients. Wealth Management is primarily focused on providing asset management services to high net worth individuals and families and endowments and includes our funds-of-hedge funds business. See Note 19 of Notes to Consolidated Financial Statements for additional information regarding the aggregation of operating segments for financial reporting purposes.

Our operating revenues primarily consist of investment advisory fees, from separate accounts and funds, and distribution and service fees. Investment advisory fees are generally calculated as a percentage of the assets of the investment portfolios that we manage. In addition, performance fees may be earned under certain investment advisory contracts for exceeding performance benchmarks. Distribution and service fees are fees received for distributing investment products and services or for providing other support services to investment portfolios, and are generally calculated as a percentage of the assets in an investment portfolio or as a percentage of new assets added to an investment portfolio. Our revenues, therefore, are dependent upon the level of our assets under management, and thus are affected by factors such as securities market conditions, our ability to attract and maintain assets under management and key investment personnel, and investment performance. The fees that we charge for our investment services vary based upon factors such as the type of underlying investment product, the amount of assets under management, and the type of services (and investment objectives) that are provided. Fees charged for equity asset management services are generally higher than fees charged for fixed income and liquidity asset management services. Accordingly, our revenues will be affected by the composition of our assets under management. In addition, in the ordinary course of our business, we may reduce or waive investment management fees, or limit total expenses, on certain products or services for particular time periods to manage fund expenses, or for other reasons, and to help retain or increase managed assets. Under revenue sharing agreements, our subsidiaries retain different percentages of revenues to cover their costs, including compensation. As such, our net income, profit margin and compensation as a percentage of operating revenues are impacted based on which subsidiaries generate our revenues, and a change in assets under management at one subsidiary can have a dramatically different effect on our revenues and earnings than an equal change at another subsidiary.

The most significant component of our cost structure is employee compensation and benefits, of which a majority is variable in nature and includes incentive compensation that is primarily based upon revenue levels and profits. The next largest component of our cost structure is distribution and servicing fees, which are primarily fees paid to third party distributors for selling our asset management products and services and are largely variable in nature. Certain other operating costs are fixed in nature, such as occupancy, depreciation and amortization, and fixed contract commitments for market data, communication and technology services, and usually do not decline with reduced levels of business activity or, conversely, usually do not rise proportionately with increased business activity.

Our financial position and results of operations are materially affected by the overall trends and conditions of the financial markets, particularly in the United States, but increasingly in the other countries in which we operate. Results of any individual period should not be considered representative of future results. Our profitability is sensitive to a variety of factors, including the amount and composition of our assets under management, and the volatility and general level of securities prices and interest rates, among other things. Sustained periods of unfavorable market conditions are likely to affect our profitability adversely. In addition, the diversification of services and products offered, investment performance, access to distribution channels, reputation in the market, attracting and retaining key employees and client relations are significant factors in determining whether we are successful in attracting and retaining clients. In the past decade, we have experienced substantial expansion due to internal growth and the strategic acquisition of asset management firms that provided, among other things, a broader range of investment expertise, additional product diversification and increased assets under management.

The financial services business in which we are engaged is extremely competitive. Our competition includes numerous global, national, regional and local asset management firms, broker-dealers and commercial banks. The industry has been affected by the consolidation of financial services firms through mergers and acquisitions. The industry in which we operate is also subject to extensive regulation under federal, state, and foreign laws. Like most firms, we have been impacted by the regulatory and legislative changes in the post-Enron era. Responding to these changes has required us to incur costs that continue to impact our profitability.

During much of fiscal 2008, and continuing thereafter, the fixed income markets have endured substantial turmoil. One effect of this turmoil was that liquidity in the markets for many types of asset backed commercial paper and medium term notes issued by structured investment vehicles (SIVs) became substantially reduced. As a result, we entered into several transactions during the fiscal year to provide support to liquidity funds that are managed by our asset managers that had invested in SIV-issued securities. These transactions resulted in aggregate charges during fiscal year 2008 of $608.3 million ($313.7 million, net of income taxes and compensation related adjustments).

On December 1, 2005, we completed a strategic acquisition to become a pure asset management company in which we transferred our Private Client and Capital Markets businesses (PC/CM) to Citigroup Inc. (Citigroup) as a portion of the consideration in exchange for substantially all of Citigroup s asset management business (CAM). Prior to the closing of this transaction, we reported the PC/CM businesses as separate business segments. However, both businesses are now included in discontinued operations for fiscal 2006 as described below. Effective November 1, 2005, we also purchased Permal Group Ltd (Permal), a leading global funds-of-hedge funds manager, to expand our global asset management business. See Notes 2 and 3 of Notes to the Consolidated Financial Statements for additional information related to the transaction with Citigroup and the acquisition of Permal.

As a result of the sale of our PC/CM businesses to Citigroup, distribution fees earned on company-sponsored investment funds are reported in continuing operations as distribution fee revenue, of which a substantial portion is passed through to third parties, including parties that were related prior to the sale, as distribution and servicing expense. All periods presented reflect this change.

Discontinued Operations

As a result of the sale of the PC/CM businesses in fiscal 2006, the results of the Private Client and Capital Markets segments are reflected in discontinued operations.

Private Client distributed a wide range of financial products through its branch distribution network, including equity and fixed income securities, proprietary and non-affiliated mutual funds and annuities. The primary sources of net revenues for Private Client were

commissions and principal credits earned on equity and fixed income transactions in customer brokerage accounts, distribution fees earned from mutual funds, fee-based account fees and net interest from customers margin loan and credit account balances. Sales credits associated with underwritten offerings initiated in the Capital Markets segment were reported in Private Client when sold through its branch distribution network.

Capital Markets consisted of our equity and fixed income institutional sales and trading and corporate and public finance. The primary sources of revenue for equity and fixed income institutional sales and trading included commissions and principal credits on transactions in both corporate and municipal products. We maintained proprietary fixed income and equity securities inventories primarily to facilitate customer transactions and as a result recognized trading profits and losses from our trading activities. Corporate finance revenues included underwriting fees and advisory fees from private placements and mergers and acquisitions. Sales credits associated with underwritten offerings were reported in Capital Markets when sold through institutional distribution channels. The results of this business segment also included realized and unrealized gains and losses on investments acquired in connection with merchant and investment banking activities.

All references to fiscal 2008, 2007 or 2006 refer to our fiscal year ended March 31 of that year. Terms such as we, us, our, and company refer t Legg Mason.

BUSINESS ENVIRONMENT AND RESULTS OF OPERATIONS

The financial environment globally and in the United States was volatile during fiscal 2008 and challenging market conditions persisted throughout most of our fiscal year. Continued contraction in worldwide credit markets due in part to sub-prime lending issues, which began in the summer of 2007, a weaker U.S. dollar, major write-downs related to the credit crisis within the financial sector, and record high oil prices continued to concern investors about the state of the U.S. and global economies. As a result, all three major U.S. equity market indices declined during the fiscal year. The Dow Jones Industrial Average,[1] NASDAQ Composite Index[2] and the S&P 500[3] were down 1%, 6% and 7%, respectively, for the fiscal year. In addition, during fiscal 2008 the Federal Reserve reduced the federal funds rate to 2.25% at March 31, 2008, down from 5.25% a year ago in an effort to ease the impact of the credit crisis. The financial environment in which we operate continues to be challenging moving into fiscal 2009. We expect the challenges presented by the credit markets to persist throughout the next fiscal year. We cannot predict how these uncertainties will impact the Company s results.

(1) Dow Jones Industrial Average is a trademark of Dow Jones & Company, which is not affiliated with Legg Mason.
(2) NASDAQ is a trademark of the NASDAQ Stock Market, Inc., which is not affiliated with Legg Mason.
(3) S&P is a trademark of Standard & Poor s, a division of the McGraw-Hill Companies, Inc., which is not affiliated with Legg Mason.

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The following table sets forth, for the periods indicated, items in the Consolidated Statements of Income as a percentage of operating revenues and the increase (decrease) by item as a percentage of the amount for the previous period:

	Percentage of Operating Revenues Years Ended March 31,			Period to Period Change[1]	
	2008	2007	2006	**2008 Compared to 2007**	2007 Compared to 2006
Operating Revenues					
Investment advisory fees					
Separate accounts	**31.6%**	33.3%	41.6%	**1.3%**	31.3%
Funds	**50.1**	46.5	37.6	**14.7**	103.5
Performance fees	**2.9**	3.3	3.8	**(6.7)**	40.0
Distribution and service fees	**14.9**	16.5	16.1	**(3.4)**	68.3
Other	**0.5**	0.4	0.9	**53.9**	(28.7)
Total operating revenues	**100.0**	100.0	100.0	**6.7**	64.2
Operating Expenses					
Compensation and benefits	**33.9**	36.1	42.6	**0.1**	39.2
Distribution and servicing	**27.5**	27.5	21.2	**6.5**	112.9
Communications and technology	**4.2**	4.0	3.4	**10.7**	95.2
Occupancy	**2.8**	2.3	1.9	**29.2**	96.7
Amortization of intangible assets	**1.2**	1.6	1.5	**(16.3)**	77.9
Impairment of management contracts	**3.3**			**n/m**	n/m
Litigation award settlement			(0.3)	**n/m**	n/m
Other	**4.4**	4.8	4.0	**0.9**	96.2
Total operating expenses	**77.3**	76.3	74.3	**8.1**	68.7
Operating Income	**22.7**	23.7	25.7	**2.1**	51.3
Other Income (Expense)					
Interest income	**1.7**	1.4	1.8	**30.6**	22.8
Interest expense	**(1.8)**	(1.6)	(2.0)	**15.7**	35.8
Other	**(13.0)**	0.5	1.5	**n/m**	(30.4)
Total other income (expense)	**(13.1)**	0.3	1.3	**n/m**	(56.5)
Income from Continuing Operations before Income Tax Provision and Minority Interests	**9.6**	24.0	27.0	**(57.5)**	45.9
Income tax provision	**3.8**	9.1	10.4	**(55.7)**	44.3
Income from Continuing Operations before Minority Interests	**5.8**	14.9	16.6	**(58.5)**	46.9
Minority interests, net of tax			(0.2)	**n/m**	n/m
Income from Continuing Operations	**5.8**	14.9	16.4	**(58.6)**	49.0
Income from discontinued operations, net of tax			2.5	**n/m**	n/m
Gain on sale of discontinued operations, net of tax			24.4	**n/m**	n/m
Net Income	**5.8%**	14.9%	43.3%	**(58.6)**	(43.5)

n/m not meaningful

(1) Calculated based on the change in actual amounts between fiscal years as a percentage of the prior year amount.

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FISCAL 2008 COMPARED WITH FISCAL 2007

Financial Overview

During fiscal 2008, we entered into several transactions to provide support to certain liquidity funds that held securities issued by SIVs that are managed by a subsidiary. These transactions resulted in aggregate charges during the fiscal year of $608.3 million. Also, during fiscal 2008, an impairment charge of $151.0 million was recorded for a reduction in the value of certain acquired management contract intangible assets. Net income for the year ended March 31, 2008 totaled $267.6 million, or $1.86 per diluted share, a decrease of 59% and 58%, respectively, from the prior year. Cash income from continuing operations (see Supplemental Non-GAAP Financial Information) was $468.5 million, or $3.25 per diluted share, both representing a decrease of 45% from the prior year. These decreases were primarily due to net losses related to liquidity fund support, net of income tax benefits and compensation related adjustments, of $313.7 million, or $2.18 per diluted share, and the impairment charge, net of income tax benefits, of $94.8 million, or $0.66 per diluted share. The pre-tax profit margin from continuing operations declined to 9.6% from 24.0% in the prior year. The pre-tax profit margin from continuing operations, as adjusted (see Supplemental Non-GAAP Financial Information), declined to 13.2% from 33.2% in the prior year. During fiscal 2008, losses related to liquidity fund support and the impairment charge reduced the pre-tax profit margin by 11.0% and 3.3%, respectively, and reduced the pre-tax profit margin, as adjusted, by 15.1% and 4.5%, respectively.

Assets Under Management

The components of the changes in our assets under management (AUM) (in billions) for the years ended March 31 were as follows:

	2008	2007
Beginning of period	**$ 968.5**	$ 867.6
Net client cash flows	**(26.3)**	44.2
Market performance and other	**9.9**	57.5
Acquisitions (dispositions), net	**(2.0)**	(0.8)
End of period	**$ 950.1**	$ 968.5

AUM at March 31, 2008 were $950.1 billion, a decrease of $18.4 billion or 2% from March 31, 2007. Net client cash outflows for the fiscal year were $26.3 billion and were driven by outflows in equity assets of approximately $44 billion, resulting, in part, from lower relative investment performance, partially offset by approximately $15 billion and $3 billion of fixed income and liquidity inflows, respectively. Due in part to investment performance, we have experienced net equity outflows in each quarter since the September 2006 quarter. We generally earn higher fees and profits on equity AUM, and outflows in this asset class will more negatively impact our revenues and net income than would outflows in other asset classes.

AUM by Asset Class

AUM by asset class (in billions) as of March 31 were as follows:

	2008	**% of Total**	2007	% of Total	% Change
Equity	**$ 271.6**	**28.6**	$ 338.0	34.9	(19.6)
Fixed Income	**508.2**	**53.5**	470.9	48.6	7.9
Liquidity	**170.3**	**17.9**	159.6	16.5	6.7
Total	**$ 950.1**	**100.0**	$ 968.5	100.0	(1.9)

Average AUM by asset class (in billions) for the year ended March 31 were as follows:

	2008	% of Total	2007	% of Total	% Change
Equity	**$ 327.6**	**33.1**	$ 325.1	35.9	0.8
Fixed Income	**498.6**	**50.3**	441.9	48.8	12.8
Liquidity	**163.9**	**16.6**	138.8	15.3	18.1
Total	**$ 990.1**	**100.0**	$ 905.8	100.0	9.3

AUM by Division

AUM by division (in billions) as of March 31 were as follows:

	2008	% of Total	2007	% of Total	% Change
Managed Investments	**$ 376.6**	**39.7**	$ 403.2	41.6	(6.6)
Institutional	**511.4**	**53.8**	496.3	51.3	3.0
Wealth Management	**62.1**	**6.5**	69.0	7.1	(10.0)
Total	**$ 950.1**	**100.0**	$ 968.5	100.0	(1.9)

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The component changes in our AUM by division (in billions) for the year ended March 31, 2008 were as follows:

	Managed Investments	Institutional	Wealth Management	Total AUM
March 31, 2007	$ 403.2	$ 496.3	$ 69.0	$ 968.5
Net client cash flows	(23.2)	2.5	(5.6)	(26.3)
Market performance and other	(2.7)	12.6		9.9
Acquisitions (dispositions), net	(0.7)		(1.3)	(2.0)
March 31, 2008	**$ 376.6**	**$ 511.4**	**$ 62.1**	**$ 950.1**

Assets managed for U.S. domiciled clients accounted for 66% and 67% of total assets managed and non-U.S. domiciled clients represented 34% and 33% of total assets managed as of March 31, 2008 and 2007, respectively.

Revenue by Division

Operating revenues by division (in millions) for the years ended March 31 were as follows:

	2008	**% of Total**	2007	% of Total	% Change
Managed Investments	**$ 2,538.4**	**54.8**	$ 2,444.4	56.3	3.8
Institutional	**1,024.5**	**22.1**	970.0	22.3	5.6
Wealth Management	**1,071.2**	**23.1**	929.3	21.4	15.3
Total	**$ 4,634.1**	**100.0**	$ 4,343.7	100.0	6.7

The increase in operating revenues in the Managed Investments division was primarily due to increased mutual fund revenues at Western Asset Management Company (Western Asset) and Royce & Associates, LLC (Royce), partially offset by decreased mutual fund revenues at ClearBridge Advisors LLC (ClearBridge). The increase in operating revenues in the Institutional division was primarily due to increased separate account revenues at Western Asset and Brandywine Global Investment Management, LLC (Brandywine), partially offset by decreased performance fees at Western Asset. The increase in operating revenues in the Wealth Management division was primarily due to increased revenues, distribution and service fees and performance fees at Permal, partially offset by decreased separate account revenues at Private Capital Management, LP (PCM).

RESULTS OF OPERATIONS

Operating Revenues

Revenues from continuing operations for the year ended March 31, 2008 were $4.6 billion, up 7% from $4.3 billion in the prior year primarily as a result of a 9% increase in average AUM, principally in the liquidity and fixed income asset classes.

Investment advisory fees from separate accounts increased 1%, or $18.7 million, to $1.46 billion, primarily as a result of higher average assets managed by Western Asset, Brandywine and Batterymarch Financial Management Inc., offset in part by a decline in advisory fees due to lower average assets managed by PCM and ClearBridge.

Investment advisory fees from funds increased 15% to $2.3 billion, primarily as a result of an increase in average assets managed by Permal, Western Asset and Royce. These increases were partially offset by a decrease in average assets managed by ClearBridge.

Performance fees decreased 7%, or $9.5 million, to $132.7 million during fiscal 2008, primarily as a result of decreases in performance fees earned by Western Asset, and Legg Mason Capital Management, Inc. (LMCM), which were partially offset by an increase in performance fees earned by Permal.

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Distribution and service fees decreased 3% to $692.3 million primarily as a result of a decline in average AUM of the retail share classes of our domestic equity funds.

Operating Expenses

Compensation and benefits remained flat at $1.6 billion, as increased revenue-share based incentive expense on higher revenues along with higher salary and benefits at certain of our subsidiaries were substantially offset by incentive expense reductions related to charges to provide support for certain liquidity funds that hold SIV-issued securities. See Note 18 of Notes to Consolidated Financial Statements for further discussion of these charges related to our liquidity business. Compensation as a percentage of operating revenues was 33.9% for fiscal 2008, down from 36.1% for fiscal 2007, primarily as a result of a reduction in compensation resulting from adjustments related to liquidity fund support.

Distribution and servicing expenses increased 7% to $1.3 billion, primarily as a result of increased average AUM at Permal and in liquidity assets for which we pay higher relative fees to third party distributors.

Communications and technology expense increased 11% to $192.8 million, primarily as a result of increased depreciation expense, technology maintenance, and other expenditures related to investment management and business continuity infrastructure and office relocations.

Occupancy expense increased 29% to $129.4 million, primarily as a result of higher rent at new office locations and the impact of duplicate rent on facilities during relocation periods.

Expense for impairment of management contracts was $151.0 million, representing the write-down of certain acquired management contracts as a result of a more accelerated rate of client attrition than previously estimated. See Note 6 of Notes to Consolidated Financial Statements for further discussion of the impairment of management contracts.

Other operating expenses increased 1% to $209.9 million, driven primarily by increased promotional expenses, offset in part by decreased expenses under a transition services agreement with Citigroup related to the integration of businesses acquired from Citigroup and prior year losses on the disposal of certain fixed assets as a result of office relocations.

Other Income (Expense)

Interest income increased $18.0 million to $76.9 million, primarily as a result of higher average firm investment account balances, offset in part by a decline in average interest rates earned on these balances. Interest expense increased $11.2 million to $82.7 million due to $500 million of new borrowings under our $1.0 billion unsecured revolving credit facility and the issuance of $1.25 billion of convertible senior notes in January 2008, offset in part by $150 million of principal reduction made on our $700 million term loan.

Other non-operating income (expense) decreased $628.7 million to a loss of $600.5 million, primarily as a result of losses related to liquidity fund support of approximately $607.3 million, which excludes $1.0 million of financing costs included in interest expense. See Note 18 of Notes to Consolidated Financial Statements for additional information.

Provision for Income Taxes

The provision for income taxes decreased 56% to $176.0 million, primarily as a result of lower earnings due to losses related to liquidity fund support and the impairment of acquired management contract assets recorded during the current year. The effective tax rate increased to 39.7% from 38.1% in the prior year primarily reflecting an increase in earnings in higher state income tax rate jurisdictions as a result of the impairment and liquidity fund support charges at lower relative state income tax rates.

Supplemental Non-GAAP Financial Information

Cash Income from Continuing Operations

As supplemental information, we are providing a performance measure that is based on a methodology other than generally accepted accounting principles (non-GAAP) for cash income from continuing operations that management uses as a benchmark in evaluating and comparing the period-to-period operating performance of Legg Mason, Inc. and its subsidiaries. We define cash income from continuing operations as income from continuing operations, plus amortization and deferred taxes related to intangible assets. We believe that cash income from continuing operations provides a good representation of our operating performance adjusted for non-cash acquisition related items and it facilitates comparison of our results to the results of other asset management firms that have not engaged in significant acquisition transactions. We also believe that cash income from continuing operations is an important metric in estimating the value of an asset management business. In considering acquisitions, we often calculate a target firm s cash earnings as a metric in estimating its value. This measure is provided in addition to income from continuing operations, but is not a substitute for income from continuing operations and may not be comparable to non-GAAP performance measures, including measures of cash earnings or cash income, of other companies. Further, cash income from continuing operations is not a liquidity measure and should not be used in place of cash flow measures determined under GAAP. We consider cash income from continuing operations to be useful to investors because it is an important metric in measuring the economic performance of asset management companies, as an indicator of value and because it facilitates comparisons of our operating results with the results of other asset management firms that have not engaged in significant acquisitions.

In calculating cash income from continuing operations, we add the impact of the amortization of intangible assets from acquisitions, such as management contracts, to income from continuing operations to reflect the fact that this non-cash expense makes it difficult to compare our operating results with the results of other asset management firms that have not engaged in significant acquisitions. Deferred taxes on indefinite-life intangible assets and goodwill represent actual tax benefits that are not realized under GAAP absent an impairment charge or the disposition of the related business. Because we actually receive these tax benefits on indefinite-life intangible assets and goodwill, we add them to income in the calculation of cash income from continuing operations. Should a disposition or impairment charge for indefinite-life intangible assets or goodwill occur, its impact on cash income from continuing operations may distort actual changes in the operating performance or value of our firm. Accordingly, we monitor changes in indefinite-life intangible assets and goodwill and the related impact on cash income from continuing operations to ensure appropriate explanations accompany disclosures of cash income from continuing operations.

Although depreciation and amortization on fixed assets are non-cash expenses, we do not add these charges in calculating cash income from continuing operations because these charges are related to assets that will ultimately require replacement.

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A reconciliation of income from continuing operations to cash income from continuing operations (in thousands except per share) is as follows:

	For the Years Ended March 31,		Period to
	2008	2007	Period Change
Income from Continuing Operations	**$ 267,610**	$ 646,246	(58.6)%
Plus:			
Amortization of intangible assets	**57,271**	68,410	(16.3)
Deferred income taxes on intangible assets	**143,600**	130,758	9.8
Cash Income from Continuing Operations	**$ 468,481**	$ 845,414	(44.6)
Cash Income per Diluted Share			
Income from continuing operations per diluted share	**$ 1.86**	$ 4.48	(58.5)
Amortization of intangible assets	**0.40**	0.47	(14.9)
Deferred income taxes on intangible assets	**0.99**	0.91	8.8
Cash Income per Diluted Share	**$ 3.25**	$ 5.86	(44.5)

The decrease in cash income from continuing operations in fiscal 2008 is primarily due to net losses related to liquidity fund support of $313.7 million, or $2.18 per diluted share, and the impairment of management contracts, net of income tax benefits, of $94.8 million, or $0.66 per diluted share.

Pre-tax Profit Margin from Continuing Operations, as Adjusted

We believe that pre-tax profit margin from continuing operations adjusted for distribution and servicing expense is a useful measure of our performance because it indicates what our margins would have been without the distribution revenues that are passed through to third parties as a direct cost of selling our products, and thus shows the effect of these revenues on our margins. This measure is provided in addition to the Company s pre-tax profit margin from continuing operations calculated under GAAP, but is not a substitute for calculations of margin under GAAP and may not be comparable to non-GAAP performance measures, including measures of adjusted margins, of other companies.

A reconciliation of pre-tax profit margin from continuing operations adjusted for distribution and servicing expense (in thousands) is as follows:

	For the Years Ended March 31,	
	2008	2007
Operating Revenues, GAAP basis	**$ 4,634,086**	$ 4,343,675
Less:		
Distribution and servicing expense	**1,273,986**	1,196,019
Operating Revenues, as adjusted	**$ 3,360,100**	$ 3,147,656
Income from Continuing Operations before Income Tax Provision and Minority Interests	**$ 443,871**	$ 1,043,854

Pre-tax profit margin, GAAP basis	**9.6%**	24.0%
Pre-tax profit margin, as adjusted	**13.2**	33.2

During fiscal 2008, losses related to liquidity fund support and the impairment of management contracts reduced the pre-tax profit margin by 11.0% and 3.3%, respectively, and reduced the pre-tax profit margin, as adjusted, by 15.1% and 4.5%, respectively.

FISCAL 2007 COMPARED WITH FISCAL 2006

Since our strategic transaction with Citigroup was completed on December 1, 2005, in which we acquired the CAM business and sold the PC/CM businesses, we have retroactively reflected the results of operations of the PC/CM businesses as discontinued operations for fiscal 2006. Effective November 1, 2005, we completed the acquisition of Permal. As a result of the acquisitions, the results of our continuing operations for fiscal 2007 include a full year of results from CAM and Permal, while the results of continuing operations for fiscal 2006 include four months of results from CAM and five months of results from Permal.

Assets Under Management

AUM at March 31, 2007 were $968.5 billion, up $100.9 billion or 12% from March 31, 2006. Net client cash inflows for the fiscal year were $44.2 billion, representing 5% of our AUM at March 31, 2006, and were driven by approximately $27 billion of client inflows in both fixed income and liquidity assets, while client outflows in equity assets resulting, in part, from lower relative investment performance, were approximately $10 billion. We generally earn higher fees and profit margins on equity AUM and outflows in this asset class will disproportionately impact our revenues and net income.

The components of the changes in our AUM (in billions) for the years ended March 31 were as follows:

	2007	2006
Beginning of period	$ 867.6	$ 374.5
Net client cash flows	44.2	35.6
Market performance and other	57.5	36.9
Acquisitions (dispositions), net	(0.8)	420.6
End of period	$968.5	$867.6

Average AUM for the years ended March 31, 2007 and 2006 were $905.8 billion and $546.9 billion, respectively. The significant increase was due to the impact of a full year of the CAM acquisition.

Our AUM by asset class (in billions) as of March 31 were as follows:

	2007	% of Total	2006	% of Total	% Change
Equity	$ 338.0	34.9	$ 324.9	37.5	4.0
Fixed Income	470.9	48.6	410.6	47.3	14.7
Liquidity	159.6	16.5	132.1	15.2	20.8
Total	$ 968.5	100.0	$ 867.6	100.0	11.6

Our AUM by division (in billions) as of March 31 were as follows:

	2007	% of Total	2006	% of Total	% Change
Managed					
Investments	$ 403.2	41.6	$ 356.5	41.1	13.1

Institutional	496.3	51.3	444.8	51.3	11.6
Wealth Management	69.0	7.1	66.3	7.6	4.1
Total	$ 968.5	100.0	$ 867.6	100.0	11.6

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The components of the changes in our AUM by division (in billions) for the years ended March 31, 2007 were as follows:

	Managed Investments	Institutional	Wealth Management	Total AUM
March 31, 2006	$ 356.5	$ 444.8	$ 66.3	$ 867.6
Net client cash flows	23.5	21.7	(1.0)	44.2
Market performance and other	23.3	30.2	4.0	57.5
Acquisitions (dispositions), net	(0.1)	(0.4)	(0.3)	(0.8)
March 31, 2007	$ 403.2	$ 496.3	$ 69.0	$ 968.5

Assets managed for U.S. domiciled clients accounted for 67% and 68% of total assets managed and non-U.S. domiciled clients represented 33% and 32% of total assets managed as of March 31, 2007 and 2006, respectively. Assets managed for non-U.S. domiciled clients as of March 31, 2006 have been revised to include $19.3 billion of assets previously included as assets managed for U.S. domiciled clients, principally non-U.S. domiciled funds.

Revenue by Division

Our operating revenues by division (in millions) for the years ended March 31 were as follows:

	2007	% of Total	2006(1)	% of Total	% Change
Managed Investments	$ 2,444.4	56.3	$ 1,364.0	51.6	79.2
Institutional	970.0	22.3	717.6	27.1	35.2
Wealth Management	929.3	21.4	563.6	21.3	64.9
Total	$ 4,343.7	100.0	$ 2,645.2	100.0	64.2

(1) Fiscal 2006 includes a reclassification of approximately $29.4 million and $4.6 million from the Institutional and Wealth Management divisions, respectively, to the Managed Investments division to reflect a change whereby the revenues generated by all proprietary funds, except those managed by Permal, are included in the Managed Investments division.

The increases in operating revenues in the Managed Investments and Institutional divisions were primarily due to including a full year s results of CAM. The increase in the operating revenues in the Wealth Management division was primarily due to including a full year s results of Permal, including growth since acquisition, offset in part by decreases at PCM.

The following discussion separately addresses the results of continuing operations and the results of our discontinued operations.

RESULTS OF CONTINUING OPERATIONS

Operating Revenues

Revenues from continuing operations for the year ended March 31, 2007 were $4.3 billion, up 64% from $2.6 billion in the prior year primarily as a result of including a full year s results of CAM and Permal, including Permal s growth since acquisition, which combined accounted for approximately 90% of the increase in revenues. Higher average AUM, reflecting favorable market conditions and net client cash flows, also contributed;587

Depreciation and amortization
8,819 6,609

	7,233	8,032
Other operating income	716	226
Operating income	$7,949	$8,258

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Revenues. Our marine transportation revenues increased $13.4 million, or 27%, for the year ended December 31, 2007 compared to the year ended December 31, 2006. Our inland marine assets generated an additional $12.4 million in revenue from increased utilization of our fleet as a result of a geographical redistribution of our assets on the Gulf Coast. We also had increased contract rates and operated an additional number of leased vessels. Our offshore revenues increased $1.0 million primarily from the acquisition of an integrated tug barge unit in the fourth quarter of 2006.

Operating expenses. Operating expenses increased $12.0 million, or 34%, for the year ended December 31, 2007 compared to the year ended December 31, 2006. We experienced increases in salaries and wages, repair and maintenance expenses, increased shipyard costs and outside towing expenses.

Selling, general and administrative expenses. Selling, general & administrative expenses were approximately the same for the year ended December 31, 2007 compared to the year ended December 31, 2006.

Depreciation and amortization. Depreciation and amortization increased $2.2 million, or 33%, for the year ended December 31, 2007 compared to the year ended December 31, 2006. This increase was the result of capital expenditures made in the last 12 months.

Other operating income. Other operating income increased $0.5 million, or 217%, for the year ended December 31, 2007 compared to the year ended December 31, 2006. This increase consisted of gains on the sale of property and equipment.

In summary, our marine transportation operating income decreased $0.3 million, or 4%, for the year ended December 31, 2007 compared to the year ended December 31, 2006.

Sulfur Services Segment

The following table summarizes our results of operations in our sulfur services segment.

	Years Ended December 31,	
	2007	2006
	(In thousands)	
Revenues	$ 131,602	$ 102,646
Cost of products sold	97,747	76,372
Operating expenses	17,033	14,283
Selling, general and administrative expenses	2,587	2,651
Depreciation and amortization	5,013	4,621
Operating income	$ 9,222	$ 4,719
Sulfur Services Volumes (long tons)	1,420.9	1,025.2

Revenues. Our sulfur services revenues increased $29.0 million, or 28%, for the year ended December 31, 2007 compared to the year ended December 31, 2006. This increase was primarily a result of a 39% increase in sales volume. The sales volume increase was due to a new molten sulfur sales contract negotiated in 2007 and increased demand for our sulfur-based products, driven by higher agricultural commodity prices.

Cost of products sold. Our cost of products sold increased $21.4 million, or 28%, for the year ended December 31, 2007 compared to the year ended December 31, 2006. This percentage increase was the same as our percentage increase in sales, as our margin per ton was approximately the same for both years.

Operating expenses. Our operating expenses increased $2.8 million, or 19%, for the year ended December 31, 2007 compared to the year ended December 31, 2006. This increase was a result of increased marine transportation costs relating to increased crew wages, outside towing expense incurred for leased vessels due to down time of vessels owned by the sulfur services segment and repairs and maintenance on vessels owned by the sulfur services segment to bring them up to higher quality standards adopted by our marine transportation group.

Selling, general, and administrative expenses. Our selling, general, and administrative expenses decreased $0.1 million, or 2%, for the year ended December 31, 2007 compared to the year ended December 31, 2006.

Depreciation and amortization. Depreciation and amortization increased $0.4 million, or 8%, for the year ended December 31, 2007 compared to the year ended December 31, 2006. This is attributable to our sulfuric acid facility coming online in the fourth quarter of 2007.

In summary, our sulfur services operating income increased $4.5 million, or 95%, for the year ended December 31, 2007 compared to the year ended December 31, 2006

Statement of Operations Items as a Percentage of Revenues

In the aggregate, our cost of products sold, operating expenses, selling, general and administrative expenses, and depreciation and amortization have remained relatively constant as a percentage of revenues for the years ended December 31, 2007 and December 31, 2006. The following table summarizes, on a comparative basis, these items of our statement of operations as a percentage of our revenues.

	Years Ended December 31,	
	2007	2006
	(In thousands)	
Revenues	100%	100%
Cost of products sold	81%	80%
Operating expenses	11%	11%
Selling, general and administrative expenses	2%	2%
Depreciation and amortization	3%	3%

Equity in Earnings of Unconsolidated Entities

For the years ended December 31, 2007 and 2006, equity in earnings of unconsolidated entities relates to our unconsolidated interest in BCP subsequent to its acquisition on June 30, 2006 and the unconsolidated interests in Waskom, Matagorda and PIPE.

Interest Expense

Our interest expense for all operations was $14.5 million for 2007 compared to $13.6 million for 2006, an increase of $0.9 million, or 7%. This increase was primarily due to an increase in average debt outstanding offset by a decrease in interest rates throughout 2007 compared to 2006 which also included a debt prepayment premium of $1.2 million. Also, we had non-cash mark-to-market charges of $0.8 million which increased interest expense in 2007.

Indirect Selling, General and Administrative Expenses

Indirect selling, general and administrative expenses were $3.2 million for 2007 compared to $3.3 million for 2006, a decrease of $0.1 million or 2%.

Martin Resource Management allocated to us a portion of its indirect selling, general and administrative expenses for services such as accounting, treasury, clerical billing, information technology, administration of insurance, engineering, general office expense and employee benefit plans and other general corporate overhead functions we share with Martin Resource Management retained businesses. This allocation is based on the percentage of time spent by Martin Resource Management personnel that provide such centralized services. Generally accepted accounting principles also permit other methods for allocation of these expenses, such as basing the allocation on the percentage of revenues contributed by a segment. The allocation of these expenses between Martin Resource Management and us is subject to a number of judgments and estimates, regardless of the method used. We can provide no assurances that our method of allocation, in the past or in the future, is or will be the most accurate or appropriate method of allocation these expenses. Other methods could result in a higher allocation of selling, general and administrative expense to us, which would reduce our net income.

In addition to the direct expenses, under the omnibus agreement, the reimbursement amount that we are required to pay to Martin Resource Management with respect to indirect general and administrative and corporate overhead expenses was capped at $2.0 million. This cap expired on November 1, 2007. Effective January 1, 2008, the Conflicts Committee of our general partner approved a reimbursement amount for indirect expenses of $2.7 million for the year ending December 31, 2008 which is not expected to cover all of the indirect general and administrative and corporate overhead expenses attributable to the services provided to us. Martin Resource Management allocated indirect selling,

general and administrative expenses of $1.5 million for both the years ended December 31, 2007 and 2006.

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Year Ended December 31, 2006 Compared to the Year Ended December 31, 2005

Our total revenues before eliminations were $579.2 million for the year ended December 31, 2006 compared to $440.8 million for the year ended December 31, 2005, an increase of $138.4 million, or 31%. Our operating income before eliminations was $26.6 million for the year ended December 31, 2006 compared to $19.0 million for the year ended December 31, 2005, an increase of $7.6 million, or 40%.

The results of operations are described in greater detail on a segment basis below.

Terminalling and Storage Segment

The following table summarizes our results of operations in our terminalling and storage segment.

	Years Ended December 31,	
	2006	2005
	(In thousands)	
Revenues:		
Services	$ 24,182	$ 23,145
Products	12,424	9,817
Total Revenues	36,606	32,962
Cost of products sold	9,999	8,267
Operating expenses	12,276	10,942
Selling, general and administrative expenses	112	250
Depreciation and amortization	4,700	4,376
	9,519	9,127
Other operating income	3,127	
Operating income	$ 12,646	$ 9,127

Revenues. Our terminalling and storage revenues increased $3.6 million, or 11%, for the year ended December 31, 2006 compared to the year ended December 31, 2005. Service revenue accounted for $1.0 million of this increase. The service revenue increase was primarily a result of acquisitions of our Corpus Christi terminal, and two asphalt terminals. Product revenue increased $2.6 million due to an 18% increase in product cost that was passed through to our customers, and a 5% increase in sales volume.

Cost of products sold. Our cost of products sold increased $1.7 million, or 21% for the year ended December 31, 2006 compared to the year ended December 31, 2005. This increase was primarily a result of an 18% increase in product cost, and a 5% increase in sales volumes.

Operating expenses. Operating expenses increased $1.3 million, or 12%, for the year ended December 31, 2006 compared to the year ended December 31, 2005. The increase was result of our acquisitions made in 2006, and also a result of increased operating activities and an increase in costs of those activities at our terminals. This accounted for $1.9 million of increased operating expenses, which was offset by a decrease in hurricane expenses of $0.5 million.

Selling, general and administrative expenses. Selling, general and administrative expenses decreased $0.1 million, or 55%, for the year ended December 31, 2006 compared to the year ended December 31, 2005.

Depreciation and amortization. Depreciation and amortization increased $0.3 million, or 7%, for the year ended December 31, 2006 compared to the year ended December 31, 2005. This increase was primarily a result of our acquisitions made in 2006.

Other operating income. Other operating income for the year ended December 31, 2006 consisted primarily of a gain of $3.1 million related to an involuntary conversion of assets. This gain resulted from insurance proceeds which

were greater than the impairment of assets destroyed by hurricanes Katrina and Rita.

In summary, terminalling and storage operating income increased $3.5 million, or 39%, for the year ended December 31, 2006 compared to the year ended December 31, 2005.

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Natural Gas Services Segment

The following table summarizes our results of operations in our natural gas services segment.

	Years Ended December 31, 2006	2005
	(In thousands)	
Revenues:		
NGLs	$ 372,997	$ 295,947
Natural gas	13,773	4,999
Non-cash mark to market adjustment of commodity derivatives	221	747
Gain (loss) on cash settlements of commodity derivatives	894	(235)
Other operating fees	1,850	218
Total revenues	389,735	301,676
Cost of products sold:		
NGLs	361,941	286,339
Natural gas	12,277	4,770
Total cost of products sold	374,218	291,109
Operating expenses	5,240	2,455
Selling, general and administrative expenses	4,373	1,753
Depreciation and amortization	1,667	356
	4,237	6,003
Other operating income	2	
Operating income	$ 4,239	$ 6,003
NGLs Volumes (Bbls)	7,688	6,441
Natural Gas Volumes (Mmbtu)	2,107	478
Information above does not include activities relating to Waskom, PIPE, Matagorda and BCP investments		
Equity in Earnings of Unconsolidated Entities	$ 8,547	$ 1,369
Waskom:		
Plant Inlet Volumes (Mmcf/d)	183	160
Frac Volumes (Bbls/d)	7,677	7,390

Revenues. Our natural gas services revenues increased $88.1 million, or 29%, for the year ended December 31, 2006 compared to the year ended December 31, 2005. Of the increase, $21.2 million is related to our historical NGL distribution segment. The increase is primarily due from an increase in our average sales price per gallon of 10% in 2006 compared to 2005, as our sales volumes in the two periods remained approximately the same. This price increase was due to a general increase in the prices of NGL s.

The remaining $66.9 million increase is related to our acquisition of Prism Gas, as we experienced a full year of operations. These revenues are comprised of $55.9 million of NGL sales, $8.8 million of natural gas sales and $1.6 million of gathering and processing fees. Also, contributing to the increase was $0.6 million of increases in gains on derivative contracts.

Costs of product sold. Our cost of products increased $83.1 million, or 29%, for the year ended December 31, 2006 compared to the year ended December 31, 2005. Of the increase, $21.9 million is related to our historical NGL distribution segment. This increase was higher than the increase in our historical NGL revenues, as our per gallon margin decreased by 5%. In 2005, our historical NGL distribution segment benefited from extraordinary market conditions due to gulf coast hurricanes. These market conditions resulted in a rapid increase in NGL prices allowing us to surpass our historical margins of approximately $0.025 per gallon and experience a margin of approximately $0.04 per gallon. For 2005, in our historical NGL segment, we experienced margins of approximately $.03 per gallon. The balance of the increase of $61.2 million relates to costs resulting from our Prism Gas acquisition, as we experienced a full year of operations.

Operating expenses. Operating expenses increased $2.8 million, or 113%, for the year ended December 31, 2006 compared to the year ended December 31, 2005. An increase of $0.6 million was a result of additional operating expenses incurred from the East Texas Pipeline acquisition, and $1.9 million resulted from the Prism Gas acquisition. Both of these acquisitions occurred in 2005. The remaining increase was a result of increased operating costs in our historical NGL distribution segment.

Selling, general and administrative expenses. Selling, general and administrative expenses increased $2.6 million, or 149%, for the year ended December 31, 2006 compared to the year ended December 31, 2005. An increase of $2.3 million was a result of additional expenses incurred from the Prism Gas acquisition, as we experienced a full year of operations. The remaining increase was a result of increased selling, general, and administrative expenses in our historical NGL distribution segment.

Depreciation and amortization. Depreciation and amortization increased $1.3 million, or 368%, for the year ended December 31, 2006 compared to the year ended December 31, 2005. This increase was primarily a result of the Prism Gas acquisition.

In summary, our natural gas services operating income decreased $1.8 million, or 29%, for the year ended December 31, 2006 compared to the year ended December 31, 2005. A portion of this decrease is related to an increase in selling, general and administrative expenses related to the Prism Gas acquisition. Prism Gas, as operator of Waskom, is required, per the partnership agreement, to perform certain services, including but not limited to accounting and engineering, for the Waskom partnership. While Prism Gas does receive an operator s fee based on a percentage of Waskom s operating costs, generally the expenses incurred are recovered in equity in earnings of unconsolidated entities.

Equity in earnings of unconsolidated entities. Equity in earnings of unconsolidated entities was $8.5 million for the year ended December 31, 2006 compared to $1.4 for the year ended December 31, 2005. In connection with the Prism Gas acquisition on November 10, 2005, we acquired an unconsolidated 50% interest in Waskom Gas Processing Company and the Matagorda Offshore Gathering System. We also acquired a 50% interest in Panther Interstate Pipeline Energy LLC, the owner of the Fishhook Gathering System. As a result, these interests are accounted for using the equity method of accounting and we do not include any portion of their net income in our operating income.

Marine Transportation Segment

The following table summarizes our results of operations in our marine transportation segment.

	Years Ended December 31,	
	2006	2005
	(In thousands)	
Revenues	$ 50,174	$ 37,724
Operating expenses	34,946	27,768
Selling, general and administrative expenses	587	357
Depreciation and amortization	6,609	4,942
	8,032	4,657
Other operating income	226	
Operating income	$ 8,258	$ 4,657

Revenues. Our marine transportation revenues increased $12.5 million, or 33%, for the year ended December 31, 2006 compared to the year ended December 31, 2005. Our offshore revenues increased $9.5 million primarily from the acquisition of two integrated tug barge units. Our inland marine assets, coupled with leased inland marine assets, had increased revenues of $3.0 million from increased utilization of our fleet as a result of a geographical redistribution of our assets on the Gulf Coast. We also had increased contract rates, and operated an additional number

of leased vessels.

Operating expenses. Operating expenses increased $7.2 million, or 26%, for the year ended December 31, 2006 compared to the year ended December 31, 2005. The increase was primarily a result of associated costs from our offshore marine vessel acquisitions. We experienced increases in other operating costs including fuel, salaries and wages, insurance premiums and repair and maintenance expenses from increased shipyard costs.

Selling, general and administrative expenses. Selling, general & administrative expenses increased $0.2 million, or 64%, for the year ended December 31, 2006 compared to the year ended December 31, 2005.

Depreciation and amortization. Depreciation and amortization increased $1.7 million, or 34%, for the year ended December 31, 2006 compared to the year ended December 31, 2005. This increase was the result of capital expenditures made in the last 12 months.

Other operating income. Other operating income for the year ended December 31, 2006 consisted of gains on the sale of property and equipment.

In summary, our marine transportation operating income increased $3.6 million, or 77%, for the year ended December 31, 2006 compared to the year ended December 31, 2005.

Sulfur Services Segment

The following table summarizes our results of operations in our sulfur segment.

	Years Ended December 31,	
	2006	**2005**
	(In thousands)	
Revenues	$ 102,646	$ 68,418
Cost of products sold	76,372	52,645
Operating expenses	14,283	7,859
Selling, general and administrative expenses	2,651	2,310
Depreciation and amortization	4,621	2,968
Operating income	$ 4,719	$ 2,636
Equity in Earnings of Unconsolidated Entities	$	$ 222
Volumes (long tons)	1,025.2	656.8

Our sulfur services segment included only sulfur-based products prior to the April 2005 acquisition of a sulfur priller and related assets located in Stockton, California. On July 15, 2005, we purchased the equity interests of CF Martin Sulphur not owned by us. Since that date, the results of CF Martin Sulphur have been added to the results reported in the above table. Prior to July 15, 2005, we owned an unconsolidated noncontrolling 49.5% limited partnership interest in CF Martin Sulphur, which was accounted for using the equity method of accounting. On July 15, 2005, CF Martin Sulphur became a wholly-owned subsidiary of the Partnership and all intercompany transactions were eliminated in consolidation. As of March 30, 2006, CF Martin Sulphur merged into Martin Operating Partnership L.P. and continues to be reported in our sulfur services segment. On January 2, 2006, we placed into service a newly constructed sulfur priller at our Neches terminal in Beaumont, Texas.

The results of operation for the twelve month period ended December 31, 2005, includes twelve months of operations at the sulfur-based products facilities but only includes operations at the Stockton, California priller facility from April 2005 through December 2005 and CF Martin Sulphur from July 15, 2005 through December 2005. The 2005 sulfur services acquisitions impacted our changes in financial performance for the year ended December 31, 2006 compared to the year ended December 31, 2005 as follows:

Revenues. Our sulfur services revenues increased $34.2 million, or 50%, for the year ended December 31, 2006 compared to the year ended December 31, 2005.

Cost of products sold. Our cost of products sold increased $23.7 million, or 45%, for the year ended December 31, 2006 compared to the year ended December 31, 2005.

Operating expenses. Our operating expenses increased $6.4 million, or 82%, for the year ended December 31, 2006 compared to the year ended December 31, 2005.

Selling, general, and administrative expenses. Our selling, general, and administrative expenses increased $0.3 million, or 15%, for the year ended December 31, 2006 compared to the year ended December 31, 2005.

Depreciation and amortization. Depreciation and amortization increased $1.7 million, or 56%, for the year ended December 31, 2006 compared to the year ended December 31, 2005.

In summary, our sulfur services operating income increased $2.1 million, or 79%, for the year ended December 31, 2006 compared to the year ended December 31, 2005.

Equity in earnings of unconsolidated entities. For the year ended December 31, 2005, equity in earnings of unconsolidated entities relates to our unconsolidated non-controlling 49.5% limited partner interest in CF Martin Sulphur prior to July 15, 2005.

Statement of Operations Items as a Percentage of Revenues

In the aggregate, our cost of products sold, operating expenses, selling, general and administrative expenses, and depreciation and amortization have remained relatively constant as a percentage of revenues for the years ended December 31, 2006 and December 31, 2005. The following table summarizes, on a comparative basis, these items of our statement of operations as a percentage of our revenues.

	Years Ended December 31,	
	2006	**2005**
	(In thousands)	
Revenues	100%	100%
Cost of products sold	80%	80%
Operating expenses	11%	11%
Selling, general and administrative expenses	2%	2%
Depreciation and amortization	3%	3%

Equity in Earnings of Unconsolidated Entities

For the years ended December 31, 2006 and 2005, equity in earnings of unconsolidated entities relates to our unconsolidated non-controlling 49.5% limited partner interest in CF Martin Sulphur prior to July 15, 2005, the unconsolidated interest in Bosque County Pipeline subsequent to its acquisition on June 30, 2006 and the unconsolidated interests in Waskom Gas Processing Company, the Matagorda Offshore Gathering System and Panther Interstate Pipeline Energy, L.L.C. owned by Prism Gas since its acquisition on November 10, 2005.

Interest Expense

Our interest expense for all operations was $13.6 million for 2006 compared to $6.9 million for 2005, an increase of $6.7 million, or 97%. This increase was primarily due to an increase in average debt outstanding, an increase in interest rates throughout 2006 compared to 2005 and a debt prepayment premium of $1.2 million paid in 2006.

Indirect Selling, General and Administrative Expenses

Indirect selling, general and administrative expenses were $3.3 million for 2006 compared to $3.5 million for 2005, a decrease of $0.2 million or 6%. This was primarily due to a decrease of $0.5 million in costs relating to compliance with the requirements of the Sarbanes-Oxley Act of 2002. This decrease was offset by an increase in overhead allocation of $0.3 million from Martin Resource Management.

Martin Resource Management allocated to us a portion of its indirect selling, general and administrative expenses for services such as accounting, treasury, clerical billing, information technology, administration of insurance, engineering, general office expense and employee benefit plans and other general corporate overhead functions we share with Martin Resource Management retained businesses. This allocation is based on the percentage of time spent by Martin Resource Management personnel that provide such centralized services. Generally accepted accounting principles also permit other methods for allocation these expenses, such as basing the allocation on the percentage of revenues contributed by a segment. The allocation of these expenses between Martin Resource Management and us is subject to a number of judgments and estimates, regardless of the method used. We can provide no assurances that our method of allocation, in the past or in the future, is or will be the most accurate or appropriate method of allocation these expenses. Other methods could result in a higher allocation of selling, general and administrative expense to us, which would reduce our net income. Under the omnibus agreement, the reimbursement amount with respect to indirect general and administrative and corporate overhead expenses was capped at $2.0 million. This cap expired on November 1, 2007. Effective January 1, 2008, the Conflicts Committee of our general partner approved a reimbursement amount for indirect expenses of $2.7 million for the year ending December 31, 2008 which is not

expected to cover all of the indirect general and administrative and corporate overhead expenses attributable to the services provided to us. Martin Resource Management allocated indirect selling, general and administrative expenses of $1.5 million for the year ended December 31, 2006 compared to $1.3 million for the year ended December 31, 2005.

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Liquidity and Capital Resources

Cash Flows and Capital Expenditures

In 2007, cash increased $0.8 million as a result of $58.0 million provided by operating activities, $127.1 million used in investing activities and $69.9 million provided by financing activities. In 2006, cash decreased $2.8 million as a result of $39.3 million provided by operating activities, $95.1 million used in investing activities and $53.0 million provided by financing activities. In 2005, cash increased $2.9 million as a result of $32.0 million provided by operating activities, $138.7 million used in investing activities and $109.7 million provided by financing activities.

For 2007, our investing activities of $127.1 million consisted primarily of capital expenditures, acquisitions, proceeds from sale of property, and investments in and returns of investments from unconsolidated partnerships. Our investment in unconsolidated partnerships helped to fund $1.2 million and $8.2 million in expansion capital expenditures made by these unconsolidated entities for the fourth quarter and year ended December 31, 2007, respectively. For 2006, our investing activities of $95.1 million consisted primarily of capital expenditures, acquisitions, proceeds from sale of property, insurance proceeds from involuntary conversion of property, plant and equipment, and investments in and returns of investments from unconsolidated partnerships. For 2005, our investing activities of $138.7 consisted primarily of capital expenditures, acquisitions, proceeds from sale of property, and investments in and returns of investments from unconsolidated partnerships.

Generally, our capital expenditure requirements have consisted, and we expect that our capital requirements will continue to consist, of:

- maintenance capital expenditures, which are capital expenditures made to replace assets to maintain our existing operations and to extend the useful lives of our assets; and

- expansion capital expenditures, which are capital expenditures made to grow our business, to expand and upgrade our existing marine transportation, terminalling, storage and manufacturing facilities, and to construct new plants, storage facilities, terminalling facilities and new marine transportation assets.

For 2007, 2006 and 2005 our capital expenditures for property and equipment were $118.2 million, $90.7 million, and $79.2 million, respectively.

As to each period:

- In 2007, we spent $107.9 million for expansion and $10.3 million for maintenance (including $3.7 million for maintenance in the fourth quarter of 2007). Our expansion capital expenditures were made in connection with the Woodlawn and Mega Lubricants acquisitions, marine vessel purchases and conversions, construction projects associated with our terminalling business, and the sulfuric acid plant construction project at our facility in Plainview, Texas. Our maintenance capital expenditures were primarily made in our marine transportation segment for routine dry dockings of our vessels pursuant to the United States Coast Guard requirements and include $0.3 million spent in connection with the restoration of assets destroyed in hurricanes Rita and Katrina.

- In 2006, we spent $78.3 million for expansion and $12.4 million for maintenance. Our expansion capital expenditures were made in connection with our marine vessel purchases, acquiring assets relating to the South Houston and Prime Asphalt terminal acquisitions, the Corpus Christi barge terminal, the sulfur priller construction project at our Neches facility in Beaumont, Texas, and the sulfuric acid plant construction project at our facility in Plainview, Texas. Our maintenance capital expenditures were primarily made in our marine transportation segment for routine dry dockings of our vessels pursuant to the United States Coast Guard requirements and in our terminal segment for terminal facilities where $4.7 million in maintenance capital expenditures was spent in connection with restoration of assets destroyed in Hurricanes Rita and Katrina.

- In 2005, we spent $74.1 million for expansion and $5.1 million for maintenance. Our expansion capital expenditures were primarily made in connection with the Prism Gas and CF Martin acquisitions, the Bay sulfur priller acquisition in Stockton, California, and the sulfur priller construction project at our Neches facility in Beaumont, Texas. Also, we were constructing a sulfuric acid plant at our facility in Plainview, Texas and we acquired A & A Fertilizer located in Beaumont, Texas. Our maintenance capital expenditures were primarily

made in our marine transportation segment for routine dockings of our vessels pursuant to the United States Coast Guard requirements and in our terminal segment for terminal facilities.

In 2007, our financing activities consisted of cash distributions paid to common and subordinated unitholders of $37.9 million, net proceeds from a follow-on public equity offering of $55.9 million, contributions of $1.2 million from our

general partner to maintain its 2% general partner interest, payments of long-term debt under our current and predecessor credit facilities of $169.0 million and borrowings of long-term debt under our current and predecessor credit facilities of $220.0 million and payments of debt issuance costs of $0.3 million.

In 2006, our financing activities consisted of cash distributions paid to common and subordinated unitholders of $32.1 million, net proceeds from a follow-on public equity offering of $95.3 million, net proceeds from the issuance of common units of $15.0 million, contributions of $2.4 million from our general partner to maintain its 2% general partner interest, payments of long-term debt under our current and predecessor credit facilities of $163.0 million and borrowings of long-term debt under our current and predecessor credit facilities of $135.8 million and payments of debt issuance costs of $0.4 million.

In 2005, our financing activities consisted of cash distributions paid to common and subordinated unitholders of $19.0 million, payments of long-term debt under our current and predecessor credit facilities of $134.1 million and borrowings of long-term debt under our current and predecessor credit facilities of $250.9 million and payments of debt issuance costs of $3.7 million. In November, 2005, we issued 756,480 common units valued at $15.0 million in connection with acquisition of Prism Gas. Our general partner contributed $0.5 million in cash to us in conjunction with the issuance in order to maintain its 2% general partner interest in us.

Capital Resources

Historically, we have generally satisfied our working capital requirements and funded our capital expenditures with cash generated from operations and borrowings. We expect our primary sources of funds for short-term liquidity needs will be cash flows from operations and borrowings under our credit facility.

As of December 31, 2007, we had $225.0 million of outstanding indebtedness, consisting of outstanding borrowings of $95.0 million under our revolving credit facility and $130.0 million under our term loan facility.

In May 2007, we completed a follow-on public offering of 1,380,000 common units, resulting in proceeds of $55.9 million, after payment of underwriters discounts, commissions and offering expenses. Our general partner contributed $1.2 million in cash to us in conjunction with the offering in order to maintain its 2% general partner interest in us. The net proceeds were used to pay down revolving debt under our credit facility and to provide working capital.

In December 2006, we issued 470,484 common units to Martin Product Sales LLC, an affiliate of Martin Resource Management, for approximately $15.3 million, including a capital contribution of approximately $0.3 million made by our general partner in order to maintain its 2% general partner interest in us. These funds were used to reduce the revolving line of credit.

In January 2006, we completed a follow-on public offering of 3,450,000 common units, resulting in proceeds of $95.3 million, after payment of underwriters discounts, commissions and offering expenses. Our general partner contributed $2.1 million in cash to us in conjunction with the offering in order to maintain its 2% general partner interest in us. Of the net proceeds, $62.0 million was used to pay then current balances under our revolving credit facility and $7.5 million was used to fund a portion of the redemption price for our U.S. Government Guaranteed Ship Financing Bonds. The remainder of the net proceeds has been or will be used to fund future organic growth projects.

We believe that cash generated from operations, and our borrowing capacity under our credit facility, will be sufficient to meet our working capital requirements, anticipated capital expenditures and scheduled debt payments in 2007. However, our ability to satisfy our working capital requirements, to fund planned capital expenditures and to satisfy our debt service obligations will depend upon our future operating performance, which is subject to certain risks. Please read Item 1A. Risk Factors Risks Related to Our Business for a discussion of such risks.

Total Contractual Cash Obligations. A summary of our total contractual cash obligations as of December 31, 2007 is as follows (dollars in thousands):

		Payment due by period			
Type of Obligation	Total Obligation	Less than One Year	1-3 Years	3-5 Years	Due Thereafter
Long-Term Debt					
Revolving credit facility	$ 95,000	$	$ 95,000	$	$
Term loan facility	130,000		130,000		
Other	21	21			
Non-competition agreements	750	250	300	100	100
Operating leases	28,190	3,562	9,582	5,294	9,752
Interest expense(1)					
Revolving Credit Facility	12,115	6,481	5,634		
Term loan facility	16,978	9,082	7,896		
Other	1	1			
Total contractual cash obligations	$ 283,055	$ 19,397	$ 248,412	$ 5,394	$ 9,852

(1) Interest commitments are estimated using our current interest rates for the respective credit agreements over their remaining terms.

Letter of Credit At December 31, 2007, we had an outstanding irrevocable letter of credit in the amount of $0.1 million which was issued under our revolving credit facility. This letter of credit was issued to the Texas Commission on Environmental Quality to provide financial assurance for our used oil handling program.

Off Balance Sheet Arrangements. We do not have any off-balance sheet financing arrangements.

Description of Our Credit Facility

On November 10, 2005, we entered into a new $225.0 million multi-bank credit facility comprised of a $130.0 million term loan facility and a $95.0 million revolving credit facility, which includes a $20.0 million letter of credit sub-limit. Our credit facility also includes procedures for additional financial institutions to become revolving lenders, or for any existing revolving lender to increase its revolving commitment, subject to a maximum of $100.0 million for all such increases in revolving commitments of new or existing revolving lenders. Effective June 30, 2006, we increased our revolving credit facility $25.0 million resulting in a committed $120.0 million revolving credit facility. Effective December 28, 2007, we increased our revolving credit facility $75.0 million resulting in a committed $195.0 million revolving credit facility. The revolving credit facility is used for ongoing working capital needs and general partnership purposes, and to finance permitted investments, acquisitions and capital expenditures. Under the amended and restated credit facility, as of December 31, 2007, we had $95.0 million outstanding under the revolving credit facility and $130.0 million outstanding under the term loan facility.

On July 14, 2005, we issued a $0.1 million irrevocable letter of credit to the Texas Commission on Environmental Quality to provide financial assurance for its used oil handling program.

Draws made under our credit facility are normally made to fund acquisitions and for working capital requirements. During the current fiscal year, draws on our credit facilities have ranged from a low of $170.6 million to a high of $239.4 million. As of December 31, 2007, we had $99.9 million available for working capital, internal expansion and acquisition activities under the Partnership s credit facility.

Our obligations under the credit facility are secured by substantially all of our assets, including, without limitation, inventory, accounts receivable, marine vessels, equipment, fixed assets and the interests in our operating subsidiaries and equity method investees. We may prepay all amounts outstanding under this facility at any time without penalty.

Indebtedness under the credit facility bears interest at either LIBOR plus an applicable margin or the base prime rate plus an applicable margin. The applicable margin for revolving loans that are LIBOR loans ranges from 1.50% to 3.00% and the applicable margin for revolving loans that are base prime rate loans ranges from 0.50% to 2.00%. The applicable margin for term loans that are LIBOR loans ranges from 2.00% to 3.00% and the applicable margin for term loans that are base prime rate loans ranges from 1.00% to 2.00%. The applicable margin for existing borrowings is 1.75%. Effective January 1, 2008, the applicable margin for existing borrowings will increase to 2.00%. As a result of our

leverage ratio test as of December 31, 2007, effective April 1, 2008, the applicable margin for existing borrowings will remain at 2.00%. We incur a commitment fee on the unused portions of the credit facility.

Effective September 2007, we entered into an interest rate swap that swaps $25.0 million of floating rate to fixed rate. The fixed rate cost is 4.605% plus our applicable LIBOR borrowing spread. This interest rate swap which matures in September, 2010 is accounted for using hedge accounting.

Effective November 2006, we entered into an interest rate swap that swaps $40.0 million of floating rate to fixed rate. The fixed rate cost is 4.82% plus our applicable LIBOR borrowing spread. This interest rate swap which matures in December, 2009 is accounted for using hedge accounting.

Effective November 2006, we entered into an interest rate swap that swaps $30.0 million of floating rate to fixed rate. The fixed rate cost is 4.765% plus our applicable LIBOR borrowing spread. This interest rate swap, which matures in March, 2010, is not accounted for using hedge accounting.

Effective March 2006, we entered into an interest rate swap that swaps $75.0 million of floating rate to fixed rate. The fixed rate cost is 5.25% plus our applicable LIBOR borrowing spread. This interest rate swap which matures in November, 2010 is accounted for using hedge accounting.

In addition, the credit facility contains various covenants, which, among other things, limit our ability to: (i) incur indebtedness; (ii) grant certain liens; (iii) merge or consolidate unless we are the survivor; (iv) sell all or substantially all of our assets; (v) make certain acquisitions; (vi) make certain investments; (vii) make certain capital expenditures; (viii) make distributions other than from available cash; (ix) create obligations for some lease payments; (x) engage in transactions with affiliates; (xi) engage in other types of business; and (xii) our joint ventures to incur indebtedness or grant certain liens.

The credit facility also contains covenants, which, among other things, require us to maintain specified ratios of: (i) minimum net worth (as defined in the credit facility) of $75.0 million plus 50% of net proceeds from equity issuances after November 10, 2005; (ii) EBITDA (as defined in the credit facility) to interest expense of not less than 3.0 to 1.0 at the end of each fiscal quarter; (iii) total funded debt to EBITDA of not more than (x) 5.5 to 1.0 for the fiscal quarter ended September 30, 2005, (y) 5.25 to 1.00 for the fiscal quarters ending December 31, 2005 through September 30, 2006, and (z) 4.75 to 1.00 for each fiscal quarter thereafter; and (iv) total secured funded debt to EBITDA of not more than (x) 5.50 to 1.00 for the fiscal quarter ended September 30, 2005, (y) 5.25 to 1.00 for the fiscal quarters ending December 31, 2005 through September 20, 2006, and (z) 4.00 to 1.00 for each fiscal quarter thereafter. We were in compliance with the debt covenants contained in the credit facility for the years ended December 31, 2007 and 2006.

On November 10 of each year, commencing with November 10, 2006, we must prepay the term loans under the credit facility with 75% of Excess Cash Flow (as defined in the credit facility), unless its ratio of total funded debt to EBITDA is less than 3.00 to 1.00. No prepayments under the term loan were required to be made in 2007 and 2006. If we receive greater than $15.0 million from the incurrence of indebtedness other than under the credit facility, we must prepay indebtedness under the credit facility with all such proceeds in excess of $15.0 million. Any such prepayments are first applied to the term loans under the credit facility. We must prepay revolving loans under the credit facility with the net cash proceeds from any issuance of its equity. We must also prepay indebtedness under the credit facility with the proceeds of certain asset dispositions. Other than these mandatory prepayments, the credit facility requires interest only payments on a quarterly basis until maturity. All outstanding principal and unpaid interest must be paid by November 10, 2010. The credit facility contains customary events of default, including, without limitation, payment defaults, cross-defaults to other material indebtedness, bankruptcy-related defaults, change of control defaults and litigation-related defaults.

As of March 4, 2008, our outstanding indebtedness includes $268.5 million under our credit facility.

Seasonality

A substantial portion of our revenues are dependent on sales prices of products, particularly NGLs and sulfur-based fertilizer products, which fluctuate in part based on winter and spring weather conditions. The demand for NGLs is strongest during the winter heating season. The demand for fertilizers is strongest during the early spring planting season. However, our terminalling and storage and marine transportation businesses and the molten sulfur business are typically not impacted by seasonal fluctuations. We expect to derive approximately half of our net income from our

terminalling and storage, marine transportation, natural gas and sulfur businesses. Therefore, we do not expect that our overall net income will be impacted by seasonality factors. However, extraordinary weather events, such as hurricanes, have in the

past, and could in the future, impact our terminalling and storage and marine transportation businesses. For example, Hurricanes Katrina and Rita in the third quarter of 2005 adversely impacted our operating expenses and the four hurricanes that impacted the Gulf of Mexico and Florida in the third quarter of 2004 adversely impacted our terminalling and storage and marine transportation business s revenues.

Impact of Inflation

Inflation in the United States has been relatively low in recent years and did not have a material impact on our results of operations in 2007, 2006 and 2005. However, inflation remains a factor in the United States economy and could increase our cost to acquire or replace property, plant and equipment as well as our labor and supply costs. We cannot assure our unitholders that we will be able to pass along increased costs to our customers.

Increasing energy prices could adversely affect our results of operations. Diesel fuel, natural gas, chemicals and other supplies are recorded in operating expenses. An increase in price of these products would increase our operating expenses which could adversely affect net income. We cannot assure our unitholders that we will be able to pass along increased operating expenses to our customers.

Environmental Matters

Our operations are subject to environmental laws and regulations adopted by various governmental authorities in the jurisdictions in which these operations are conducted. We incurred no significant environmental costs, liabilities or expenditures to mitigate or eliminate environmental contamination during 2007, 2006 or 2005.

Item 7A. Quantitative and Qualitative Disclosures about Market Risk

Market risk is the risk of loss arising from adverse changes in market rates and prices. We are exposed to market risks associated with commodity prices, counterparty credit and interest rates. Historically, we have not engaged in commodity contract trading or hedging activities. However, in connection with our acquisition of Prism Gas, we have established a hedging policy. For the year ended December 31, 2007, changes in the fair value of our derivative contracts were recorded both in earnings and comprehensive income since we have designated a portion of our derivative instruments as hedges as of December 31, 2007.

Commodity Price Risk

We are exposed to market risks associated with commodity prices, counterparty credit and interest rates. Historically, we have not engaged in commodity contract trading or hedging activities. Under our hedging policy, we monitor and manage the commodity market risk associated with the commodity risk exposure of Prism Gas. In addition, we are focusing on utilizing counterparties for these transactions whose financial condition is appropriate for the credit risk involved in each specific transaction.

We use derivatives to manage the risk of commodity price fluctuations**.** Our counterparties to the commodity derivative contracts include Shell Energy North America (US), L.P., Morgan Stanley Capital Group Inc. and Wachovia Bank.

On all transactions where we are exposed to counterparty risk, we analyze the counterparty s financial condition prior to entering into an agreement, and have established a maximum credit limit threshold pursuant to our hedging policy and monitor the appropriateness of these limits on an ongoing basis.

As a result of the Prism Gas acquisition, we are exposed to the impact of market fluctuations in the prices of natural gas, NGLs and condensate as a result of gathering, processing and sales activities. Prism Gas gathering and processing revenues are earned under various contractual arrangements with gas producers. Gathering revenues are generated through a combination of fixed-fee and index-related arrangements. Processing revenues are generated primarily through contracts which provide for processing on percent-of-liquids (POL) and percent-of-proceeds (POP) basis. Prism Gas has entered into hedging transactions through 2010 to protect a portion of its commodity exposure from these contracts. These hedging arrangements are in the form of swaps for crude oil, natural gas, ethane, iso butane, normal butane and natural gasoline.

Based on estimated volumes, as of December 31, 2007, Prism Gas had hedged approximately 77%, 24%, and 17% of its commodity risk by volume for 2008, 2009, and 2010, respectively. As of December 31, 2007, commodity

derivative assets of $235 were included in other current assets on the balance sheet. Commodity derivative liabilities of $3,261 were included in current liabilities and $2,140 were included in long-term liabilities on the balance sheet. We anticipate entering into additional commodity derivatives on an ongoing basis to manage risk associated with these market fluctuations, and will consider using various commodity derivatives, including forward contracts, swaps, collars, futures and options, although there is no assurance that we will be able to do so or that the terms thereof will be similar to our existing hedging arrangements. In addition, we will enter into derivative arrangements that include the specific NGL products as well as natural gas and crude oil.

Hedging Arrangements in Place

As of December 31, 2007

Year	Commodity Hedged	Volume	Type of Derivative	Basis Reference
2008	Condensate & Natural Gasoline	5,000 BBL/Month	Crude Oil Swap ($66.20)	NYMEX
2008	Natural Gas	30,000 MMBTU/Month	Natural Gas Swap ($8.12)	Houston Ship Channel
2008	Ethane	5,000 BBL/Month	Ethane Swap ($27.30)	Mt. Belvieu
2008	Natural Gasoline	3,000 BBL/Month	Crude Oil Swap ($70.75)	NYMEX
2008	Iso Butane	1,000 BBL/Month	Iso Butane Swap ($75.90)	Mt. Belvieu (Non-TET)
2008	Normal Butane	2,000 BBL/Month	Normal Butane Swap ($75.06)	Mt. Belvieu (Non-TET)
2008	Natural Gasoline	3,000 BBL/Month	Natural Gasoline Swap ($87.31)	Mt. Belvieu (Non-TET)
2008	Natural Gasoline	3,000 BBL/Month	Natural Gasoline Swap ($85.10)	Mt. Belvieu (Non-TET)
2009	Condensate & Natural Gasoline	3,000 BBL/Month	Crude Oil Swap ($69.08)	NYMEX
2009	Natural Gasoline	3,000 BBL/Month	Crude Oil Swap ($70.90)	NYMEX
2009	Condensate	1,000 BBL/Month	Crude Oil Swap ($70.45)	NYMEX
2010	Condensate	2,000 BBL/Month	Crude Oil Swap ($69.15)	NYMEX
2010	Natural Gasoline	3,000 BBL/Month	Crude Oil Swap ($72.25)	NYMEX

Our principal customers with respect to Prism Gas natural gas gathering and processing services are large, natural gas marketing services, oil and gas producers and industrial end-users. In addition, substantially all of our natural gas and NGL sales are made at market-based prices. Our standard gas and NGL sales contracts contain adequate assurance provisions which allows for the suspension of deliveries, cancellation of agreements or continuance of deliveries to the buyer after the buyer provides security for payment in a form satisfactory to us. For additional information regarding our hedging activities, please see Note 15 Commodity Cash Flow Hedges in our Notes to Consolidated Financial Statements contained herein.

Interest Rate Risk

We are exposed to changes in interest rates as a result of our credit facility, which had a weighted-average interest rate of 6.81% as of December 31, 2007. We had a total of $225.0 million of indebtedness outstanding under our credit facility as of the date hereof of which $55.0 million was unhedged floating rate debt. Based on the amount of unhedged floating rate debt owed by us on December 31, 2007, the impact of a 1% increase in interest rates on this amount of debt would result in an increase in interest expense and a corresponding decrease in net income of approximately $0.6 million annually.

As of March 4, 2008, we had a total of $268.5 million of indebtedness outstanding under our credit facility. The impact of a 1% increase in interest rates on this amount of unhedged floating rate debt would result in an increase in interest expense, and a corresponding decrease in net income of approximately $0.7 million annually.

Item 8. Financial Statements and Supplementary Data

The following financial statements of Martin Midstream Partners L.P. (Partnership):

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Report of Independent Registered Public Accounting Firm

The Board of Directors
Martin Midstream GP LLC:

We have audited the accompanying consolidated balance sheets of Martin Midstream Partners L.P. and subsidiaries as of December 31, 2007 and 2006, and the related consolidated statements of operations, changes in capital, comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 2007. These financial statements are the responsibility of Martin Midstream s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Martin Midstream Partners L.P. and subsidiaries and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2007, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Accounting Oversight Board (United States), Martin Midstream Partners L.P. and subsidiaries internal control over financial reporting as of December 31, 2007, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 5, 2008 expressed an adverse opinion on the effectiveness of Martin Midstream Partners L.P. and subsidiaries internal control over financial reporting.

KPMG LLP
/s/ KPMG LLP
Shreveport, Louisiana
March 5, 2008

Report of Independent Registered Public Accounting Firm

The Board of Directors
Martin Midstream GP LLC:

We have audited Martin Midstream Partners L.P. and subsidiaries internal control over financial reporting as of December 31, 2007, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Martin Midstream s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management s Report on Internal Control Over Financial Reporting in Item 9A(b). Our responsibility is to express an opinion on Martin Midstream s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company s annual or interim financial statements will not be prevented or detected on a timely basis. The following material weakness has been identified and included in management s assessment:

The Company s policies and procedures related to the review and resolution of identified reconciling items on product exchange reconciliations were not effective. This material weakness resulted in errors in the accounting for product exchange transactions which affect inventory and cost of products sold. We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Martin Midstream Partners L.P. and subsidiaries as of December 31, 2007 and 2006, and the related consolidated statements of operations, changes in capital, comprehensive income, and cash flows for each of the years in the three year period ended December 31, 2007. This material weakness was considered in determining the nature, timing, and extent of audit tests applied in our audit of the 2007 consolidated financial statements, and this report does not affect our report dated March 5, 2008, which expressed an unqualified opinion on those consolidated financial statements.

In our opinion, because of the effect of the aforementioned material weakness on the achievement of the objectives of the control criteria, Martin Midstream Partners L.P. and subsidiaries has not maintained effective internal control over financial reporting as of December 31, 2007, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission.

/s/ KPMG LLP
KPMG LLP
Shreveport, Louisiana
March 5, 2008

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MARTIN MIDSTREAM PARTNERS L.P.
CONSOLIDATED BALANCE SHEETS

	December 31, 2007	December 31, 2006
	(Dollars in thousands)	
Assets		
Cash	$ 4,113	$ 3,303
Accounts and other receivables, less allowance for doubtful accounts of $211 and $394	88,039	56,712
Product exchange receivables	10,912	7,076
Inventories	51,798	33,019
Due from affiliates	2,325	1,330
Other current assets	819	2,041
Total current assets	158,006	103,481
Property, plant, and equipment, at cost	441,117	323,967
Accumulated depreciation	(98,080)	(76,122)
Property, plant and equipment, net	343,037	247,845
Goodwill	37,405	27,600
Investment in unconsolidated entities	75,690	70,651
Other assets, net	9,439	7,884
	$ 623,577	$ 457,461
Liabilities and Capital		
Current installments of long-term debt	$ 21	$ 74
Trade and other accounts payable	104,598	53,450
Product exchange payables	24,554	14,737
Due to affiliates	7,543	10,474
Income taxes payable	602	86
Other accrued liabilities	13,930	3,876
Total current liabilities	151,248	82,697
Long-term debt	225,000	174,021
Deferred income taxes	8,815	
Other long-term obligations	2,666	2,218
Total liabilities	387,729	258,936

Partners capital	242,610	198,403
Accumulated other comprehensive income (loss)	(6,762)	122
Total partners capital	235,848	198,525
Commitments and contingencies		
	$ 623,577	$ 457,461

See accompanying notes to consolidated financial statements.

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MARTIN MIDSTREAM PARTNERS L.P.
CONSOLIDATED STATEMENTS OF OPERATIONS

	Year Ended December 31,		
	2007	2006	2005
	(Dollars in thousands, except per unit amounts)		
Revenues:			
Terminalling and storage	$ 29,400	$ 24,182	$ 23,081
Marine transportation	59,579	47,835	35,451
Product sales:			
Natural gas services	515,992	389,735	301,676
Sulfur services	131,326	102,597	68,418
Terminalling and storage	29,525	12,035	9,817
	676,843	504,367	379,911
Total revenues	765,822	576,384	438,443
Costs and expenses:			
Cost of products sold:			
Natural gas services	495,641	374,218	291,109
Sulfur services	97,577	75,165	52,632
Terminalling and storage	25,471	9,787	8,079
	618,689	459,170	351,820
Expenses:			
Operating expenses	83,533	65,387	46,888
Selling, general and administrative	11,985	10,977	8,133
Depreciation and amortization	23,442	17,597	12,642
Total costs and expenses	737,649	553,131	419,483
Other operating income	703	3,356	
Operating income	28,876	26,609	18,960
Other income (expense):			
Equity in earnings of unconsolidated entities	10,941	8,547	1,591
Interest expense	(14,533)	(12,466)	(6,909)
Debt prepayment premium		(1,160)	
Other, net	299	713	238
Total other income (expense)	(3,293)	(4,366)	(5,080)
Net income before taxes	25,583	22,243	13,880

Income taxes	644		
Net income	$ 24,939	$ 22,243	$ 13,880
General partner s interest in net income	$ 1,564	$ 949	$ 278
Limited partners interest in net income	$ 23,375	$ 21,294	$ 13,602
Net income per limited partner unit basic and diluted	$ 1.67	$ 1.69	$ 1.58
Weighted average limited partner units basic	14,018,799	12,602,000	8,583,634
Weighted average limited partner units diluted	14,022,545	12,604,425	8,583,634

See accompanying notes to consolidated financial statements.

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MARTIN MIDSTREAM PARTNERS L.P.
CONSOLIDATED STATEMENTS OF CHANGES IN CAPITAL
For the years ended December 31, 2007, 2006 and 2005

	Partners Capital						
	Limited Partners				General Partner	Accumulated Comprehensive Income	
	Common		Subordinated				
	Units	Amount	Units	Amount	Amount	Amount	Total
			(Dollars in thousands)				
Balances December 31, 2004	4,222,500	$ 79,680	4,253,362	$ (4,772)	$ 626		$ 75,534
Net income		6,756		6,846	278		13,880
Units issued in connection with Prism Gas acquisition	756,480	24,616					24,616
Conversion of subordinated units to common units	850,672	(1,599)	(850,672)	1,599			
General partner contribution					502		502
Cash distributions ($2.19 per unit)		(9,247)		(9,315)	(405)		(18,967)
Balances December 31, 2005	5,829,652	100,206	3,402,690	(5,642)	1,001		95,565
Net income		16,069		5,225	949		22,243
Follow-on public offering	3,450,000	95,272					95,272
Issuance of common units	470,484	15,000					15,000
General partner contribution					2,358		2,358
Conversion of subordinated units to common units	850,672	(2,495)	(850,672)	2,495			

Unit-based compensation	3,000	24					24
Cash distributions ($2.44 per unit)		(22,650)		(8,302)	(1,107)		(32,059)
Commodity hedging gains reclassified to earnings						2	2
Adjustment in fair value of derivatives						120	120
Balances December 31, 2006	10,603,808	$ 201,426	2,552,018	$ (6,224)	$ 3,201	$ 122	$ 198,525
Net Income		19,781		3,594	1,564		24,939
Follow-on public offering	1,380,000	55,933					55,933
General partner contribution					1,192		1,192
Conversion of subordinated units to common units	850,672	(3,243)	(850,672)	3,243			
Unit-based compensation	3,000	46					46
Cash distributions ($2.60 per unit)		(29,423)		(6,635)	(1,845)		(37,903)
Commodity hedging gains reclassified to earnings						478	478
Adjustment in fair value of derivatives						(7,362)	(7,362)
Balances December 31, 2007	12,837,480	$ 244,520	1,701,346	$ (6,022)	$ 4,112	$ (6,762)	$ 235,848

See accompanying notes to consolidated financial statements.

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MARTIN MIDSTREAM PARTNERS L.P.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Dollars in thousands)

	Year Ended December 31,		
	2007	2006	2005
	(Dollars in thousands)		
Net income	$ 24,939	$ 22,243	$ 13,880
Changes in fair values of commodity cash flow hedges	(3,569)	370	
Cash flow hedging gains reclassified to earnings	478	2	
Changes in fair value of interest rate cash flow hedges	(3,793)	(250)	
Comprehensive income	$ 18,055	$ 22,365	$ 13,880

See accompanying notes to consolidated financial statements.

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MARTIN MIDSTREAM PARTNERS L.P.
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended December 31,		
	2007	2006	2005
	(Dollars in thousands)		
Cash flows from operating activities:			
Net income	$ 24,939	$ 22,243	$ 13,880
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	23,442	17,597	12,642
Amortization of deferred debt issue costs	1,233	1,040	600
Deferred income taxes	(149)		
Gain on disposition or sale of property, plant, and equipment	(703)	(231)	(37)
Gain on involuntary conversion of property, plant, and equipment		(3,125)	
Equity in earnings of unconsolidated entities	(10,941)	(8,547)	(1,591)
Distributions from unconsolidated entities	1,523	541	231
Distribution in-kind from unconsolidated entities	9,337	8,311	1,115
Non-cash derivatives (gain) loss	3,904	(389)	(555)
Other	46	24	
Change in current assets and liabilities, excluding effects of acquisitions and dispositions:			
Accounts and other receivables	(27,066)	13,763	(10,565)
Product exchange receivables	(3,836)	(4,935)	(1,974)
Inventories	(18,297)	890	(4,474)
Due from affiliates	(995)	145	417
Other current assets	198	115	36
Trade and other accounts payable	47,535	(13,937)	27,669
Product exchange payables	9,817	5,113	(8,238)
Due to affiliates	(2,931)	6,982	3,063
Income taxes payable	245		
Other accrued liabilities	870	(5,912)	(496)
Change in other non-current assets and liabilities, net	(154)	(386)	254
Net cash provided by operating activities	58,017	39,302	31,977
Cash flows from investing activities:			
Payments for property, plant, and equipment	(82,164)	(66,352)	(24,814)
Acquisitions, net of cash acquired	(41,271)	(24,306)	(114,167)
Proceeds from sale of property, plant, and equipment	1,290	1,825	95
Insurance proceeds from involuntary conversion of property, plant and equipment		4,812	
Return of investments from unconsolidated entities	1,952	433	466
Investments in unconsolidated entities	(6,910)	(11,510)	(322)
Net cash used in investing activities	(127,103)	(95,098)	(138,742)

Cash flows from financing activities:			
Payments of long-term debt	(169,024)	(163,010)	(134,091)
Net proceeds from follow on public offering	55,933	95,272	
General partner contribution	1,192	2,358	502
Proceeds from long-term debt	219,950	135,801	250,900
Payments of debt issuance costs	(252)	(371)	(3,655)
Cash distributions paid	(37,903)	(32,059)	(18,967)
Proceeds from issuance of common units		15,000	15,000
Net cash provided by financing activities	69,896	52,991	109,689
Net increase in cash	810	(2,805)	2,924
Cash at beginning of period	3,303	6,108	3,184
Cash at end of period	$ 4,113	$ 3,303	$ 6,108
Non-cash:			
Financed portion of non-compete agreement	$	$	$ 690
Common units issued for acquisitions	$	$	$ 9,616

See accompanying notes to consolidated financial statements.

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MARTIN MIDSTREAM PARTNERS L.P.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Dollars in Thousands)

(1) ORGANIZATION AND DESCRIPTION OF BUSINESS

Martin Midstream Partners L.P. (the Partnership) is a publicly traded limited partnership with a diverse set of operations focused primarily in the United States Gulf Coast region. Its four primary business lines include: terminalling and storage services for petroleum products and by-products, natural gas services, marine transportation services for petroleum products and by products and sulfur and sulfur based products processing, manufacturing, marketing and distribution.

The petroleum products and by-products the Partnership collects, transports, stores and distributes are produced primarily by major and independent oil and gas companies who often turn to third parties, such as the Partnership, for the transportation and disposition of these products. In addition to these major and independent oil and gas companies, our primary customers include independent refiners, large chemical companies, fertilizer manufacturers and other wholesale purchasers of these products. The Partnership operates primarily in the Gulf Coast region of the United States, which is a major hub for petroleum refining, natural gas gathering and processing and support services for the oil and gas exploration and production industry.

On November 10, 2005, the Partnership acquired Prism Gas Systems I, L.P. (Prism Gas) which is engaged in the gathering, processing and marketing of natural gas and natural gas liquids, predominantly in Texas and northwest Louisiana. Through the acquisition of Prism Gas, the Partnership also acquired 50% ownership interest in Waskom Gas Processing Company (Waskom), the Matagorda Offshore Gathering System (Matagorda), and the Panther Interstate Pipeline Energy LLC (PIPE) each accounted for under the equity method of accounting.

On July 15, 2005 the Partnership acquired all of the outstanding partnership interests of CF Martin Sulphur, L.P. (CF Martin Sulphur) not owned by the Partnership. As a result, CF Martin Sulphur has been consolidated in the Partnership s consolidated financial statements and in the Partnership s sulfur services segment. Prior to the acquisition, the Partnership owned an unconsolidated non-controlling 49.5% limited partnership interest in CF Martin Sulphur. The sulfur services segment includes the marketing, transportation, terminalling and storage, processing and distribution of molten and pelletized sulfur and the manufacturing of sulfur-based fertilizers and products.

(2) SIGNIFICANT ACCOUNTING POLICIES

(a) Principles of Presentation and Consolidation

The consolidated financial statements include the financial statements of the Partnership and its wholly-owned subsidiaries and equity method investees. In the opinion of the management of the Partnership s general partner, all adjustments and elimination of significant intercompany balances necessary for a fair presentation of the Partnership s results of operations, financial position and cash flows for the periods shown have been made. All such adjustments are of a normal recurring nature. In addition, the Partnership evaluates its relationships with other entities to identify whether they are variable interest entities as defined by FASB Interpretation No 46(R) *Consolidation of Variable Interest Entities* (FIN 46R) and to assess whether it is the primary beneficiary of such entities. If the determination is made that the Partnership is the primary beneficiary, then that entity is included in the consolidated financial statements in accordance with FIN 46(R). No such variable interest entities exist as of December 31, 2007 or 2006.

(b) Product Exchanges

The Partnership enters into product exchange agreements with third parties whereby the Partnership agrees to exchange NGLs and sulfur with third parties. The Partnership records the balance of exchange products due to other companies under these agreements at quoted market product prices and the balance of exchange products due from other companies at the lower of cost or market. Cost is determined using the first-in, first-out (FIFO) method.

MARTIN MIDSTREAM PARTNERS L.P.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Dollars in Thousands)

(c) Inventories

Inventories are stated at the lower of cost or market. Cost is determined by using the FIFO method for all inventories.

(d) Revenue Recognition

Terminalling and storage - Revenue is recognized for storage contracts based on the contracted monthly tank fixed fee. For throughput contracts, revenue is recognized based on the volume moved through the Company s terminals at the contracted rate. When lubricants and drilling fluids are sold by truck, revenue is recognized upon delivering product to the customers as title to the product transfers when the customer physically receives the product.

Natural gas services - Natural gas gathering and processing revenues are recognized when title passes or service is performed. NGL distribution revenue is recognized when product is delivered by truck to our NGL customers, which occurs when the customer physically receives the product. When product is sold in storage, or by pipeline, the Company recognizes NGL distribution revenue when the customer receives the product from either the storage facility or pipeline.

Marine transportation - Revenue is recognized for contracted trips upon completion of the particular trip. For time charters, revenue is recognized based on a per day rate.

Sulfur services - Revenues are recognized when the products are delivered, which occurs when the customer has taken title and has assumed the risks and rewards of ownership based on specific contract terms at either the shipping or delivery point.

(e) Equity Method Investments

The Partnership uses the equity method of accounting for investments in unconsolidated entities where the ability to exercise significant influence over such entities exists. Investments in unconsolidated entities consist of capital contributions and advances plus the Partnership s share of accumulated earnings as of the entities latest fiscal year-ends, less capital withdrawals and distributions. Investments in excess of the underlying net assets of equity method investees, specifically identifiable to property, plant and equipment, are amortized over the useful life of the related assets. Excess investment representing equity method goodwill is not amortized but is evaluated for impairment, annually. Under the provisions of Statement of Financial Accounting Standards (SFAS) No. 142, *Goodwill and Other Intangible Assets*, this goodwill is not subject to amortization and is accounted for as a component of the investment. Equity method investments are subject to impairment under the provisions of Accounting Principles Board (APB) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*. No portion of the net income from these entities is included in the Partnership s operating income.

Prior to July 15, 2005, the Partnership used the equity method of accounting for its unconsolidated non-controlling 49.5% limited partner interest in CF Martin Sulphur. On July 15, 2005, the Partnership acquired the remaining interests in CF Martin Sulphur not previously owned by it. Subsequent to the acquisition, CF Martin Sulphur is included in the consolidated financial presentation of the Partnership s sulfur services segment.

Following the Partnership s acquisition of Prism Gas in November 2005, the Partnership owns an unconsolidated 50% interest in Waskom, Matagorda, and PIPE. As a result, these assets are accounted for by the equity method.

On June 30, 2006, the Partnership, through the Partnership s Prism Gas subsidiary, acquired a 20% ownership interest in a partnership which owns the lease rights to the assets of the Bosque County Pipeline (BCP). This interest is accounted for by the equity method of accounting.

(f) Property, Plant, and Equipment

Owned property, plant, and equipment is stated at cost, less accumulated depreciation. Owned buildings and equipment are depreciated using straight-line method over the estimated lives of the respective assets.

MARTIN MIDSTREAM PARTNERS L.P.
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Routine maintenance and repairs are charged to operating expense while costs of betterments and renewals are capitalized. When an asset is retired or sold, its cost and related accumulated depreciation are removed from the accounts and the difference between net book value of the asset and proceeds from disposition is recognized as gain or loss.

(g) Goodwill and Other Intangible Assets

Goodwill represents the excess of costs over fair value of assets of businesses acquired. Goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but instead tested for impairment at least annually in accordance with the provisions of SFAS No. 142, *Goodwill and Other Intangible Assets*. Intangible assets with estimated useful lives are amortized over their respective estimated useful lives to their estimated residual values, and reviewed for impairment in accordance with FASB Statement No. 144 (SFAS No. 144), *Accounting for Impairment or Disposal of Long-Lived Assets*. Other intangible assets primarily consist of covenants not-to-compete and contracts obtained through business combinations and are being amortized over the life of the respective agreements.

(h) Debt Issuance Costs

In connection with the Partnership s multi-bank credit facility, on November 10, 2005, it incurred debt issuance costs of $3,258. In connection with the amendment and expansion of the Partnership s multi-bank credit facility on June 30, 2006, it incurred debt issuance costs of $372. In connection with the amendment and expansion of the Partnership s multi-bank credit facility on December 28, 2007, it incurred debt issuance costs of $252. These debt issuance costs, along with the remaining unamortized deferred issuance costs relating to the line of credit facility as of November 10, 2005 which remain deferred, are amortized over the remainder of the 60 month term of the original debt arrangement.

Amortization of debt issuance cost, which are included in interest expense for the years ended December 31, 2007, 2006 and 2005, totaled $1,233, $1,040, and $600, respectively, and accumulated amortization amounted to $4,324 and $3,091 at December 31, 2007 and 2006, respectively. The unamortized balance of debt issuance costs, classified as other assets amounted to $3,188 and $4,169 at December 31, 2007 and 2006, respectively.

(i) Impairment of Long-Lived Assets

In accordance with SFAS No. 144, long-lived assets, such as property, plant and equipment, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset. Assets to be disposed of would be separately presented in the balance sheet and reported at the lower of the carrying amount or fair value less costs to sell, and are no longer depreciated. The assets and liabilities of a disposed group classified as held for sale would be presented separately in the appropriate asset and liability sections of the balance sheet. Goodwill is tested annually for impairment, and is tested for impairment more frequently if events and circumstances indicate that the asset might be impaired. An impairment loss is recognized to the extent that the carrying amount exceeds the asset s fair value. This determination is made at the reporting unit level and consists of two steps. First, the Partnership determines the fair value of a reporting unit and compares it to its carrying amount. Second, if the carrying amount of a reporting unit exceeds its fair value, an impairment loss is recognized for any excess of the carrying amount of the reporting unit s goodwill over the implied fair value of that goodwill. The implied fair value of goodwill is determined by allocating the fair value of the reporting unit in a manner similar to a purchase price allocation, in accordance with FASB Statement No. 141, *Business Combinations*. The residual fair value after this allocation is the implied fair value of the reporting unit goodwill.

The Partnership performed its annual tests in the third quarters of 2005, 2006 and 2007, with no indication of impairment.

(j) Asset Retirement Obligation

Under SFAS No. 143, Accounting for Asset Retirement Obligations (Statement No. 143) which provides accounting requirements for costs associated with legal obligations to retire tangible, long-lived assets, the Partnership records an Asset Retirement Obligation (ARO) at fair value in the period in which it is incurred by increasing the

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(Dollars in Thousands)

carrying amount of the related long-lived asset. In each subsequent period, the liability is accreted over time towards the ultimate obligation amount and the capitalized costs are depreciated over the useful life of the related asset.

Financial Accounting Standards Board Interpretation No. 47, Accounting for Conditional Asset Retirement Obligations (FIN 47), an interpretation of SFAS 143, clarifies that the recognition and measurement provisions of SFAS 143 apply to asset retirement obligations in which the timing or method of settlement may be conditional on a future event that may or may not be within the control of the entity. The Partnership s fixed assets include land, buildings, transportation equipment, storage equipment, marine vessels and operating equipment.

The transportation equipment includes pipelines system. The Partnership transports NGLs through the pipeline system and gathering system. The Partnership also gathers natural gas from wells owned by producers and delivers natural gas and NGLs on the Partnership s pipeline systems, primarily in Texas and Louisiana to the fractionation facility of the Partnership s 50% owned joint venture. The Partnership is obligated by contractual or regulatory requirements to remove certain facilities or perform other remediation upon retirement of the Partnership s assets. However, the Partnership is not able to reasonably determine the fair value of the asset retirement obligations for the Partnership s trunk and gathering pipelines and the Partnership s surface facilities, since future dismantlement and removal dates are indeterminate. In order to determine a removal date of the Partnership s gathering lines and related surface assets, reserve information regarding the production life of the specific field is required. As a transporter and gatherer of natural gas, the Partnership is not a producer of the field reserves, and the Partnership therefore does not have access to adequate forecasts that predict the timing of expected production for existing reserves on those fields in which the Partnership gathers natural gas. In the absence of such information, the Partnership is not able to make a reasonable estimate of when future dismantlement and removal dates of the Partnership s gathering assets will occur. With regard to the Partnership s trunk pipelines and their related surface assets, it is impossible to predict when demand for transportation of the related products will cease. The Partnership s right-of-way agreements allow us to maintain the right-of-way rather than remove the pipe. In addition, the Partnership can evaluate the Partnership s trunk pipelines for alternative uses, which can be and have been found. The Partnership will record such asset retirement obligations in the period in which more information becomes available for us to reasonably estimate the settlement dates of the retirement obligations.

(k) Derivative Instruments and Hedging Activities

In accordance with Statement of Financial Accounting Standards No. 133 (SFAS No. 133), *Accounting for Derivative Instruments and Hedging Activities*, all derivatives and hedging instruments are included on the balance sheet as an asset or liability measured at fair value and changes in fair value are recognized currently in earnings unless specific hedge accounting criteria are met. If a derivative qualifies for hedge accounting, changes in the fair value can be offset against the change in the fair value of the hedged item through earnings or recognized in other comprehensive income until such time as the hedged item is recognized in earnings. In early 2006, the Partnership adopted a hedging policy that allows it to use hedge accounting for financial transactions that are designated as hedges.

Derivative instruments not designated as hedges are being marked to market with all market value adjustments being recorded in the consolidated statements of operations. As of December 31, 2007, the Partnership has designated a portion of its derivative instruments as qualifying cash flow hedges. Fair value changes for these hedges have been recorded in other comprehensive income as a component of equity.

(l) Comprehensive Income

Comprehensive income includes net income and other comprehensive income. Other comprehensive income for the partnership includes unrealized gains and losses on derivative financial instruments. In accordance with SFAS No. 133, the partnership records deferred hedge gains and losses on its derivative financial instruments that qualify as cash flow hedges as other comprehensive income.

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(Dollars in Thousands)

(m) Unit Grants

In May 2007, the Partnership issued 1,000 restricted common units to each of its three independent, non-employee directors under its long-term incentive plan. These units vest in 25% increments beginning in January 2008 and will be fully vested in January 2011.

In January 2006, the Partnership issued 1,000 restricted common units to each of its three independent, non-employee directors under its long-term incentive plan. These units vest in 25% increments on the anniversary of the grant date each year and will be fully vested in January 2010.

The Partnership accounts for the transaction under *Emerging Issues Task Force 96-18 Accounting for Equity Instruments That are Issued to other than Employees For Acquiring, or in Conjunction with Selling, Goods or Services.* The cost resulting from the share-based payment transactions was $46 and $24 for the years ended December 31, 2007 and 2006, respectively. The Partnership s general partner contributed cash of $2 in May 2007 and $2 in January 2006 to the Partnership in conjunction with the issuance of these restricted units in order to maintain its 2% general partner interest in the Partnership.

(n) Incentive Distribution Rights

The Partnership s general partner, Martin Midstream GP LLC, holds a 2% general partner interest and certain incentive distribution rights in the Partnership. Incentive distribution rights represent the right to receive an increasing percentage of cash distributions after the minimum quarterly distribution, any cumulative arrearages on common units, and certain target distribution levels have been achieved. The Partnership is required to distribute all of its available cash from operating surplus, as defined in the partnership agreement. The target distribution levels entitle the general partner to receive 15% of quarterly cash distributions in excess of $0.55 per unit until all unit holders have received $0.625 per unit, 25% of quarterly cash distributions in excess of $0.625 per unit until all unit holders have received $0.75 per unit, and 50% of quarterly cash distributions in excess of $0.75 per unit. For the years ended December 31, 2007, 2006 and 2005, the general partner received $1,087, $484 and $0 in incentive distributions.

(o) Net Income per Unit

Except as discussed in the following paragraph, basic and diluted net income per limited partner unit is determined by dividing net income after deducting the amount allocated to the general partner interest (including its incentive distribution in excess of its 2% interest) by the weighted average number of outstanding limited partner units during the period. Subject to applicability of *Emerging Issues Task Force Issue No. 03-06 (EITF 03-06), Participating Securities and the Two-Class Method under FASB Statement No. 128,* as discussed below, Partnership income is first allocated to the general partner based on the amount of incentive distributions. The remainder is then allocated between the limited partners and general partner based on percentage ownership in the Partnership.

EITF 03-06 addresses the computation of earnings per share by entities that have issued securities other than common stock that contractually entitle the holder to participate in dividends and earnings of the entity when, and if, it declares dividends on its common stock. Essentially, EITF 03-06 provides that in any accounting period where the Partnership s aggregate net income exceeds the Partnership s aggregate distribution for such period, the Partnership is required to present earnings per unit as if all of the earnings for the periods were distributed, regardless of the pro forma nature of this allocation and whether those earnings would actually be distributed during a particular period from an economic or practical perspective. EITF 03-06 does not impact the Partnership s overall net income or other financial results; however, for periods in which aggregate net income exceeds the Partnership s aggregate distributions for such period, it will have the impact of reducing the earnings per limited partner unit. This result occurs as a larger portion of the Partnership s aggregate earnings is allocated to the incentive distribution rights held by the Partnership s general partner, as if distributed, even though the Partnership makes cash distributions on the basis of cash available for distributions, not earnings, in any given accounting period. In accounting periods where aggregate net income does not exceed the Partnership s aggregate distributions for such period, EITF 03-06 does not have any impact on the Partnership s earnings per unit calculation.

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The weighted average units outstanding for basic net income per unit were 14,018,799, 12,602,000 and 8,583,634 for years ended December 31, 2007, 2006 and 2005, respectively. For diluted net income per unit, the weighted average units outstanding were increased by 3,746 units and 2,425 units for the years ended December 31, 2007 and 2006, respectively, due to the dilutive effect of restricted units granted under the Partnership s long-term incentive plan.

(p) Indirect Selling, General and Administrative Expenses

Indirect selling, general and administrative expenses are incurred by Martin Resource Management Corporation (Martin Resource Management) and allocated to the Partnership to cover costs of centralized corporate functions such as accounting, treasury, engineering, information technology, risk management and other corporate services. Such expenses are based on the percentage of time spent by Martin Resource Management s personnel that provide such centralized services. Under the omnibus agreement, the reimbursement amount with respect to indirect general and administrative and corporate overhead expenses was capped at $2.0 million. This cap expired on November 1, 2007. Effective January 1, 2008, the Conflicts Committee of our general partner approved a reimbursement amount of $2.7 million for the year ending December 31, 2008, which is not expected to cover all of the indirect general and administrative and corporate overhead expenses attributable to the services provided to the Partnership.

(q) Environmental Liabilities

The Partnership s policy is to accrue for losses associated with environmental remediation obligations when such losses are probable and reasonably estimable. Accruals for estimated losses from environmental remediation obligations generally are recognized no later than completion of the remedial feasibility study. Such accruals are adjusted as further information develops or circumstances change. Costs of future expenditures for environmental remediation obligations are not discounted to their present value. Recoveries of environmental remediation costs from other parties are recorded as assets when their receipt is deemed probable.

(r) Allowance for Doubtful Accounts.

Trade accounts receivable are recorded at the invoiced amount and do not bear interest. The allowance for doubtful accounts is the Partnership s best estimate of the amount of probable credit losses in the Partnership s existing accounts receivable.

(s) Use of Estimates

Management has made a number of estimates and assumptions relating to the reporting of assets and liabilities and the disclosure of contingent assets and liabilities to prepare these consolidated financial statements in conformity with accounting principles generally accepted in the United States of America. Actual results could differ from those estimates.

(t) Income Taxes

With respect to our taxable subsidiary (Woodlawn Pipeline Co., Inc.), income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

(3) RECENT ACCOUNTING PRONOUNCEMENTS

In December 2007, the FASB issued SFAS No. 141 (revised 2007) ("SFAS 141R), "Business Combinations and SFAS No. 160 ("SFAS 160), "Noncontrolling Interests in Consolidated Financial Statements, an amendment of Accounting Research Bulletin No. 51 . SFAS 141R will change how business acquisitions are accounted for and will impact financial statements both on the acquisition date and in

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subsequent periods. SFAS 160 will change the accounting and reporting for minority interests, which will be recharacterized as noncontrolling interests and classified as a component of equity. SFAS 141R and SFAS 160 are effective for us beginning in the first quarter of 2010. Early adoption is not permitted. We are currently evaluating the impact that SFAS 141R and SFAS 160 will have on the Partnership s consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159 ("SFAS 159), "The Fair Value Option for Financial Assets and Financial Liabilities . Under SFAS 159, companies may elect to measure certain financial instruments and certain other items at fair value. The standard requires that unrealized gains and losses on items for which the fair value option has been elected be reported in earnings. SFAS 159 is effective for the Partnership beginning in the first quarter of fiscal 2008.

In September 2006, the FASB issued SFAS No. 157 ("SFAS 157), "Fair Value Measurements, which defines fair value, establishes guidelines for measuring fair value and expands disclosures regarding fair value measurements. SFAS 157 does not require any new fair value measurements but rather eliminates inconsistencies in guidance found in various prior accounting pronouncements. SFAS 157 is effective for fiscal years beginning after November 15, 2007. However, on December 14, 2007, the FASB issued proposed FSP FAS 157-b which would delay the effective date of SFAS 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). This proposed FSP partially defers the effective date of Statement 157 to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years for items within the scope of this FSP. Effective for fiscal 2008, we will adopt SFAS 157 except as it applies to those nonfinancial assets and nonfinancial liabilities as noted in proposed FSP FAS 157-b. The partial adoption of SFAS 157 will not have a material impact on our consolidated financial position, results of operations or cash flows.

(4) ACQUISITIONS

(a) Asphalt Terminal.

In October 2007, the Partnership acquired the asphalt assets of Monarch Oil, Inc. and related companies (Monarch Oil) for $3,927 which was allocated to property, plant and equipment. The results of Monarch Oil s operations have been included in the consolidated financial statements beginning October 2, 2007. The assets are located in Omaha, Nebraska. The Partnership entered into an agreement with Martin Resource Management, whereby Martin Resource Management will operate the facilities through a terminalling service agreement based upon throughput rates and will bear all additional expenses to operate the facility.

(b) Lubricants Terminal

In June 2007, the Partnership acquired all of the operating assets of Mega Lubricants Inc. (Mega Lubricants) located in Channelview, Texas. The results of Mega Lubricant s operations have been included in the consolidated financial statements beginning June 13, 2007. The excess of the fair value over the carrying value of the assets was allocated to all identifiable assets. After recording all identifiable assets at their fair values, the remaining $1,020 was recorded as goodwill. The goodwill was a result of Mega Lubricant s strategically located assets combined with the Partnership s access to capital and existing infrastructure. This will enhance the Partnership s ability to offer additional lubricant blending and truck loading and unloading services to customers. In accordance with FAS 142, the goodwill will not be amortized but tested for impairment. The terminal is located on 5.6 acres of land, and consists of 38 tanks with a storage capacity of approximately 15,000 Bbls, pump and piping infrastructure for lubricant blending and truck loading and unloading operations, 34,000 square feet of warehouse space and an administrative office.

The purchase price of $4,738, including two three-year non-competition agreements totaling $530 and goodwill of $1,020, was allocated as follows:

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Current assets	$ 446
Property, plant and equipment, net	3,042
Goodwill	1,020
Other assets	530
Other liabilities	(300)
Total	$ 4,738

In connection with the acquisition, the Partnership borrowed approximately $4,600 under its credit facility.

(c) Woodlawn Pipeline Co., Inc.

On May 2, 2007, the Partnership, through its subsidiary Prism Gas, acquired 100% of the outstanding stock of Woodlawn. The results of Woodlawn s operations have been included in the consolidated financial statements beginning May 2, 2007. The excess of the fair value over the carrying value of the assets was allocated to all identifiable assets. After recording all identifiable assets at their fair values, the remaining $8,785 was recorded as goodwill. The goodwill was a result of Woodlawn s strategically located assets combined with the Partnership s access to capital and existing infrastructure. This will enhance the Partnership s ability to offer additional gathering services to customers through internal growth projects including natural gas processing, fractionation and pipeline expansions as well as new pipeline construction. In accordance with FAS 142, the goodwill will not be amortized but tested for impairment.

Woodlawn is a natural gas gathering and processing company which owns integrated gathering and processing assets in East Texas. Woodlawn s system consists of approximately 135 miles of natural gas gathering pipe, approximately 36 miles of condensate transport pipe and a 30 Mcf/day processing plant. Prism Gas also acquired a nine-mile pipeline, from a Woodlawn related party, that delivers residue gas from Woodlawn to the Texas Eastern Transmission pipeline system.

The selling parties in this transaction were Lantern Resources, L.P., David P. Deison, and Peak Gas Gathering L.P. The final purchase price, after final adjustments for working capital, was $32,606 and was funded by borrowings under the Partnership s credit facility.

The purchase price of $32,606, including four two-year non-competition agreements and other intangibles reflected as other assets, was allocated as follows:

Current assets	$ 4,297
Property, plant and equipment, net	29,101
Goodwill	8,785
Other assets	3,339
Current liabilities	(3,889)
Deferred income taxes	(8,964)
Other long-term obligations	(63)
Total	$ 32,606

The identifiable intangible assets of $3,339 are subject to amortization over a weighted-average useful life of approximately ten years. The intangible assets include four non-competition agreements totaling $40, customer contracts associated with the gathering and processing assets of $3,002, and a transportation contract associated with the residue gas pipeline of $297.

In connection with the acquisition, the Partnership borrowed approximately $33,000 under its credit facility.

***(d) Asphalt Terminals*.** In August 2006 and October 2006, respectively, the Partnership acquired the assets of Gulf States Asphalt Company LP and Prime Materials and Supply Corporation (Prime), for $4,679 which was allocated to property, plant and equipment. The assets are located in Houston, Texas and Port Neches,

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Texas. The Partnership entered into an agreement with Martin Resource Management, which Martin Resource Management will operate the facilities through a terminalling service agreement based upon throughput rates and will assume all additional expenses to operate the facility.

(e) Corpus Christi Barge Terminal. In July 2006, the Partnership acquired a marine terminal located near Corpus Christi, Texas and associated assets from Koch Pipeline Company, LP for $6,200 which was all allocated to property, plant and equipment. The terminal is located on approximately 25 acres of land, and includes three tanks with a combined shell capacity of approximately 240,000 barrels, pump and piping infrastructure for truck unloading and product delivery to two oil docks, and there are several pumps, controls, and an office building on site for administrative use.

(f) Marine Vessels. In November 2006, the Partnership acquired the *La Force*, an offshore tug, for $6,001 from a third party. This vessel is a 5,100 horse power offshore tug that was rebuilt in 1999 with new engines installed in 2005.

In January 2006, the Partnership acquired the *Texan*, an offshore tug, and the *Ponciana*, an offshore NGL barge, for $5,850 from Martin Resource Management. The acquisition price was based on a third-party appraisal. In March 2006, these vessels went into service under a long term charter with a third party. In February 2006, the Partnership acquired the *M450*, an offshore barge, for $1,551 from a third party. In March 2006, this vessel went into service under a one-year charter with an affiliate of Martin Resource Management.

(g) A & A Fertilizer, Ltd. In December 2005, the Partnership completed the purchase of the net operating assets of A & A Fertilizer for $5,667. A & A Fertilizer is a manufacturer and distributor of liquid sulfur based fertilizer products to the continental United States. The A & A Fertilizer manufacturing facility is located at the Partnership s Port Neches deep-water marine terminal near Beaumont, Texas. This acquisition is reported in the Partnership s sulfur services segment.

The purchase price of $5,667, including non-competition agreements in other assets of $691, was allocated as follows:

Current assets	$ 955
Property, plant and equipment, net	5,448
Other assets	691
Current liabilities	(891)
Other liabilities	(536)
Total	$ 5,667

(h) Prism Gas Acquisition. In November 2005 the Partnership acquired Prism Gas. As of November 2005, Prism Gas had ownership interests in over 330 miles of gathering and transmission pipelines located in the natural gas producing regions of East Texas, Northwest Louisiana, the Texas Gulf Coast and offshore Texas and federal waters in the Gulf of Mexico as well as a 150 MMcfd capacity natural gas processing plant located in East Texas. The fair market value of the assets acquired was appraised at $93,938. The excess of the fair value over the carrying value of the assets was allocated to all identifiable assets. After recording all identifiable assets at their fair values, the remaining $20,145 was recorded as goodwill. The goodwill was a result of Prism Gas strategically located assets combined with the Partnership s access to capital and existing infrastructure. This will enhance the Partnership s ability to offer additional gathering and processing services to customers through internal growth projects including natural gas processing, fractionation and pipeline expansions as well as new pipeline construction. In accordance with FAS 142, the goodwill will not be amortized but tested for impairment.

The selling parties in this transaction were Natural Gas Partners V, L.P. and certain members of the Prism Gas management team. The final purchase price was $93,938. The purchase price was funded by $63,052 in borrowings

under the Partnership s credit facility, $5,000 in a previously funded escrow account, $15,502 in new equity capital

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provided by Martin Resource Management, $9,616 in seller financing, and $768 in capital provided by Martin Resource Management for acquisition costs and to maintain its 2% general partner interest in the Partnership.

The purchase price of $93,938, including two-year non-competition agreements included in other assets of $600, was allocated as follows:

Current assets	$ 4,449
Other current assets	10,772
Property, plant and equipment, net	17,810
Investment in unconsolidated entities	60,000
Other assets	942
Goodwill	20,145
Current liabilities	(19,901)
Other liabilities	(279)
Total	$ 93,938

The following table presents unaudited pro forma financial information incorporating the historical (pre-acquisition) financial results of Prism Gas. This information has been prepared as if the acquisition of Prism Gas had been completed on January 1 of the respective periods presented as opposed to the actual date that the acquisition occurred. The pro forma information is based upon data currently available and certain estimates and assumptions made by management. As a result, this information is not necessarily indicative of the financial results had the transactions actually occurred on these dates. Likewise, the unaudited pro forma information is not necessarily indicative of future financial results.

	2005
Total revenues	$512,970
Cost of products sold	422,624
Operating expenses	48,218
Selling, general and administrative	13,953
Depreciation and amortization	13,843
Operating income	14,332
Net income before taxes	13,615
Net income	13,615
Net income per limited partner unit	$ 1.22

The operations related to the Prism Gas acquisition have been included in the Partnership s results of operations only since the date of acquisition.

In connection with the purchase of Prism Gas, a portion of the purchase price was funded by the issuance of 460,971 common units of the Partnership to Martin Resource Management, the owner of the Partnership s general partner, which provided $15,000 of new equity capital. Martin Midstream GP LLC contributed $502 to maintain its 2% general partner interest in the partnership. In addition, 295,509 common units of the Partnership, representing approximately $9,616 of the purchase price, was issued to the sellers.

(i) CF Martin Sulphur. In July 2005, the Partnership acquired all of the outstanding partnership interests in CF Martin Sulphur not owned by the Partnership from CF Industries, Inc. and certain subsidiaries of Martin Resource Management for $18,871. In connection with the acquisition the Partnership also assumed the indebtedness described below. Prior to this transaction, the Partnership owned an unconsolidated non-controlling 49.5% limited partnership interest in CF Martin Sulphur, which was accounted for using the equity method of accounting. Subsequent to the

acquisition, CF Martin Sulphur is a wholly-owned subsidiary included in the Partnership s consolidated financial statements and in the Partnership s sulfur segment.

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In connection with the acquisition, the Partnership assumed $11,500 of indebtedness owed by CF Martin Sulphur and promptly repaid $2,400 of such indebtedness. The Partnership also pledged its equity interests in CF Martin Sulphur to the Partnership s lenders under its credit facility. As part of this transaction, CF Industries, Inc. entered into a five-year sulfur supply contract with the Partnership that is based on Tampa market pricing.

The purchase price paid to CF Industries, Inc. and certain subsidiaries of Martin Resource Management was allocated as follows:

Current assets	$ 11,283
Property, plant and equipment, net	26,735
Other assets	921
Current liabilities	(8,573)
Debt	(11,495)
Total use of proceeds	$ 18,871

(j) Bay Sulfur Asset Acquisition. In April 2005, the Partnership completed the acquisition of the operating assets and sulfur inventories of Bay Sulfur Company located at the Port of Stockton, California for $5,900 which includes $4,000 allocated to goodwill. Goodwill was recognized as a result of the total price paid for the business, and is supported by its historical cash flows. The remaining $1,900 was allocated to property, plant and equipment ($1,400), a covenant not to compete ($100) and inventory and other current assets ($400). The assets acquired are used to process molten sulfur into pellets. This acquisition is reported in the Partnership s new sulfur segment. The acquisition was financed through the Partnership s credit facility (see Note 11).

(k) Natural Gas Liquids Pipeline Purchase. In January 2005, the Partnership acquired a natural gas liquids (NGL) pipeline located in East Texas from an unrelated third party for $3,800. The purchase price included the value of the natural gas liquids in the pipeline which is considered pipeline fill. The pipeline, which is used by the Partnership to transport NGL for third parties as well as its own account, spans approximately 200 miles, running from Kilgore to Beaumont in Texas. The acquisition was financed through the Partnership s credit facility (see Note 11).

(5) PUBLIC OFFERINGS

In May 2007, the Partnership completed a public offering of 1,380,000 common units at a price of $42.25 per common unit, before the payment of underwriters discounts, commissions and offering expenses (per unit value is in dollars, not thousands). Following this offering, the common units represented a 64.3% limited partnership interest in the Partnership. Total proceeds from the sale of the 1,380,000 common units, net of underwriters discounts, commissions and offering expenses were $55,933. The Partnership s general partner contributed $1,190 in cash to the Partnership in conjunction with the issuance in order to maintain its 2% general partner interest in the Partnership. The net proceeds were used to pay down revolving debt under the Partnership s credit facility and to provide working capital.

A summary of the proceeds received from these transactions and the use of the proceeds received therefrom is as follows (all amounts are in thousands):

Proceeds received:	
Sale of common units	$ 58,305
General partner contribution	1,190
Total proceeds received	$ 59,495

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Use of Proceeds:	
Underwriter s fees	$ 2,107
Professional fees and other costs	265
Repayment of debt under revolving credit facility	55,850
Working capital	1,273
Total use of proceeds	$ 59,495

In January 2006, the Partnership completed a public offering of 3,450,000 common units at a price of $29.12 per common unit, before the payment of underwriters discounts, commissions and offering expenses (per unit value is in dollars, not thousands). Following this offering, the common units represented a 61.6% limited partnership interest in the Partnership. Total proceeds from the sale of the 3,450,000 common units, net of underwriters discounts, commissions and offering expenses were $95,272. The Partnership s general partner contributed $2,050 in cash to the Partnership in conjunction with the issuance in order to maintain its 2% general partner interest in the Partnership. The net proceeds were used to pay down revolving debt under the Partnership s credit facility and to provide working capital.

A summary of the proceeds received from these transactions and the use of the proceeds received therefrom is as follows (all amounts are in thousands):

Proceeds received:	
Sale of common units	$ 100,464
General partner contribution	2,050
Total proceeds received	$ 102,514

Use of Proceeds:	
Underwriter s fees	$ 4,521
Professional fees and other costs	671
Repayment of debt under revolving credit facility	62,000
Working capital	35,322
Total use of proceeds	$ 102,514

(6) INVENTORIES

Components of inventories at December 31, 2007 and 2006 were as follows:

	2007	2006
Natural gas liquids	$ 31,283	$ 17,061
Sulfur	7,490	4,425
Sulfur-based fertilizer products	6,626	7,191
Lubricants	5,345	2,592
Other	1,054	1,750
	$ 51,798	$ 33,019

(7) PROPERTY, PLANT AND EQUIPMENT

At December 31, 2007 and 2006, property, plant, and equipment consisted of the following:

	Depreciable Lives	2007	2006
Land		$ 14,515	$ 12,559
Improvements to land and buildings	10-39 years	34,585	26,868
Transportation equipment	3- 7 years	616	531
Storage equipment	5-20 years	38,652	22,343

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	Depreciable Lives	2007	2006
Marine vessels	4-30 years	147,627	124,323
Operating equipment	3-30 years	172,282	103,929
Furniture, fixtures and other equipment	3-20 years	1,542	1,450
Construction in progress		31,298	31,964
		$ 441,117	$ 323,967

Depreciation expense for the year ended December 31, 2007, 2006 and 2005 was $22,455, $16,932, and $12,062, respectively.

(8) GOODWILL AND OTHER INTANGIBLE ASSETS

The following information relates to goodwill balances as of the periods presented:

	December 31, 2007	December 31, 2006
Carrying amount of goodwill:		
Terminalling and storage	$ 1,020	$
Natural gas services	29,010	20,225
Marine transportation	2,026	2,026
Sulfur services	5,349	5,349
	$ 37,405	$ 27,600

The following information relates to covenants not-to-compete as of the periods presented:

	December 31, 2007	December 31, 2006
Covenants not-to-compete:		
Terminalling and storage	$ 1,928	$ 1,561
Natural gas services	640	600
Sulfur services	790	790
	3,358	2,951
Less accumulated amortization	1,610	877
	$ 1,748	$ 2,074

Intangible assets consists of the covenants not-to-compete listed above, customer contracts associated with gathering and processing assets and a transportation contract associated with the residue gas pipeline. The covenants not-to-compete and contracts are presented in the consolidated balance sheets as other assets, net. Aggregate amortization expense for amortizing intangible assets was $987, $665 and $580 for the years ended December 31, 2007, 2006, and 2005, respectively. Estimated amortization expenses for the years subsequent to December 31, 2007

are as follows: 2008 - $895; 2009 - $877; 2010 - $585; 2011 - $501; 2012 - $496; subsequent years -$1,885.

(9) LEASES

The Partnership has numerous non-cancelable operating leases primarily for transportation and other equipment. The leases generally provide that all expenses related to the equipment are to be paid by the lessee. Management expects to renew or enter into similar leasing arrangements for similar equipment upon the expiration of the current lease agreements. The Partnership also has cancelable operating lease land rentals and outside marine vessel charters.

The future minimum lease payments under non-cancelable operating leases for years subsequent to December 31, 2007 are as follows: 2008 - $3,562; 2009 - $3,293; 2010 - $3,203; 2011 - $3,085; 2012 - $2,880 - subsequent years -$12,166.

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Rent expense for operating leases for the years ended December 31, 2007, 2006 and 2005 was $12,492, $8,407 and $6,993, respectively.

(10) INVESTMENT IN UNCONSOLIDATED ENTITIES AND JOINT VENTURES

In July 2005, the Partnership acquired all of the outstanding partnership interests in CF Martin Sulphur not owned by the Partnership from CF Industries, Inc. and certain subsidiaries of Martin Resource Management. Prior to this transaction, the Partnership owned an unconsolidated non-controlling 49.5% limited partnership interest in CF Martin Sulphur, which was accounted for using the equity method of accounting. Equity in earnings of CF Martin Sulphur was $222 in 2005. Subsequent to the acquisition, CF Martin Sulphur was a wholly-owned subsidiary included in the Partnership s consolidated financial statements and in the Partnership s sulfur services segment. Effective March 30, 2006, CF Martin Sulphur was merged into the Partnership.

On November 10, 2005, the Partnership acquired Prism Gas which is engaged in the gathering, processing and marketing of natural gas and natural gas liquids, predominantly in Texas and northwest Louisiana. Through the acquisition of Prism Gas, the Partnership also acquired 50% ownership interests in Waskom, Matagorda and PIPE. Each of the interests referenced above are accounted for under the equity method of accounting.

On June 30, 2006, the Partnership, through its Prism Gas subsidiary, acquired a 20% ownership interest in a partnership for approximately $196, which owns the lease rights to the assets of BCP. BCP is an approximate 67 mile pipeline located in the Barnett Shale extension. The pipeline traverses four counties with the most concentrated drilling occurring in Bosque County. BCP is operated by Panther Pipeline Ltd. who is the 42.5% interest owner. This interest is accounted for under the equity method of accounting.

In accounting for the acquisition of the interests in Waskom, Matagorda and Fishhook, the carrying amount of these investments exceeded the underlying net assets by approximately $46,176. The difference was attributable to property and equipment of $11,872 and equity method goodwill of $34,304. The excess investment relating to property and equipment is being amortized over an average life of 20 years, which approximates the useful life of the underlying assets. Such amortization amounted to $594 for both the years ended December 31, 2007 and 2006 and has been recorded as a reduction of equity in earnings of unconsolidated equity method investees. The remaining unamortized excess investment relating to property and equipment was $10,685 and $11,279 at December 31, 2007 and 2006, respectively. The equity-method goodwill is not amortized in accordance with SFAS 142; however, it is analyzed for impairment annually. No impairment was recognized in 2007 or 2006.

As a partner in Waskom, the Partnership receives distributions in kind of natural gas liquids that are retained according to Waskom s contracts with certain producers. The natural gas liquids are valued at prevailing market prices. In addition, cash distributions are received and cash contributions are made to fund operating and capital requirements of Waskom.

Activity related to these investment accounts is as follows:

	Waskom	PIPE	Matagorda	BCP	Total
Investment in unconsolidated entities, December 31, 2005	54,087	1,723	4,069		59,879
Acquisition of interests				196	196
Distributions in kind	(8,311)				(8,311)
Cash contributions	11,238			76	11,314
Cash distributions	(150)	(214)	(610)		(974)
Equity in earnings:					
Equity in earnings from operations	8,623	224	356	(62)	9,141
Amortization of excess investment	(550)	(15)	(29)		(594)

Investment in unconsolidated entities, December 31, 2006	$ 64,937	$ 1,718	$ 3,786	$ 210	$ 70,651
Distributions in kind	(9,337)				(9,337)
Cash contributions	6,803			107	6,910
Cash distributions	(2,625)	(635)	(215)		(3,475)

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	Waskom	PIPE	Matagorda	BCP	Total
Equity in earnings:					
Equity in earnings from operations	11,009	514	151	(139)	11,535
Amortization of excess investment	(550)	(15)	(29)		(594)
Investment in unconsolidated entities, December 31, 2007	$ 70,237	$ 1,582	$ 3,693	$ 178	$ 75,690

Select financial information for significant unconsolidated equity method investees is as follows:

	Total Assets	Long-Term Debt	Partner s Capital	Revenues	Net Income (Loss)
2007					
Waskom	$ 66,772	$	$ 57,149	$ 81,797	$ 22,019
2006					
Waskom	$ 53,260	$	$ 45,450	$ 65,600	$ 17,246
2005					
Waskom (November 10 December 31)	$ 28,369	$	$ 22,650	$ 9,165	$ 2,559
CF Martin (January 1 July 15)				33,900	(120)
	$ 28,369	$	$ 22,650	$ 43,065	$ 2,439

As of December 31, 2007 and 2006, the Partnership s interest in cash of the unconsolidated equity method investees is $1,018 and $767, respectively.

(11) LONG-TERM DEBT

At December 31, 2007 and December 31, 2006, long-term debt consisted of the following:

	December 31, 2007	December 31, 2006
**$195,000 Revolving loan facility at variable interest rate (6.57%* weighted average at December 31, 2007), due November 2010 secured by substantially all of our assets, including, without limitation, inventory, accounts receivable, vessels, equipment, fixed assets and the interests in our operating subsidiaries	$ 95,000	$ 44,000

and equity method investees		
***$130,000 Term loan facility at variable interest rate (6.99%* at December 31, 2007), due November 2010, secured by substantially all of our assets, including, without limitation, inventory, accounts receivable, vessels, equipment, fixed assets and the interests in our operating subsidiaries	130,000	130,000
Other secured debt maturing in 2008, 7.25%	21	95
Total long-term debt	225,021	174,095
Less current installments	21	74
Long-term debt, net of current installments	$ 225,000	$ 174,021

* Interest rate fluctuates based on the LIBOR rate plus an applicable margin set on the date of each advance. The margin above LIBOR is set every three months. Indebtedness under the credit facility bears interest at either LIBOR plus an applicable margin or the base prime rate plus an applicable margin. The applicable margin for revolving loans that are LIBOR loans ranges from 1.50% to 3.00% and the applicable margin for revolving loans that are base prime rate loans ranges from 0.50% to 2.00%.

The applicable margin for term loans that are LIBOR loans ranges from 2.00% to 3.00% and the applicable margin for term loans that are base prime rate loans ranges from 1.00% to 2.00%. The applicable margin for existing borrowings is 1.75%. Effective January 1, 2008, the applicable margin for existing borrowings will increase to 2.00%. As a result of our leverage ratio test as of December 31, 2007,

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effective April 1, 2008, the applicable margin for existing borrowings will remain at 2.00%. The Partnership incurs a commitment fee on the unused portions of the credit facility.

** Effective September, 2007, the Partnership entered into a cash flow hedge that swaps $25,000 of floating rate to fixed rate. The fixed rate cost is 4.605% plus the Partnership s applicable LIBOR borrowing spread. The cash flow hedge matures in September, 2010.

** Effective November, 2006, the Partnership entered into a cash flow hedge that swaps $40,000 of floating rate to fixed rate. The fixed rate cost is 4.82% plus the

Partnership s applicable LIBOR borrowing spread. The cash flow hedge matures in December, 2009.

*** The $130,000 term loan has $105,000 hedged. Effective March, 2006, the Partnership entered into a cash flow hedge that swaps $75,000 of floating rate to fixed rate. The fixed rate cost is 5.25% plus the Partnership s applicable LIBOR borrowing spread. The cash flow hedge matures in November, 2010. Effective November 2006, the Partnership entered into an additional interest rate swap that swaps $30,000 of floating rate to fixed rate. The fixed rate cost is 4.765% plus the Partnership s applicable LIBOR borrowing spread. This cash flow hedge matures in March, 2010.

On August 18, 2006, the Partnership purchased certain terminalling assets and assumed associated long term debt of $113 with a fixed rate cost of 7.25%.

On November 10, 2005, the Partnership entered into a new $225,000 multi-bank credit facility comprised of a $130,000 term loan facility and a $95,000 revolving credit facility, which includes a $20,000 letter of credit sub-limit. This credit facility also includes procedures for additional financial institutions to become revolving lenders, or for any existing revolving lender to increase its revolving commitment, subject to a maximum of $100,000 for all such increases in revolving commitments of new or existing revolving lenders. Effective June 30, 2006, the Partnership increased its revolving credit facility $25,000 resulting in a committed $120,000 revolving credit facility. Effective December 28, 2007, the Partnership increased its revolving credit facility $75,000 resulting in a committed $195,000 revolving credit facility. The revolving credit facility is used for ongoing working capital needs and general partnership purposes, and to finance permitted investments, acquisitions and capital expenditures. Under the amended and restated credit facility, as of December 31, 2007, the Partnership had $95,000 outstanding under the revolving credit facility and $130,000 outstanding under the term loan facility. As of December 31, 2007, the Partnership had $99,880 available under its revolving credit facility.

On July 14, 2005, the Partnership issued a $120 irrevocable letter of credit to the Texas Commission on Environmental Quality to provide financial assurance for its used oil handling program.

The Partnership s obligations under the credit facility are secured by substantially all of the Partnership s assets, including, without limitation, inventory, accounts receivable, vessels, equipment, fixed assets and the interests in its operating subsidiaries and equity method investees. The Partnership may prepay all amounts outstanding under this facility at any time without penalty.

In addition, the credit facility contains various covenants, which, among other things, limit the Partnership s ability to: (i) incur indebtedness; (ii) grant certain liens; (iii) merge or consolidate unless it is the survivor; (iv) sell all or substantially all of its assets; (v) make certain acquisitions; (vi) make certain investments; (vii) make certain capital expenditures; (viii) make distributions other than from available cash; (ix) create obligations for some lease payments; (x) engage in transactions with affiliates; (xi) engage in other types of business; and (xii) its joint ventures to incur indebtedness or grant certain liens.

The credit facility also contains covenants, which, among other things, require the Partnership to maintain specified ratios of: (i) minimum net worth (as defined in the credit facility) of $75,000 plus 50% of net proceeds from equity issuances after November 10, 2005; (ii) EBITDA (as defined in the credit facility) to interest expense of not less than 3.0 to 1.0 at the end of each fiscal quarter; (iii) total funded debt to EBITDA of not more than (x) 5.5 to 1.0 for the fiscal quarter ended September 30, 2005, (y) 5.25 to 1.00 for the fiscal quarters ending December 31, 2005 through September 30, 2006, and (z) 4.75 to 1.00 for each fiscal quarter thereafter; and (iv) total secured

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funded debt to EBITDA of not more than (x) 5.50 to 1.00 for the fiscal quarter ended September 30, 2005, (y) 5.25 to 1.00 for the fiscal quarters ending December 31, 2005 through September 20, 2006, and (z) 4.00 to 1.00 for each fiscal quarter thereafter. The Partnership was in compliance with the debt covenants contained in credit facility for the years ended December 31, 2007 and 2006.

On November 10 of each year, commencing with November 10, 2006, the Partnership must prepay the term loans under the credit facility with 75% of Excess Cash Flow (as defined in the credit facility), unless its ratio of total funded debt to EBITDA is less than 3.00 to 1.00. There were no prepayments made or required under the term loan through December 31, 2007. If the Partnership receives greater than $15,000 from the incurrence of indebtedness other than under the credit facility, it must prepay indebtedness under the credit facility with all such proceeds in excess of $15,000. Any such prepayments are first applied to the term loans under the credit facility. The Partnership must prepay revolving loans under the credit facility with the net cash proceeds from any issuance of its equity. The Partnership must also prepay indebtedness under the credit facility with the proceeds of certain asset dispositions. Other than these mandatory prepayments, the credit facility requires interest only payments on a quarterly basis until maturity. All outstanding principal and unpaid interest must be paid by November 10, 2010. The credit facility contains customary events of default, including, without limitation, payment defaults, cross-defaults to other material indebtedness, bankruptcy-related defaults, change of control defaults and litigation-related defaults.

Draws made under the Partnership s credit facility are normally made to fund acquisitions and for working capital requirements. During the current fiscal year, draws on the Partnership s credit facility have ranged from a low of $170,600 to a high of $239,400. As of December 31, 2007, the Partnership had $99,880 available for working capital, internal expansion and acquisition activities under the Partnership s credit facility.

On July 15, 2005, the Partnership assumed $9,400 of U.S. Government Guaranteed Ship Financing Bonds, maturing in 2021, relating to the acquisition of CF Martin Sulphur L.P. (CF Martin Sulphur). The outstanding balance as of December 31, 2005 was $9,104. These bonds were payable in equal semi-annual installments of $291, and were secured by certain marine vessels owned by CF Martin Sulphur. Pursuant to the terms of an amendment to the Partnership s credit facility that it entered into in connection with the acquisition of CF Martin Sulphur, the Partnership was obligated to repay these bonds by March 31, 2006. The Partnership redeemed these bonds on March 6, 2006 with available cash and borrowings from its credit facility. Also, at redemption, a pre-payment premium was paid in the amount of $1,160.

In connection with the Partnership s Monarch acquisition on October 2, 2007, the Partnership borrowed approximately $3,900 under its revolving credit facility.

In connection with the Partnership s Mega Lubricants acquisition on June 13, 2007, the Partnership borrowed approximately $4,600 under its revolving credit facility.

In connection with the Partnership s Woodlawn acquisition on May 2, 2007, the Partnership borrowed approximately $33,000 under its revolving credit facility.

The Partnership paid cash interest in the amount of $17,253, $12,426 and $5,278 for the years ended December 31, 2007, 2006 and 2005 respectively. Capitalized interest was $2,483, $1,546 and $237 for the years ended December 31, 2007, 2006 and 2005 respectively.

(12) INTEREST RATE CASH FLOW HEDGES

In September 2007, the Company entered into a cash flow hedge agreement with a notional amount of $25,000 to hedge its exposure to increases in the benchmark interest rate underlying its variable rate term loan credit facility. This interest rate swap matures in September 2010. The Company designated this swap agreement as a cash flow hedge. Under the swap agreement, the Company pays a fixed rate of interest of 4.605% and receives a floating rate based on a three-month U.S. Dollar LIBOR rate. Because this is designated as a cash flow hedge, the changes in fair value, to the extent the swap is effective, are recognized in other comprehensive income until the hedged interest costs are recognized in earnings. At the inception of the hedge, the swap was identical to the hypothetical

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swap as of the trade date, and will continue to be identical as long as the accrual periods and rate resetting dates for the debt and the swap remain equal. This condition results in a 100% effective swap.

In April, 2006, the Partnership entered into a cash flow hedge agreement with a notional amount of $75,000 to hedge its exposure to increases in the benchmark interest rate underlying its variable rate term loan credit facility. This interest rate swap matures in November 2010. The Partnership designated this swap agreement as a cash flow hedge. Under the swap agreement, the Partnership pays a fixed rate of interest of 5.25% and receives a floating rate based on a three-month U.S. Dollar LIBOR rate. Because this is designated as a cash flow hedge, the changes in fair value, to the extent the swap is effective, are recognized in other comprehensive income until the hedged interest costs are recognized in earnings. At the inception of the hedge, the swap was identical to the hypothetical swap as of the trade date, and will continue to be identical as long as the accrual periods and rate resetting dates for the debt and the swap remain equal. This condition results in a 100% effective swap.

In December 2006, the Partnership entered into a cash flow hedge agreement with a notional amount of $40,000 to hedge its exposure to increases in the benchmark interest rate underlying its variable rate revolving credit facility. This interest rate swap matures in December 2009. The Partnership designated this swap agreement as a cash flow hedge. Under the swap agreement, the Partnership pays a fixed rate of interest of 4.82% and receives a floating rate based on a three-month U.S. Dollar LIBOR rate. Because this is designated as a cash flow hedge, the changes in fair value, to the extent the swap is effective, are recognized in other comprehensive income until the hedged interest costs are recognized in earnings. At the inception of the hedge, the swap was identical to the hypothetical swap as of the trade date, and will continue to be identical as long as the accrual periods and rate resetting dates for the debt and the swap remain equal. This condition results in a 100% effective swap.

In December 2006, the Partnership entered into an interest rate swap that swaps $30,000 of floating rate to fixed rate. The fixed rate cost is 4.765% plus the Partnership s applicable LIBOR borrowing spread. This interest rate swap matures in March 2010. The underlying debt related to this swap was paid prior to December 31, 2006, therefore, hedge accounting was not utilized. The swap has been recorded at fair value at December 31, 2006 with an offset to current operations.

During the year ended December 31, 2007, the Partnership recognized increases in interest expense of $0.2 million related to the difference between the fixed rate and the floating rate of interest on the interest rate swaps. The total fair value of the interest rate swaps agreement was a liability of $4,677 at December 31, 2007.

The fair value of derivative liabilities is as follows:

		December 31, 2007
Fair value of derivative liabilities current	$	(1,241)
Fair value of derivative liabilities long term		(3,436)
Net fair value of derivatives	$	(4,677)

(13) RELATED PARTY TRANSACTIONS

Included in the consolidated financial statements are various related party transactions and balances primarily with 1) Martin Resource Management and affiliates, 2) CF Martin Sulphur (through July 15, 2005) and 3) Waskom since November 10, 2005.

Related party transactions include sales and purchases of products and services between the Partnership and these related entities as well as payroll and associated costs and allocation of overhead.

The impact of these related party transactions is reflected in the consolidated financial statement as follows:

	2007	2006	2005
Revenues:			
Terminalling and storage	$ 11,816	$ 8,926	$ 8,938

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	2007	2006	2005
Marine transportation	23,729	15,319	11,606
Product sales:			
Natural gas services	3,206	1,303	44
Sulfur services	4,326	24	229
Terminalling and storage	45	59	5
	7,577	1,386	278
	$ 43,122	$ 25,631	$ 20,822
Costs and expenses:			
Cost of products sold:			
Natural gas services	$ 62,686	$ 52,030	$ 15,827
Sulfur services	13,992	11,913	9,843
Terminalling and storage		1	31
	$ 76,678	$ 63,944	$ 25,701
Expenses:			
Operating expenses Marine transportation	$ 20,891	$ 20,051	$ 15,746
Natural gas services	1,538	1,560	1,236
Sulfur services	1,234	928	295
Terminalling and storage	5,328	3,931	3,485
	$ 28,991	$ 26,470	$ 20,762
Selling, general and administrative:			
Natural gas services	927	773	833
Sulfur services	1,770	1,714	1,444
Terminalling and storage	41	74	76
Indirect overhead allocation, net of reimbursement	1,351	1,305	1,120
	$ 4,089	$ 3,866	$ 3,473

(14) FINANCIAL INSTRUMENTS

Statement of Financial Accounting Standards No. 107, Disclosures about Fair Value of Financial Instruments, requires that the Partnership disclose estimated fair values for its financial instruments. Fair value estimates are set forth below for the Partnership s financial instruments. The following methods and assumptions were used to estimate the fair value of each class of financial instrument:

Accounts and other receivables, trade and other accounts payable, other accrued liabilities, income taxes payable and due from/to affiliates The carrying amounts approximate fair value because of the short maturity

of these instruments.

Long-term debt including current installments The carrying amount of the revolving and term loan facilities approximates fair value due to the debt having a variable interest rate.

(15) COMMODITY CASH FLOW HEDGES

The Partnership is exposed to market risks associated with commodity prices, counterparty credit and interest rates. In connection with the acquisition of Prism Gas, the Partnership established a hedging policy and monitors and manages the commodity market risk associated with the commodity risk exposure of the Prism Gas acquisition. In addition, the Partnership is focusing on utilizing counterparties for these transactions whose financial condition is appropriate for the credit risk involved in each specific transaction.

The Partnership uses derivatives to manage the risk of commodity price fluctuations**.** Additionally, the Partnership manages interest rate exposure by targeting a ratio of fixed and floating interest rates it deems prudent and using hedges to attain that ratio.

In accordance with Statement of Financial Accounting Standards No. 133 (SFAS No. 133), *Accounting for Derivative Instruments and Hedging Activities*, all derivatives and hedging instruments are included on the balance

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sheet as an asset or a liability measured at fair value and changes in fair value are recognized currently in earnings unless specific hedge accounting criteria are met. If a derivative qualifies for hedge accounting, changes in the fair value can be offset against the change in the fair value of the hedged item through earnings or recognized in other comprehensive income until such time as the hedged item is recognized in earnings. In early 2006, the Partnership adopted a hedging policy that allows it to use hedge accounting for financial transactions that are designated as hedges.

Derivative instruments not designated as hedges are being marked to market with all market value adjustments being recorded in the consolidated statements of operations. As of December 31, 2007, the Partnership has designated a portion of its derivative instruments as qualifying cash flow hedges. Fair value changes for these hedges have been recorded in other comprehensive income as a component of equity.

The components of gain/loss on derivatives qualifying for hedge accounting and those that do not qualify for hedge accounting are included in the revenue of the hedged item in the Consolidated Statements of Operations for the year ended December 31, 2007 and 2006 as follows:

	December 31,	
	2007	**2006**
Change in fair value of derivatives that do not qualify for hedge accounting	$ (3,129)	$ 1,117
Ineffective portion of derivatives qualifying for hedge accounting	(586)	(2)
Change in fair value of derivatives in the Consolidated Statement of Operations	$ (3,715)	$ 1,115

The fair value of derivative assets and liabilities are as follows:

	December 31,	
	2007	**2006**
Fair value of derivative assets current	$ 235	$ 882
Fair value of derivative assets long term		221
Fair value of derivative liabilities current	(3,261)	
Fair value of derivative liabilities long term	(2,140)	(74)
Net fair value of derivatives	$ (5,166)	$ 1,029

Set forth below is the summarized notional amount and terms of all instruments held for price risk management purposes at December 31, 2007 (all gas quantities are expressed in British Thermal Units, crude oil and natural gas liquids are expressed in barrels). As of December 31, 2007, the remaining term of the contracts extend no later than December 2010, with no single contract longer than one year. The Partnership s counterparties to the derivative contracts include Shell Energy North America (US) L.P., Morgan Stanley Capital Group Inc. and Wachovia Bank. For the period ended December 31, 2007, changes in the fair value of the Partnership s derivative contracts were recorded in both earnings and in other comprehensive income as a component of equity since the Partnership has designated a portion of its derivative instruments as hedges as of December 31, 2007.

December 31, 2007				
Transaction Type	Total Volume Per Month	Pricing Terms	Remaining Terms of Contracts	Fair Value

Mark to Market Derivatives::

Natural Gas swap	30,000 MMBTU	Fixed price of $8.12 settled against Houston Ship Channel first of the month	January 2008 to December 2008	235
Crude Oil Swap	3,000 BBL	Fixed price of $70.75 settled against WTI NYMEX average monthly closings	January 2008 to December 2008	(810)

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	December 31, 2007				
Transaction Type	Total Volume Per Month	Pricing Terms	Remaining Terms of Contracts		Fair Value
Crude Oil Swap	3,000 BBL	Fixed price of $69.08 settled against WTI NYMEX average monthly closings	January 2009 to December 2009		(628)
Crude Oil Swap	3,000 BBL	Fixed price of $70.90 settled against WTI NYMEX average monthly closings	January 2009 to December 2009		(569)
Total swaps not designated as cash flow hedges				$	(1,772)
Cash Flow Hedges:					
Crude Oil Swap	5,000 BBL	Fixed price of $66.20 settled against WTI NYMEX average monthly closings	January 2008 to December 2008		(1,612)
Ethane Swap	5,000 BBL	Fixed price of $27.30 settled against Mt. Belvieu Purity Ethane average monthly postings	January 2008 to December 2008		(773)
Iso butane Swap	1,000 BBL	Fixed price of $75.90 settled against Mt. Belvieu Non-TET Iso butane average monthly postings	January 2008 to March 2008		(9)
Normal Butane Swap	2,000 BBL	Fixed price of $75.06 settled against Mt. Belvieu Non-TET normal butane average monthly postings	January 2008 to March 2008		(19)
Natural Gasoline Swap	3,000 BBL	Fixed price of $87.31 (Jan-Mar) and $85.10 (Apr-June) settled against Mt. Belvieu Non-TET natural gasoline average monthly postings.	January 2008 to June 2008		(38)
Crude Oil Swap	1,000 BBL	Fixed price of $70.45 settled against WTI NYMEX average monthly closings	January 2009 to December 2009		(194)

Crude Oil Swap	2,000 BBL	Fixed price of $69.15 settled against WTI NYMEX average monthly closings	January 2010 to December 2010	(337)
Crude Oil Swap	3,000 BBL	Fixed price of $72.25 settled against WTI NYMEX average monthly closings	January 2010 to December 2010	(412)
Total swaps designated as cash flow hedges				$ (3,394)
Total net fair value of derivatives				$ (5,166)

On all transactions where the Partnership is exposed to counterparty risk, the Partnership analyzes the counterparty s financial condition prior to entering into an agreement, and has established a maximum credit limit threshold pursuant to its hedging policy, and monitors the appropriateness of these limits on an ongoing basis. The Partnership has incurred no losses associated with the counterparty non-performance on derivative contracts.

As a result of the Prism Gas acquisition, the Partnership is exposed to the impact of market fluctuations in the prices of natural gas, natural gas liquids (NGLs) and condensate as a result of gathering, processing and sales activities. Prism Gas gathering and processing revenues are earned under various contractual arrangements with gas producers. Gathering revenues are generated through a combination of fixed-fee and index-related arrangements. Processing revenues are generated primarily through contracts which provide for processing on percent-of-liquids (POL) and percent-of-proceeds (POP) basis. Prism Gas has entered into hedging transactions through 2010 to protect a portion of its commodity exposure from these contracts. These hedging arrangements are in the form of swaps for crude oil, natural gas, ethane, iso butane, normal butane and natural gasoline.

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Based on estimated volumes, as of December 31, 2007, Prism Gas had hedged approximately 77%, 24%, and 17% of its commodity risk by volume for 2008, 2009, and 2010, respectively. The Partnership anticipates entering into additional commodity derivatives on an ongoing basis to manage its risks associated with these market fluctuations, and will consider using various commodity derivatives, including forward contracts, swaps, collars, futures and options, although there is no assurance that the Partnership will be able to do so or that the terms thereof will be similar to the Partnership s existing hedging arrangements. In addition, the Partnership will consider derivative arrangements that include the specific NGL products as well as natural gas and crude oil.

Hedging Arrangements in Place
As of December 31, 2007

Year	Commodity Hedged	Volume	Type of Derivative	Basis Reference
2008	Condensate & Natural Gasoline	5,000 BBL/Month	Crude Oil Swap ($66.20)	NYMEX
2008	Natural Gas	30,000 MMBTU/Month	Natural Gas Swap ($8.12)	Houston Ship Channel
2008	Ethane	5,000 BBL/Month	Ethane Swap ($27.30)	Mt. Belvieu
2008	Natural Gasoline	3,000 BBL/Month	Crude Oil Swap ($70.75)	NYMEX
2008	Iso Butane	1,000 BBL/Month	Iso Butane Swap ($75.90)	Mt. Belvieu (Non-TET)
2008	Normal Butane	2,000 BBL/Month	Normal Butane Swap ($75.06)	Mt. Belvieu (Non-TET)
2008	Natural Gasoline	3,000 BBL/Month	Natural Gasoline Swap ($87.31)	Mt. Belvieu (Non-TET)
2008	Natural Gasoline	3,000 BBL/Month	Natural Gasoline Swap ($85.10)	Mt. Belvieu (Non-TET)
2009	Condensate & Natural Gasoline	3,000 BBL/Month	Crude Oil Swap ($69.08)	NYMEX
2009	Natural Gasoline	3,000 BBL/Month	Crude Oil Swap ($70.90)	NYMEX
2009	Condensate	1,000 BBL/Month	Crude Oil Swap ($70.45)	NYMEX
2010	Condensate	2,000 BBL/Month	Crude Oil Swap ($69.15)	NYMEX
2010	Natural Gasoline	3,000 BBL/Month	Crude Oil Swap ($72.25)	NYMEX

The Partnership s principal customers with respect to Prism Gas natural gas gathering and processing are large, natural gas marketing services, oil and gas producers and industrial end-users. In addition, substantially all of the Partnership s natural gas and NGL sales are made at market-based prices. The Partnership s standard gas and NGL sales contracts contain adequate assurance provisions which allows for the suspension of deliveries, cancellation of agreements or discontinuance of deliveries to the buyer unless the buyer provides security for payment in a form satisfactory to the Partnership.

Impact of Cash Flow Hedges

Crude Oil

For the years ended December 31, 2007 and 2006, net gains and losses on swap hedge contracts decreased crude revenue by $3,374 and increased crude revenue by $76, respectively. As of December 31, 2007 an unrealized derivative fair value loss of $1,880, related to cash flow hedges of crude oil price risk, was recorded in other comprehensive income (loss). Fair value losses of $949, $190 and $741 are expected to be reclassified into earnings in 2008, 2009 and 2010, respectively. The actual reclassification to earnings will be based on mark-to-market prices at the contract settlement date, along with the realization of the gain or loss on the related physical volume, which is not reflected above.

Natural Gas

For the years ended December 31, 2007 and 2006, net gains on swap hedge contracts increased gas revenue by $180 and $1,097, respectively.

Natural Gas Liquids

For the years ended December 31, 2007 and 2006, net losses on swap hedge contracts decreased liquids revenue by $521 and $58, respectively. As of December 31, 2007, an unrealized derivative fair value loss of $839

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related to cash flow hedges of natural gas liquids price risk was recorded in other comprehensive income (loss). This fair value loss is expected to be reclassified into earnings in 2008. The actual reclassification to earnings will be based on mark-to-market prices at the contract settlement date, along with the realization of the gain or loss on the related physical volume, which is not reflected above.

(16) PARTNERS CAPITAL

As of December 31, 2007, partners capital consists of 12,837,480 common limited partner units, representing a 86.5% partnership interest, 1,701,346 subordinated limited partner units, representing an 11.5% partnership interest and a 2% general partner interest. Martin Resource Management and its subsidiaries, in the aggregate, owned an approximate 34.9% limited partnership interest consisting of 3,483,471 common limited partner units and 1,701,346 subordinated limited partner units and a 2% general partner interest.

The Partnership Agreement contains specific provisions for the allocation of net income and losses to each of the partners for purposes of maintaining their respective partner capital accounts

Distributions of Available Cash

The Partnership distributes all of its Available Cash (as defined in the Partnership Agreement) within 45 days after the end of each quarter to unitholders of record and to the general partner. Available Cash is generally defined as all cash and cash equivalents of the Partnership on hand at the end of each quarter less the amount of cash reserves its general partner determines in its reasonable discretion is necessary or appropriate to: (i) provide for the proper conduct of the Partnership s business; (ii) comply with applicable law, any debt instruments or other agreements; or (iii) provide funds for distributions to unitholders and the general partner for any one or more of the next four quarters, plus all cash on the date of determination of available cash for the quarter resulting from working capital borrowings made after the end of the quarter.

Subordination Period

During the subordination period (defined in the Partnership Agreement), the common units have the right to receive distributions of available cash in an amount equal to the minimum quarterly distribution of $0.50 per quarter, plus any arrearages in the payment of the minimum quarterly distribution on the common units from prior quarters, before any distributions of available cash from operating surplus may be made on the subordinated units.

The subordination period ends on the first day of any quarter beginning after September 30, 2009, when certain financial tests (defined in the Partnership Agreement) are met. Additionally, a portion of the subordinated units may convert earlier into common units on a one-for-one basis if additional financial tests (defined in the Partnership Agreement) are met.

The partnership agreement provides that before the end of the subordination period, a portion of the subordinated units may convert into common units on a one-for-one basis immediately after the distribution of available cash to the partners in respect of any quarter ending on or after:

September 30, 2005 with respect to 20% of the subordinated units;

September 30, 2006 with respect to 20% of the subordinated units;

September 30, 2007 with respect to 20% of the subordinated units;

September 30, 2008 with respect to 20% of the subordinated units;

As a result of achieving the defined financial test, 850,672 subordinated units representing 20% of the total originally issued subordinated units were converted into common units on each of November 14, 2007, 2006 and 2005. A total of 2,552,016 subordinated units representing 60% of the total originally issued subordinated units have been converted into common units as of December 31, 2007. When the subordination period ends, any remaining subordinated units will convert into common units on a one-for-one basis and the common units will no longer be entitled to arrearages.

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(17) GAIN ON INVOLUNTARY CONVERSION OF ASSETS

During the third quarter of 2005, several of the Partnership s facilities in the Gulf of Mexico were in the path of two major storms, Hurricane Katrina and Hurricane Rita. Physical damage to the Partnership s assets caused by the hurricanes, as well as the related removal and recovery costs, are covered by insurance subject to a deductible. Losses incurred as a result of a single hurricane (an occurrence) are limited to a maximum aggregate deductible of $100 for flood damage and the greater of $100 or 2% of total insured value at each location for wind damage. The Partnership s total flood coverage is $5,000 and total wind coverage is $40,000.

The most significant damage to the Partnership s assets was sustained at the Cameron East location. Property damage also occurred at the Partnership s Sabine Pass, Venice, Intracoastal City, Port Fourchon, Galveston, Cameron West, Neches and Stanolind locations. Based on an analysis of the damage as performed by the Partnership and its insurance underwriters, the Partnership had estimated its non-cash impairment charge as $1,200 for all the locations which is equal to the net-book value of the damaged assets. A receivable was established for the expected insurance recovery equal to the impairment charge.

The Partnership recognized a $700 estimated loss during the last half of 2005, which approximates the Partnership s hurricane deductibles under its applicable insurance policies, incurred as a result of Hurricanes Katrina and Rita. The loss is included in operating expenses in the consolidated statement of operations for the year ended December 31, 2005.

Insurance proceeds received as a result of the aforementioned claims exceeded net book value of the Partnership s assets determined to be impaired. During 2006, the Partnership received insurance proceeds of $4,812 for this involuntary conversion of assets, which resulted in a gain of $3,125 which is reported in other operating income.

(18) INCOME TAXES

The operations of a partnership are generally not subject to income taxes, except as discussed below, because its income is taxed directly to its partners. The net tax basis in the Partnership s assets and liabilities is less than the reported amounts on the financial statements by approximately $35.4 million as of December 31, 2007. Effective January 1, 2007, the Partnership is subject to the Texas margin tax as described below. Our subsidiary, Woodlawn, is subject to income taxes due to its corporate structure. Current income taxes related to the operations of this subsidiary were $118 for the year ended December 31, 2007. In connection with the Woodlawn acquisition, the Partnership also established deferred income taxes of $8,964 associated with book and tax basis differences of the acquired assets and liabilities. The basis differences are primarily related to property, plant and equipment. A deferred tax benefit related to these basis differences of $149 was recorded for the year ended December 31, 2007, and a deferred tax liability of $8,815 related to the basis differences existing at December 31, 2007.

As a result of its acquisition of Prism Gas, the Partnership assumed a current tax liability of $6.3 million as a result of a tax event triggered by the transfer of the ownership of the assets of Prism Gas in 2005 from a corporate to a partnership structure through the partial liquidation of the corporation. This liability was paid in 2006. The final liquidation of this corporate entity was completed on November 15, 2006. Additional federal and state income taxes of $173 resulting from the liquidation were recorded in current year income tax expense for the year ended December 31, 2007.

On May 18, 2006, the Texas Governor signed into law a Texas margin tax (H.B. No. 3) which restructures the state business tax by replacing the taxable capital and earned surplus components of the current franchise tax with a new taxable margin component. Since the tax base on the Texas margin tax is derived from an income-based measure, the margin tax is construed as an income tax and, therefore, the provisions of SFAS 109 regarding the recognition of deferred taxes apply to the new margin tax. In accordance with SFAS 109, the effect on deferred tax assets of a change in tax law should be included in tax expense attributable to continuing operations in the period that includes the enactment date. Therefore, the Partnership has calculated its deferred tax assets and liabilities for Texas based on the new margin tax. The cumulative effect of the change was immaterial. The impact of the change in deferred tax assets does not have a material impact on tax expense. State income taxes attributable to the Texas margin

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tax of $538 were recorded in current year income tax expense for the year ended December 31, 2007. There was no state income tax expense recorded for the year ended December 31, 2006.

In June 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes . FIN 48 is an interpretation of FASB Statement No. 109, Accounting for Income Taxes . FIN 48 prescribes a comprehensive model for recognizing, measuring, presenting and disclosing in the financial statements uncertain tax positions taken or expected to be taken. The Partnership adopted FIN 48 effective January 1, 2007. There was no impact to the Partnership s financial statements as a result of adopting FIN 48.

The components of income tax expense (benefit) from operations recorded for the year ended December 31, 2007 are as follows:

	Year Ended December 31, 2007
Current:	
Federal	$ 274
State	519
	$ 793
Deferred:	
Federal	$ (149)
	$ 644

(19) COMMITMENTS AND CONTINGENCIES

From time to time, the Partnership is subject to various claims and legal actions arising in the ordinary course of business. In the opinion of management, the ultimate disposition of these matters will not have a material adverse effect on the Partnership.

In addition to the foregoing, as a result of an inspection by the U.S. Coast Guard of the Partnership s tug Martin Explorer at the Freeport Sulfur Dock Terminal in Tampa, Florida, the Partnership has been informed that an investigation has been commenced concerning a possible violation of the Act to Prevent Pollution from Ships, 33 USC 1901, et. seq., and the MARPOL Protocol 73/78. The Partnership is cooperating with the investigation and at this time no formal charges, fines and/or penalties have been asserted. Accordingly, the Partnership cannot reasonably estimate the amount or range of possible loss at this time.

(20) BUSINESS SEGMENTS

The Partnership has four reportable segments: terminalling and storage, natural gas services, marine transportation, and sulfur services. The Partnership s reportable segments are strategic business units that offer different products and services. The operating income of these segments is reviewed by the chief operating decision maker to assess performance and make business decisions.

The accounting policies of the operating segments are the same as those described in Note 2 of the notes to consolidated financial statements. The Partnership evaluates the performance of its reportable segments based on operating income. There is no allocation of administrative expenses or interest expense.

	Operating	Operating

	Operating Revenues	Intersegment Eliminations	Revenues After Eliminations	Depreciation and Amortization	Income (Loss) after Eliminations	Capital Expenditures
Year ended December 31, 2007:						
Terminalling and storage	$ 59,790	$ (865)	$ 58,925	$ 6,358	$ 10,273	$ 26,023
Natural gas services	515,992		515,992	3,252	4,492	4,090
Marine transportation	63,533	(3,954)	59,579	8,819	4,270	37,562
Sulfur services	131,602	(276)	131,326	5,013	13,040	14,489
Indirect selling, general, and administrative					(3,199)	
Total	$ 770,917	$ (5,095)	$ 765,822	$ 23,442	$ 28,876	$ 82,164
Year ended December 31, 2006:						
Terminalling and storage	$ 36,606	$ (389)	$ 36,217	$ 4,700	$ 12,504	$ 13,371
Natural gas services	389,735		389,735	1,667	4,239	5,552

MARTIN MIDSTREAM PARTNERS L.P.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Dollars in Thousands)

	Operating Revenues	Intersegment Eliminations	Operating Revenues After Eliminations	Depreciation and Amortization	Operating Income (Loss) after Eliminations	Capital Expenditures
Marine transportation	50,174	(2,339)	47,835	6,609	6,411	18,840
Sulfur services	102,646	(49)	102,597	4,621	6,708	28,589
Indirect selling, general, and administrative					(3,253)	
Total	$ 579,161	$ (2,777)	$ 576,384	$ 17,597	$ 26,609	$ 66,352
Year ended December 31, 2005						
Terminalling and storage	$ 32,962	$ (64)	$ 32,898	$ 4,376	$ 9,314	$ 4,708
Natural gas services	301,676		301,676	356	6,003	1,669
Marine transportation	37,724	(2,273)	35,451	4,942	2,384	6,020
Sulfur services	68,418		68,418	2,968	4,722	12,417
Indirect selling, general, and administrative					(3,463)	
Total	$ 440,780	$ (2,337)	$ 438,443	$ 12,642	$ 18,960	$ 24,814

The following table reconciles operating income to net income:

	2007	2006	2005
Operating income	$ 28,876	$ 26,609	$ 18,960
Equity in earnings of unconsolidated entities	10,941	8,547	1,591
Interest expense	(14,533)	(12,466)	(6,909)
Debt prepayment premium		(1,160)	
Other, net	299	713	238
Income taxes	(644)		
Net income s	$ 24,939	$ 22,243	$ 13,880

Revenues from one customer in the Natural gas services segment were $66,989, $60,870, and $45,396 for the years ended December 31, 2007, 2006 and 2005, respectively.

Total assets by segment are as follows:

	2007	2006
Total assets:		

Terminalling and storage	$ 126,575	$ 89,354
Natural gas services	268,230	184,464
Marine transportation	107,081	77,668
Sulfur services	121,691	105,975
Total assets	$ 623,577	$ 457,461

Investments in unconsolidated entities totaled $75,690, $70,651 and $59,879 at December 31, 2007, 2006, and 2005, respectively, and are included in the natural gas services segment.

(21) QUARTERLY FINANCIAL INFORMATION

CONSOLIDATED QUARTERLY INCOME STATEMENT INFORMATION

	(Unaudited)			
	First Quarter	**Second Quarter**	**Third Quarter**	**Fourth Quarter**
	(Dollar in thousands, except per unit amounts)			
2007				
Revenues	$155,796	$162,314	$184,850	$262,862(1)
Operating Income	7,600	6,167	6,565	8,544

MARTIN MIDSTREAM PARTNERS L.P.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Dollars in Thousands)

	(Unaudited)			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(Dollar in thousands, except per unit amounts)			
Equity in earnings of unconsolidated entities	2,050	2,418	2,736	3,737
Net income	5,803	5,927	5,503	7,706
Net income per limited partner unit	$ 0.42	$ 0.41	$ 0.35	$ 0.49

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(Dollar in thousands, except per unit amounts)			
2006				
Revenues	$146,822	$133,052	$147,505	$149,005
Operating Income	5,884	5,874	4,720	10,131(2)
Equity in earnings of unconsolidated entities	2,412	2,310	2,720	1,105(3)
Net income	4,287	5,248	4,329	8,378(2)
Net income per limited partner unit	$ 0.33	$ 0.40	$ 0.32	$ 0.64

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(Dollar in thousands, except per unit amounts)			
2005				
Revenues	$ 96,140	$ 84,896	$112,780	$144,627(4)
Operating Income	4,495	3,877	6,433	4,155
Equity in earnings of unconsolidated entities	75	120	27	1,369(5)
Net income	3,531	2,943	4,846	2,560
Net income per limited partner unit	$ 0.41	$ 0.34	$ 0.56	$ 0.28

(1) Increased total revenues of $78,012 was due primarily to a 35% increase in NGL sales volumes in the fourth quarter and an increase in the NGL average sales price.

(2) Includes recognition of gain on involuntary

conversion of assets of $2,272.

(3) Decrease in equity in earnings of unconsolidated entities due a shutdown of the Waskom plant in the fourth quarter.

(4) Includes Prism Gas revenues of $17,459 since acquisition date on November 10, 2005.

(5) Represents $1,369 in equity in earnings of unconsolidated entities and joint ventures of Prism Gas since its acquisition on November 10, 2005.

(22) CONSOLIDATING FINANCIAL STATEMENTS

In connection with the Partnership s filing of a shelf registration statement on Form S-3 with the Securities and Exchange Commission (the Registration Statement), Martin Operating Partnership L.P. (the Operating Partnership), the Partnership s wholly-owned subsidiary, may issue unconditional guarantees of senior or subordinated debt securities of the Partnership in the event that the Partnership issues such securities from time to time under the registration statement. If issued, the guarantees will be full, irrevocable and unconditional. In addition, the Operating Partnership may also issue senior or subordinated debt securities under the Registration Statement which, if issued, will be fully, irrevocably and unconditionally guaranteed by the Partnership. The Partnership does not provide separate financial statements of the Operating Partnership because the Partnership has no independent assets or operations, the guarantees are full and unconditional and the other subsidiary of the Partnership is minor. There are no significant restrictions on the ability of the Partnership or the Operating Partnership to obtain funds from any of their respective subsidiaries by dividend or loan.

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Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None.

Item 9A. Controls and Procedures

(a) *Evaluation of disclosure controls and procedures.* In accordance with Rules 13a-15 and 15d-15 of the Securities Exchange Act of 1934, as amended (the Exchange Act), we, under the supervision and with the participation of the Chief Executive Officer and Chief Financial Officer of our general partner, carried out an evaluation of the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) of the Exchange Act) as of December 31, 2007. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer of our general partner concluded that, because of the material weakness described below in item (b), our disclosure controls and procedures were not effective as of December 31, 2007.

(b) *Management s Report on Internal Control Over Financial Reporting.* Management is responsible for establishing and maintaining adequate internal control over financial reporting. Our management, including the Chief Executive Officer and Chief Financial Officer of our general partner, conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on its evaluation under the framework in *Internal Control Integrated Framework,* our management concluded that our internal control over financial reporting was not effective as of December 31, 2007 due to the material weakness described below. A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the annual or interim financial statements will not be prevented or detected on a timely basis.

Management s assessment identified the following material weakness in internal control over financial reporting as of December 31, 2007:

Our policies and procedures related to the review and resolution of identified reconciling items on product exchange reconciliations were not effective. This material weakness resulted in errors in the accounting for product exchange transactions which affect inventory and costs of products sold.

The errors identified as a result of the material weakness did not have a material impact on the financial statements related to the fourth quarter, but had the potential to do so. As a result, management concluded that this internal control deficiency constitutes a material weakness in internal control over financial reporting because there is a reasonable possibility that a material misstatement of the interim or annual financial statements would not have been prevented or detected on a timely basis.

The effectiveness of our internal control over financial reporting as of December 31, 2007 has been audited by KPMG LLP, our independent registered public accounting firm, as stated in their report appearing on page 71.

(c) *Changes in internal controls.* There were no changes in our internal controls over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) that occurred during our most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

We are beginning the process of remediating the material weakness described above by increasing our monitoring of reconciliations and requiring additional accounting staff to perform independent monitoring of such reconciliations to ensure that reconciliations are properly recorded.

Item 9B. Other Information

None.

PART III

Item 10. Directors and Executive Officers of the Registrant

Management of Martin Midstream Partners L.P.

Martin Midstream GP LLC, as our general partner, manages our operations and activities on our behalf. Our general partner was not elected by our unitholders and will not be subject to re-election in the future. Unitholders do not directly or indirectly participate in our management or operation. Our general partner owes a fiduciary duty to our unitholders. Our general partner is liable, as general partner, for all of our debts (to the extent not paid from our assets), except for indebtedness or other obligations that are made specifically non-recourse to it. However, whenever possible, our general partner seeks to provide that our indebtedness or other obligations are non-recourse to our general partner.

Three directors of our general partner serve on a conflicts committee to review specific matters that the directors believe may involve conflicts of interest. The conflicts committee determines if the resolution of the conflict of interest is fair and reasonable to us. The members of the conflicts committee may not be officers or employees of our general partner or directors, officers, or employees of its affiliates and must meet the independence standards to serve on an audit committee of a board of directors established by NASDAQ and applicable securities laws. Any matters approved by the conflicts committee will be conclusively deemed to be fair and reasonable to us, approved by all of our partners, and not a breach by our general partner of any duties it may owe us or our unitholders. In addition, the members of the conflicts committee also serve on an audit committee that reviews our external financial reporting, recommends engagement of our independent auditors and reviews procedures for internal auditing and the adequacy of our internal accounting controls. The members of the conflicts committee also serve on the compensation committee, which oversees compensation decisions for the officers of our general partner as well as the compensation plans described below. The current members of our conflicts committee, audit committee, nominating committee and compensation committee are our outside directors, John P. Gaylord, C. Scott Massey and Howard Hackney, all of whom meet the independence standards established by NASDAQ.

We are managed and operated by the directors and officers of our general partner. All of our operational personnel are employees of Martin Resource Management. All of the officers of our general partner will spend a substantial amount of time managing the business and affairs of Martin Resource Management and its other affiliates. These officers may face a conflict regarding the allocation of their time between our business and the other business interests of Martin Resource Management. Our general partner intends to cause its officers to devote as much time to the management of our business and affairs as is necessary for the proper conduct of our business and affairs.

Directors and Executive Officers of Martin Midstream GP LLC

The following table shows information for the directors and executive officers of our general partner. Executive officers and directors are elected for one-year terms.

Name	Age	Position with the General Partner
Ruben S. Martin	56	President, Chief Executive Officer and Director
Robert D. Bondurant	49	Executive Vice President and Chief Financial Officer
Donald R. Neumeyer	60	Executive Vice President and Chief Operating Officer
Wesley M. Skelton	60	Executive Vice President, Chief Administrative Officer and Controller
Randy Tauscher	42	Executive Vice President
Scott D. Martin	42	Executive Vice President and Director
Chris Booth	38	Vice President, General Counsel and Secretary
John P. Gaylord	47	Director
C. Scott Massey	55	Director
Howard Hackney	68	Director

Ruben S. Martin serves as President, Chief Executive Officer and a member of the Board of Directors of our general partner. Mr. Martin has served in such capacities since June 2002. Mr. Martin has served as President of Martin Resource Management since 1981 and has served in various capacities within the company since 1974.

Mr. Martin and

Scott D. Martin, see below, are brothers. Mr. Martin holds a bachelor of science degree in industrial management from the University of Arkansas.

Robert D. Bondurant serves as Executive Vice President and Chief Financial Officer of our general partner. Mr. Bondurant has served in such capacities since June 2002. Mr. Bondurant joined Martin Resource Management in 1983 as Controller and subsequently was appointed Chief Financial Officer and a member of its Board of Directors in 1990. Mr. Bondurant served in the audit department at Peat Marwick, Mitchell and Co from 1980 to 1983. Mr. Bondurant holds a bachelor of business administration degree in accounting from Texas A&M University and is a Certified Public Accountant, licensed in the state of Texas.

Donald R. Neumeyer serves as Executive Vice President and Chief Operating Officer of our general partner. Mr. Neumeyer has served in such capacities since June 2002. Mr. Neumeyer joined Martin Resource Management in March of 1982 as an operations manager. He has served as Vice President of Operations and Chief Operating Officer since 1983 and as a Director since 1990. From 1978 to 1982 Mr. Neumeyer was employed by Crystal Oil Company of Shreveport, Louisiana as Vice President of Marketing, Refining and Gas Processing. From 1970 to 1978 Mr. Neumeyer was employed by Mobil Oil Corporation in various capacities within its pipeline, crude oil, and gas liquid operations. Mr. Neumeyer holds a bachelor of science in mechanical engineering from Southern Methodist University in Dallas and is a registered professional engineer in the state of Texas.

Wesley M. Skelton serves as Executive Vice President, Controller and Chief Administrative Officer of our general partner. Mr. Skelton has served in such capacities since June 2002. Mr. Skelton joined Martin Resource Management in 1981 and has served as Chief Administrative Officer since 1981 and a Director since 1990. Prior to joining Martin Resource Management, Mr. Skelton served as Treasurer of First Federal Savings & Loan, Marshall, Texas from January 1977 through January 1981 and was employed by Peat Marwick, Mitchell & Co. from August 1973 through January 1977. Mr. Skelton holds a bachelor of business administration degree from the University of Texas, and is a Certified Public Accountant licensed in the state of Texas.

Scott D. Martin serves as Executive Vice President and as a member of the Board of Directors of our general partner. Mr. Martin has served as a director of our general partner since June 2002. He was appointed as Executive Vice President of our general partner in February 2006. Mr. Martin has served as a Director of Martin Resource Management since 1990. He has held a variety of positions in marketing, transportation, terminalling, finance, operations and business development with Martin Resource Management since 1988. Mr. Martin and Ruben S. Martin, see above, are brothers. Mr. Martin holds a bachelor of science degree in business administration from University of Arkansas, where he previously served as a member of the Walton Business School advisory board.

Randy Tauscher serves as Executive Vice President of our general partner. Mr. Tauscher has served in this capacity since November 1, 2007. Prior to joining Martin, Mr. Tauscher was employed by Koch Industries for over 18 years, most recently as Senior Vice President of the Koch Carbon Division. Mr. Tauscher earned a Bachelor of Business Administration degree from Kansas State University.

Chris Booth serves as Vice-President, General Counsel and Secretary of our general partner. Mr. Booth has served in the capacities of Vice President and General Counsel since February 2006 and in the capacity of Secretary since November 2006. Mr. Booth joined Martin Resource Management in October 2005. Prior to joining Martin Resource Management, Mr. Booth was an attorney with the law firm of Mehaffy Weber located in Beaumont, Texas. Mr. Booth holds a doctor of jurisprudence degree and a masters of business administration degree from the University of Houston. Additionally, Mr. Booth holds a bachelor of science degree in business management from LeTourneau University. Mr. Booth is an attorney licensed to practice in the State of Texas.

John P. Gaylord serves as a member of the Board of Directors of our general partner. Mr. Gaylord has served as a Director since June 2002. Mr. Gaylord has served as the President of Jacintoport Terminal Company since 1992. He originally joined Jacintoport Terminal Company when it was founded in 1989 as Vice President of Finance. Jacintoport Terminal Company is the general partner of Chartco Terminal L.P. which has terminalling and storage operations in Houston, Texas. Mr. Gaylord holds a bachelor of arts degree from Texas Christian University and a master of business administration degree from Southern Methodist University.

C. Scott Massey serves as a member of the Board of Directors of our general partner. Mr. Massey has served as a Director since June 2002. Mr. Massey has been self employed as a Certified Public Accountant since 1998. From

1977 to 1998, Mr. Massey worked for KPMG Peat Marwick, LLP in various positions, including, most recently, as a Partner in the firm s Tax Practice Energy, Real Estate, Timber from 1986 to 1998. Mr. Massey received a bachelor of business administration degree from the University of Texas at Austin and a juris doctor degree from the University of Houston. Mr. Massey is a Certified Public Accountant, licensed in the states of Louisiana and Texas.

Howard Hackney serves as a member of the Board of Directors of our general partner. Mr. Hackney has served as a Director since May 2005. Mr. Hackney currently serves as a director of Texas Bank and Trust of Longview, Texas and Federal Home Loan Bank of Dallas, Texas, where he is the Chairman of the Audit Committee and a member of the Executive and Risk Management Committees. Mr. Hackney from time to time is an adjunct faculty member at LeTourneau University Business School in finance and management. His past experience includes service as the President of Texas Bank and Trust of Longview, Texas, President of Bank One of Longview, Texas, President and a director of Merchant and Planters National Bank of Sherman, Texas and Executive Vice President and a director of Capital National Bank of Houston, Texas. Mr. Hackney received a BBA and MBA from Southern Methodist University.

Independence of Directors

Messrs. Gaylord, Massey and Hackney qualify as independent in accordance with the published listing requirements of NASDAQ and applicable securities laws. The NASDAQ independence definition includes a series of objective tests, such as that the director is not an employee of us and has not engaged in various types of business dealings with us. In addition, as further required by the NASDAQ rules, the board of directors has made a subjective determination as to each independent director that no relationships exist which, in the opinion of the board, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director. In making these determinations, the directors reviewed and discussed information provided by the directors and us with regard to each director s business and personal activities as they may relate to us and our management.

Board Meetings and Committees

From January 1, 2007 to December 31, 2007, the Board of Directors of our general partner held 12 meetings. All five directors then in office attended each of these meetings, either in person or by teleconference, with the exception of two meetings whereby one director was absent. Additionally, the Board of Directors undertook action two times during 2007 without a meeting by acting through written unanimous consent. We have standing conflicts, audit, compensation and nominating committees of the Board of Directors of our general partner. The Board of Directors of our general partner appoints the members of the Audit, Compensation, Nominating and Conflicts Committees. Each member of the Audit, Compensation, Nominating and Conflicts Committees is an independent director in accordance with NASDAQ and applicable securities laws. Each of the board committees has a written charter approved by the board. Copies of each charter are posted on our website at www.martinmidstream.com under the Governance section. The current members of the committees, the number of meetings held by each committee from January 1, 2007 to December 31, 2007, and a brief description of the functions performed by each committee are set forth below:

Conflicts Committee (3 meetings). The members of the conflicts committee are Messrs. Gaylord (chairman), Massey and Hackney. All of the members of the conflicts committee, attended all meetings of the committee for the period noted above. The primary responsibility of the conflicts committee is to review matters that the directors believe may involve conflicts of interest. The conflicts committee determines if the resolution of the conflict of interest is fair and reasonable to us. The members of the conflicts committee may not be officers or employees of our general partner or directors, officers, or employees of its affiliates and must meet the independence standards to serve on an audit committee of a board of directors established by NASDAQ. Any matters approved by the conflicts committee will be conclusively deemed to be fair and reasonable to us, approved by all of our partners, and not a breach by our general partner of any duties it may owe us or our unitholders.

Audit Committee (4 meetings). The members of the audit committee are Messrs. Gaylord, Massey (chairman) and Hackney. All of the members, attended all meetings of the audit committee for the period noted above, with the exception of two meetings whereby one member was absent. The primary responsibilities of the audit committee are to assist the Board of Directors in its general oversight of our financial reporting, internal controls and audit functions, and it is directly responsible for the appointment, retention, compensation and oversight of the work

of our independent auditors. The members of the Audit Committee of the Board of Directors of our general partner each qualify as

independent under standards established by the SEC for members of audit committees, and the Audit Committee includes at least one member who is determined by the Board of Directors to meet the qualifications of an audit committee financial expert in accordance with SEC rules, including that the person meets the relevant definition of an independent director. C. Scott Massey is the independent director who has been determined to be an audit committee financial expert. Unitholders should understand that this designation is a disclosure requirement of the SEC related to Mr. Massey s experience and understanding with respect to certain accounting and auditing matters. The designation does not impose on Mr. Massey any duties, obligations or liability that are greater than are generally imposed on him as a member of the Audit Committee and board of directors, and his designation as an audit committee financial expert pursuant to this SEC requirement does not affect the duties, obligations or liability of any other member of the Audit Committee or board of directors.

Compensation Committee (2 meetings). The members of the compensation committee are Messrs. Gaylord, Massey and Hackney (chairman). The primary responsibility of the compensation committee is to oversee compensation decisions for the outside directors of our general partner and executive officers of our general partner (in the event they are to be paid by our general partner) as well as our long-term incentive plan.

Nominating Committee (1 meeting). The members of the nominating committee are Messrs. Gaylord, Massey and Hackney (chairman). The primary responsibility of the nominating committee is to select and recommend nominees for election to the Board of Directors of our general partner.

Compensation of Directors

Officers of our general partner who also serve as directors will not receive additional compensation. Non-employee directors of our general partner are entitled to receive an annual retainer fee of $35,000. All directors of our general partner are entitled to reimbursement for their reasonable out-of-pocket expenses in connection with their travel to and from, and attendance at, meetings of the Board of Directors or committees thereof. Each director will be fully indemnified by us for actions associated with being a director to the extent permitted under Delaware law. On May 3, 2007, we issued 1,000 restricted common units to each of our three independent, non-employee, directors under our long-term incentive plan. These restricted common units vest in equal installments of 250 units on January 24, 2008, 2009, 2010 and 2011, respectively. On January 24, 2006, we issued 1,000 restricted common units to each of our three independent, non-employee, directors under our long-term incentive plan. These restricted common units vest in equal installments of 250 units on each of the anniversaries following the grant date.

Compensation Committee Interlocks and Insider Participation

The current members of the compensation committee of our general partner that are identified above were the only persons who served on such committee during 2007. Other than these independent directors, no other officer or employee of our general partner or its subsidiaries is a member of the compensation committee. Employees of Martin Resource Management, through our general partner, are the individuals who work on our matters.

Code of Ethics and Business Conduct

Our general partner has adopted a Code of Ethics and Business Conduct applicable to all of our general partner s employees (including any employees of Martin Resource Management who undertake actions with respect to us or on our behalf), including all officers, and including our general partner s independent directors, who are not employees of our general partner, with regard to their activities relating to us. The Code of Ethics and Business Conduct incorporate guidelines designed to deter wrongdoing and to promote honest and ethical conduct and compliance with applicable laws and regulations. They also incorporate our expectations of our general partner s employees (including any employees of Martin Resource Management who undertake actions with respect to us or on our behalf) that enable us to provide accurate and timely disclosure in our filings with the Securities and Exchange Commission and other public communications. The Code of Ethics and Business Conduct is publicly available on our website under the Governance section (at www.martinmidstream.com). This website address is intended to be an inactive, textual reference only, and none of the material on this website is part of this report. If any substantive amendments are made to the Code of Ethics and Business Conduct or if we or our general partner grant any waiver, including any implicit waiver, from a provision of the code to any of our general partner s executive officers and directors, we will disclose the nature of such amendment or waiver on that website or in a report on Form 8-K.

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Section 16(a) Beneficial Ownership Reporting Compliance

Our general partner s directors, officers and beneficial owners of more than 10 percent of a registered class of our equity securities are required to file reports of ownership and reports of changes in ownership with the SEC and NASDAQ. Directors, officers and beneficial owners of more than 10% of our equity securities are also required to furnish us with copies of all such reports that are filed. Based on our review of copies of such forms and amendments, we believe directors, executive officers and greater than 10% beneficial owners complied with all filing requirements during the year ended December 31, 2007 except as follows: two reports on Form 4 following allocations pursuant to a benefit plan of Martin Resource Management were filed late by each of Messrs. Ruben Martin, Scott Martin, Skelton, Neumeyer, Bondurant and Booth.

Reimbursement of Expenses of our General Partner

Our general partner does not receive a management fee or other compensation for its management of our partnership. However, our general partner and its affiliates are reimbursed for expenses incurred on our behalf. All direct general and administrative expenses are charged to us as incurred. We reimbursed Martin Resource Management for $53.9 million of direct costs and expenses for the twelve months ended December 31, 2007 compared to $49.1 million for the twelve months ended December 31, 2006. There is no monetary limitation on the amount we are required to reimburse Martin Resource Management for direct expenses.

Indirect general and administrative and corporate overhead costs relate to centralized corporate functions that we share with Martin Resource Management, including certain accounting, treasury, engineering, information technology, insurance, administration of employee benefit plans and other corporate services. In addition to the direct expenses, under the omnibus agreement, the reimbursement amount with respect to indirect general and administrative and corporate overhead expenses was capped at $2.0 million. This cap expired on November 1, 2007. Effective January 1, 2008, the Conflicts Committee of our general partner approved a reimbursement amount for indirect expenses of $2.7 million for the year ending December 31, 2008, which is not expected to cover all of the indirect general and administrative and corporate overhead expenses attributable to the services provided to us. We reimbursed Martin Resource Management for $1.5 million of indirect expenses for the twelve months ended December 31, 2007 and 2006.

Our partnership agreement provides that our general partner will determine the expenses that are allocable to us in any reasonable manner determined by our general partner in its sole discretion. Please read Item 13. Certain Relationships and Related Transactions Agreements Omnibus Agreement.

<u>Item 11</u>. <u>Executive Compensation</u>

Compensation Discussion and Analysis

We are a master limited partnership and have no employees. We are managed by the executive officers of our general partner. These executive officers are employed by Martin Resource Management. We reimburse Martin Resource Management for a portion of the indirect general and administrative expenses, including compensation expense relating to the service of these individuals that are allocated to us pursuant to the omnibus agreement. Under the omnibus agreement, the reimbursement amount with respect to indirect general and administrative and corporate overhead expenses was capped at $2.0 million. This cap expired on November 1, 2007. Effective January 1, 2008, the Conflicts Committee of our general partner approved a reimbursement amount of $2.7 million for the year ending December 31, 2008, which is not expected to cover all of the indirect general and administrative and corporate overhead expenses attributable to the services provided to us. Please see Item 13. Certain Relationships and Related Transactions Agreements Omnibus Agreement for a discussion of the omnibus agreement.

The compensation policies and philosophy of Martin Resource Management govern the types and amount of compensation granted each of the named executive officers of our general partner listed in the summary compensation table set forth below (the Named Executive Officers). The board of directors and the compensation committee of our general partner do not have responsibility for approving the elements of compensation presented in the tables which follow this discussion. The board of directors and Conflicts Committee of our general partner do have responsibility for evaluating and determining the reasonableness of the total amount we are charged for managerial, administrative and operational support, including compensation of the Named Executive Officers, provided by Martin Resource Management under the omnibus agreement.

Our allocation for the costs incurred by Martin Resource Management in providing compensation and benefits to its employees who serve as the Named Executive Officers is governed by the omnibus agreement. In general, this allocation is based upon estimates of the relative amounts of time that these employees devote to the business and affairs of our general partner and to the business and affairs of Martin Resource Management. We bear substantially

less than a majority of Martin Resource Management s costs of providing compensation and benefits to the Named Executive Officers.

Although we bear an allocated portion of Martin Resource Management s costs of providing compensation and benefits to the Named Executive Officers, we do not have control over such costs and do not establish or direct the compensation policies or practices of Martin Resource Management. Ruben S. Martin, the Chief Executive Officer of our general partner, controls Martin Resource Management and has ultimate decision-making authority with respect to compensation of the Named Executive Officers. The following elements of compensation, and Martin Resource Management s decisions with respect to determinations on payments, will not be subject to approvals by our general partner s board of directors or its Compensation Committee. Awards under our long-term incentive plan, which to date have consisted only of the grant of restricted common units to the independent directors of our general partner, are approved by the Compensation Committee. Martin Resource Management does not have a separate compensation committee.

The elements of Martin Resource Management s compensation program discussed below, along with Martin Resource Management s other rewards, are intended to provide a total rewards package designed to drive performance and reward contributions in support of the business strategies of Martin Resource Management and its affiliates, including us. During 2007, Martin Resource Management did not use any elements of compensation based on specific performance-based criteria and did not have any other specific performance-based objectives.

During 2007, elements of compensation paid to the Named Executive Officers by Martin Resource Management consisted of the following:

- Annual base salary;
- Discretionary annual cash awards;
- Awards pursuant to Martin Resource Management employee benefit plans; and
- Other compensation, including limited perquisites.

With respect to compensation objectives and decisions regarding the Named Executive Officers during 2007, Martin Resource Management takes note of market data for determining relevant compensation levels and compensation program elements through the review of and, in certain cases, participation in, various relevant compensation surveys. Martin Resource Management did not consult with any compensation consultants with respect to determining 2007 compensation for any of our named executive officers.

The compensation paid by Martin Resource Management to the Named Executive Officers is intended to yield competitive total cash compensation and drive performance in support of our business strategies, as well as the performance of Martin Resource Management and other Martin Resource Management affiliates for which the Named Executive Officers perform services.

The 2007 equity-based awards under our long-term incentive plan that were given to our independent directors were determined by the Compensation Committee. Any equity-based awards under Martin Resource Management employee benefit plans given to the Named Executive Officers are determined by Mr. Ruben Martin.

Martin Midstream Partners L.P. Long-Term Incentive Plan

Our general partner has adopted the Martin Midstream Partners L.P. Long-Term Incentive Plan for employees and directors of our general partner and its affiliates who perform services for us. The long-term incentive plan was amended in January 2006 to clarify the Partnership s ability to grant restricted common units under the long-term incentive plan and to remove provisions relating to grants of distribution equivalent rights and phantom units.

common units to each of our three independent directors. These restricted common units vest in equal installments of 250 units on each of the four anniversaries following the grant date. There have been no other awards granted pursuant to the long-term incentive plan.

The long-term incentive plan consists of two components, restricted units and unit options. The long-term incentive plan currently permits the grant of awards covering an aggregate of 725,000 common units, 241,667 of which may be awarded in the form of restricted units and 483,333 of which may be awarded in the form of unit options. The plan is administered by the compensation committee of our general partner s board of directors.

Our general partner s board of directors or the Compensation Committee, in their discretion, may terminate or amend the long-term incentive plan at any time with respect to any units for which a grant has not yet been made. Our general partner s board of directors or the Compensation Committee also have the right to alter or amend the long-term incentive plan or any part of the plan from time to time, including increasing the number of units that may be reserved for issuance under the plan subject to any applicable unitholder approval. However, no change in any outstanding grant may be made that would materially impair the rights of the participant without the consent of the participant.

Restricted Units. A restricted unit is a unit that is granted to grantees with certain vesting restrictions. Once these restrictions lapse, the grantee is entitled to full ownership of the unit without restrictions. A phantom unit that entitles the grantee to receive a common unit upon the vesting of the phantom unit, or in the discretion of the compensation committee, cash equivalent to the value of a common unit. The compensation committee may determine to make grants under the plan to employees and directors containing such terms as the compensation committee shall determine under the plan. The compensation committee will determine the period over which restricted units or phantom units granted to employees and directors will vest. The committee may base its determination upon the achievement of specified financial objectives. In addition, the restricted units or phantom units will vest upon a change of control of us, our general partner or Martin Resource Management or if our general partner ceases to be an affiliate of Martin Resource Management.

If a grantee s employment or membership on the board of directors terminates for any reason, the grantee s restricted units or phantom units will be automatically forfeited unless, and to the extent, the compensation committee provides otherwise. Common units to be delivered upon the vesting of restricted units or phantom units may be common units acquired by our general partner in the open market, common units already owned by our general partner, common units acquired by our general partner directly from us or any affiliate of our general partner or any combination of the foregoing. Our general partner will be entitled to reimbursement by us for the cost incurred in acquiring common units. If we issue new common units upon vesting of the restricted units or phantom units, the total number of common units outstanding will increase.

We intend the issuance of the common units upon vesting of the restricted units or phantom units under the plan to serve as a means of incentive compensation for performance and not primarily as an opportunity to participate in the equity appreciation of the common units. Therefore, plan participants will not pay any consideration for the common units they receive, and we will receive no remuneration for the units.

On May 3, 2007, we issued 1,000 restricted common units to each of our three independent, non-employee, directors under our long-term incentive plan. These restricted common units vest in equal installments of 250 units on January 24, 2008, 2009, 2010 and 2011, respectively. On January 24, 2006, we issued 1,000 restricted common units to each of our three independent directors. These restricted common units vest in equal installments of 250 units on each of the four anniversaries following the grant date.

Unit Options. The long-term incentive plan currently permits the grant of options covering common units. As of March 5, 2008, we have not granted any common unit options to directors or employees of our general partner, or its affiliates. In the future, the compensation committee may determine to make grants under the plan to employees and directors containing such terms as the committee shall determine. Unit options will have an exercise price that, in the discretion of the committee, may not be less than the fair market value of the units on the date of grant. In general, unit options granted will become exercisable over a period determined by the compensation committee. In addition, the unit options will become exercisable upon a change in control of us, our general partner,

Martin Resource Management or if our general partner ceases to be an affiliate of Martin Resource Management or upon the achievement of specified financial objectives.

Upon exercise of a unit option, our general partner will acquire common units in the open market or directly from us or any affiliate of our general partner or use common units already owned by our general partner, or any combination of the foregoing. Our general partner will be entitled to reimbursement by us for the difference between the cost incurred by our general partner in acquiring these common units and the proceeds received by our general partner from an optionee at the time of exercise. Thus, the cost of the unit options will be borne by us. If we issue new common units upon exercise of the unit options, the total number of common units outstanding will increase, and our general partner will pay us the proceeds it received from the optionee.

Martin Resource Management Employee Benefit Plans

Martin Resource Management has employee benefit plans for its employees who perform services for us. The following summary of these plans is not complete but outlines the material provisions of these plans.

Martin Resource Management Purchase Plan for Units of Martin Midstream Partners L.P. Martin Resource Management maintains a purchase plan for our Units to provide employees of Martin Resource Management and its affiliates who perform services for us the opportunity to acquire an equity interest in the us through the purchase of our common units. Each individual employed by Martin Resource Management or an affiliate of Martin Resource Management that provides services to us is eligible to participate in the purchase plan. Enrollment in the purchase plan by an eligible employee will constitute a grant by Martin Resource Management to the employee of the right to purchase common units under the purchase plan. The right to purchase common units granted by the Company under the purchase plan is for the term of a purchase period.

During each purchase period, each participating employee may elect to make contributions to his bookkeeping account each pay period in an amount not less than one percent of his compensation and not more than ten percent of his compensation. The rate of contribution shall be designated by the employee at the time of enrollment. On each purchase date (the last day of such purchase period), Units will be purchased for each participating employee at the fair market value of such Units. The fair market value of the Units to be purchased during such purchase period shall mean the closing sales price of a Unit on the purchase date.

Martin Resource Management Employee Stock Ownership Plan. Martin Resource Management maintains an employee stock ownership plan that covers employees who satisfy certain minimum age and service requirements. This employee stock ownership plan is referred to as the ESOP. Under the terms of the ESOP, Martin Resource Management has the discretion to make contributions in an amount determined by its board of directors. Those contributions are allocated under the terms of the ESOP and invested primarily in the common stock of Martin Resource Management. Participants in the ESOP become 100% vested upon completing five years of vesting service or upon their attainment of age 65, permanent disability or death during employment. Any forfeitures of non-vested accounts are allocated to the accounts of employed participants. Except for rollover contributions, participants are not permitted to make contributions to the ESOP.

Martin Resource Management Profit Sharing Plan. Martin Resource Management maintains a profit sharing plan that covers employees who satisfy certain minimum age and service requirements. This profit sharing plan is referred to as the 401(k) Plan. Eligible employees may elect to participate in the 401(k) Plan by electing pre-tax contributions up to 30% of their regular compensation and/or a portion of their discretionary bonuses. Matching contributions are made to the 401(k) Plan equal to 100% of the first 3% of eligible compensation, and 50% of the next 2% of eligible compensation. Martin Resource Management may make annual discretionary profit sharing contributions in an amount at the plan year end as determined by the board of directors of Martin Resource Management. Participants in the 401(k) Plan become 100% vested in matching contributions immediately and become vested in the discretionary contributions made for them upon completing five years of vesting service or upon their attainment of age 65, permanent disability or death during employment.

Martin Resource Management Phantom Stock Plan. Under Martin Resource Management s phantom stock plan, phantom stock units granted there under have a ten year life and are non-transferable. Each recipient may exercise an election to receive either

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an equivalent number of shares of Martin Resource Management or

cash based on the latest valuation of the shares of common stock of Martin Resource Management held by the ESOP.

Any common stock of Martin Resource Management received under this phantom stock plan cannot be pledged or encumbered. The recipient must sign an agreement waiving any voting rights with respect to shares received under this plan. Cash elections are paid in five equal annual installments. A put option, exercisable at the then fair market value of the common stock, is exercisable by the employee in the event Martin Resource Management is sold prior to an employee s election to receive common stock or cash.

Martin Resource Management Non-Qualified Option Plan. In September 1999, Martin Resource Management adopted a stock option plan designed to retain and attract qualified management personnel, directors and consultants. Under the plan, Martin Resource Management is authorized to issue to qualifying parties from time to time options to purchase up to 2,000 shares of its common stock with terms not to exceed ten years from the date of grant and at exercise prices generally not less than fair market value on the date of grant. In November 2007, Martin Resource Management adopted an additional stock option plan designed to retain and attract qualified management personnel, directors and consultants. Under the plan, Martin Resource Management is authorized to issue to qualifying parties from time to time options to purchase up to 2,000 shares of its common stock with terms not to exceed ten years from the date of grant and at exercise prices generally not less than fair market value on the date of grant.

Other Compensation

Martin Resource Management generally does not pay for perquisites for any of our named executive officers, other than general recreational activities at certain Martin Resource Management s properties located in Texas, car allowances, and use of Martin Resource Management vehicles, including aircraft.

SUMMARY COMPENSATION TABLE

The following table sets forth the compensation expense that was allocated to us for the services of the named executive officers for the periods from January 1, 2007 to December 31, 2007 and January 1, 2006 to December 31, 2006.

Name and Principal Position	Year	Salary ($)	Total Compensation
Ruben S. Martin			
President and Chief Executive Officer	2007	$134,271	$ 134,271
	2006	$137,718	$ 137,718
Robert D. Bondurant			
Executive Vice President	2007	$116,234	$ 116,234
and Chief Financial Officer	2006	$105,565	$ 105,565
Donald R. Neumeyer			
Executive Vice President and Chief Operating Officer	2007	$116,170	$ 116,170
	2006	$108,065	$ 108,065
Wesley M. Skelton			
Executive Vice President, Controller and Chief			
Administrative Officer	2007	$151,936	$ 151,936
	2006	$117,780	$ 117,780
Chris H. Booth			
Vice President, General Counsel and Secretary	2007	$120,938	$ 120,938

2006	$ 98,585	$ 98,585

Director Compensation

As a partnership, we are managed by our general partner. The board of directors of our general partner performs for us the functions of a board of directors of a business corporation. We are allocated 100 percent of the director compensation of these board members. Martin Resource Management employees who are a member of the board of directors of our general partner do not receive any additional compensation for serving in such capacity.

Name	Fees Earned Paid in Cash ($)	Stock Awards ($)(1)	Total ($)
Ruben S. Martin	N/A	N/A	N/A
Scott D. Martin	N/A	N/A	N/A
John P. Gaylord	$ 35,000	$ 41,050	$ 76,050
C. Scott Massey	$ 35,000	$ 41,050	$ 76,050
Howard Hackney	$ 35,000	$ 41,050	$ 76,050

(1) On May 3, 2007, we issued 1,000 restricted common units to each of our three independent, non-employee, directors under our long-term incentive plan. These restricted common units vest in equal installments of 250 units on January 24, 2008, 2009, 2010 and 2011, respectively. In calculating the fair value of the award, we multiplied the closing price of our common units on the NASDAQ on the date of grant, May 3, 2007, by the number of restricted

common units
granted to each
director.

COMPENSATION REPORT OF THE COMPENSATION COMMITTEE

The Compensation Committee of the general partner of Martin Midstream Partners L.P. has reviewed and discussed the Compensation Discussion and Analysis section of this report with management of the general partner of Martin Midstream Partners L.P. and, based on that review and discussions, has recommended that the Compensation Discussion and Analysis be included in this report.

/s/ Howard Hackney

Howard Hackney, Committee Chair

/s/ John P. Gaylord

John P. Gaylord

/s/ C. Scott Massey

C. Scott Massey

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The following table sets forth the beneficial ownership of our units as of March 5, 2008 held by beneficial owners of 5% or more of the units outstanding, by directors of our general partner, by each executive officer and by all directors and executive officers of our General Partner as a group.

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Name of Beneficial Owner(1)	Common Units Beneficially Owned	Percentage of Common Units Beneficially Owned(2)	Subordinated Units Beneficially Owned	Percentage of Subordinated Units Beneficially Owned	Percentage of Total Units Beneficially Owned(2)
Martin Resource Management Corporation(3)	3,483,471	27.1%	1,701,346	100%	35.7%
Martin Product Sales LLC(3)	1,857,732	14.5%	617,520	36.3%	17.0%
Midstream Fuel Service LLC(3)	372,387	2.9%	248,257	14.6%	4.3%
Martin Resource LLC(3)	1,253,352	9.8%	835,569	49.1%	14.4%
Ruben S. Martin(4)	3,510,921	27.3%	1,701,346	100%	35.9%
Scott D. Martin(5)	3,495,763	27.2%	1,701,346	100%	35.7%
Donald R. Neumeyer	3,898				
Wesley M. Skelton	2,036				
Robert D. Bondurant	4,042				
Chris Booth	561				
Randall Tauscher	4,122				
John P. Gaylord(6)	12,000				
C. Scott Massey(6)(7)	5,000				
Howard Hackney(6)	2,000				
Kayne Anderson Capital Advisors, L.P.(8)	1,022,429	8.0%			7.0%
All directors and executive officers as a group (10 persons)(9)	3,556,872	27.7%	1,701,346	100%	36.2%

(1) The address for Martin Resource Management Corporation and all of the individuals listed in this table, unless otherwise indicated, is c/o Martin Midstream Partners L.P., 4200 Stone Road, Kilgore, Texas 75662.

(2) The percent of class shown is less than one percent unless

otherwise noted.

(3) Martin Resource Management Corporation is the owner of Martin Product Sales LLC, Midstream Fuel Service LLC and Martin Resource LLC, and as such may be deemed to beneficially own the common and subordinated units held by such entities.

(4) Includes 3,483,471 common units and 1,701,346 subordinated units beneficially owned by Martin Resource Management Corporation through its ownership of Martin Product Sales LLC, Midstream Fuel Service LLC and Martin Resource LLC. Ruben S. Martin beneficially owns securities in Martin Resource Management Corporation representing approximately 54.1% of the voting power thereof and

serves as its Chairman of the Board and President. As a result, Ruben S. Martin may be deemed to be the beneficial owner of the common units and the subordinated units owned by Martin Resource Management Corporation.

(5) Includes 3,483,471 common units and 1,701,346 subordinated units beneficially owned by Martin Resource Management Corporation through its ownership of Martin Product Sales LLC, Midstream Fuel Service LLC and Martin Resource LLC. Scott D. Martin beneficially owns securities in Martin Resource Management Corporation representing approximately 69.3% of the voting power thereof and serves as an executive officer and on

its Board of Directors. As a result, Scott D. Martin may be deemed to be the beneficial owner of the common units and the subordinated units owned by Martin Resource Management Corporation.

(6) On May 3, 2007, we issued 1,000 restricted common units to each of our three independent directors. These restricted common units vest in equal installments of 250 units on each of the four anniversaries following the grant date.

On January 24, 2006, we issued 1,000 restricted common units to each of our three independent directors. These restricted common units vest in equal installments of 250 units on each of the four anniversaries following the grant date.

(7) Mr. Massey may be deemed to be the beneficial owner of 250 common units held by his wife.

(8) Based on a Schedule 13G (Amendment No. 3), dated January 24, 2008 filed by Kayne Anderson Capital Advisors, L.P. with the United States Securities and Exchange Commission. The filing is made jointly with Richard A. Kayne. The filers report that they have shared voting power with respect to the 1,022,429 common units. The address of Kayne Anderson Capital Advisors, L.P. is 1800 Avenue of the Stars, Second Floor, Los Angeles, California 90067.

(9) The total for all directors and executive officers as a group includes the common units directly owned by such directors and executive officers as well as the common

units and subordinated units beneficially owned by Martin Resource Management Corporation as both Ruben S. Martin and Scott D. Martin may be deemed to be the beneficial owners thereof.

Martin Resource Management Corporation owns our general partner and, together with our general partner, owns approximately 35.7% of our outstanding limited partner units. The table below sets forth information as of March 5, 2008 concerning (i) each person beneficially owning in excess of 5% of common stock of Martin Resource Management Corporation, and (ii) the beneficial common stock ownership of (a) each director of Martin Resource Management Corporation, (b) each executive officer of Martin Resource Management Corporation, and (c) all such executive officers and directors of Martin Resource Management Corporation as a group. Except as indicated, each individual has sole voting and investment power over all shares listed opposite his or her name.

	Beneficial Ownership of Common Stock	
Name of Beneficial Owner(1)	**Number of Shares**	**Percent of Outstanding**
R.S. Martin Jr. Children s Trust No. One f/b/o Angela Santi Jones (2)	1,278.00	15.3%
Martin Resource Management Corporation Employee Stock Ownership Trust (3)	638.00	7.6%
RSM, III Investments, Ltd.(4)	2,266.67	27.2%
Ruben S. Martin III Dynasty Trust (5)	635.00	7.6%
SKM Partnership, Ltd. (6)	2,560.00	30.7%
Martin Transport, Inc. (7)	40.00	*
Ruben S. Martin (2) (3) (4) (7)	4,517.00	54.1%
Scott D. Martin (2) (3) (5) (6) (7)	5,785.00	69.3%
Donald R. Neumeyer (8)	66.00	*
Wesley M. Skelton (3) (8)	696.00	8.3%
Robert D. Bondurant (8)	140.00	1.6%
Executive officers and directors as a group (5 individuals)	8,346.00	100%

* Represents less than 1.0%

(1) The business address of each shareholder, director and executive officer of Martin Resource

Management Corporation is c/o Martin Resource Management Corporation, 4200 Stone Road, Kilgore, Texas 75662.

(2) Ruben S. Martin and Scott D. Martin are the co-investment trustees of the R.S. Martin Jr. Children s Trust No. One f/b/o Angela Santi Jones and exercise shared control over the voting of the securities owned by this trust. Scott D. Martin is the sole dispositive trustee of the R.S. Martin Jr. Childrens Trust No. 1 f/b/o Angela Santi Jones and exercises sole control over the disposition of the securities owned by this trust. As a result, these persons may be deemed to be the beneficial owners of the securities held by such trust; thus, the number of shares of common stock reported herein

as beneficially owned by such individuals includes the 1,278 shares owned by such trust.

(3) Ruben S. Martin, Scott D. Martin and Wesley M. Skelton are the co-trustees of the Martin Resource Management Corporation Employee Stock Ownership Trust and exercise shared control over the voting and disposition of the securities owned by this trust. As a result, these persons may be deemed to be the beneficial owners of the securities held by such trust; thus, the number of shares of common stock reported herein as beneficially owned by such individuals includes the 638 shares owned by such trust. Mr. Skelton disclaims beneficial ownership of these 638 shares.

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(4) Ruben S. Martin is the beneficial owner of the general partner of RSM, III Investments, Ltd. and exercises control over the voting and disposition of the securities owned by this entity. As a result, he may be deemed to be the beneficial owner of the securities held by such entity; thus, the number of shares of common stock reported herein as beneficially owned by such individual includes the 2,267.67 shares owned by such entity.

(5) Scott D. Martin is the trustee of the Ruben S. Martin III Dynasty Trust and exercises control over the voting and disposition of the securities owned by the trust. As a result, he may be deemed to be the beneficial owner of the securities held by the trust; thus, the number of shares of common stock reported herein as beneficially owned by Scott D. Martin

includes the 635 shares owned by such trust. These 635 shares have been pledged as security to a third party to secure payment for a loan made by such third party.

(6) Scott D. Martin is the beneficial owner of the general partner of SKM Partnership, Ltd. and exercises control over the voting and disposition of the securities owned by this entity. As a result, he may be deemed to be the beneficial owner of the securities held by such entity; thus, the number of shares of common stock reported herein as beneficially owned by such individual includes the 2,560 shares owned by such entity.

(7) Ruben S. Martin beneficially owns securities in Martin Resource Management Corporation representing approximately 54.1% of the voting power thereof and serves as its Chairman of the Board and President. Scott D.

Martin beneficially owns securities in Martin Resource Management Corporation representing approximately 69.3% of the voting power thereof and serves as an executive officer thereof and as a member of its Board of Directors. Martin Transport, Inc. is a wholly owned subsidiary of Martin Resource Management Corporation. As a result, each of Ruben S. Martin and Scott D. Martin may be deemed to be the beneficial owner of the securities held by Martin Transport, Inc.; thus, the number of shares of common stock reported herein as beneficially owned by such individuals includes the 40 shares owned by Martin Transport, Inc.

(8) Messrs. Neumeyer, Skelton and Bondurant have the right to acquire 66, 58 and 140 shares, respectively, by virtue of options issued under

Martin Resource Management Corporation s nonqualified stock option plan.

Item 13. Certain Relationships and Related Transactions

Martin Resource Management owns 3,483,471 of our common units and 1,701,346 subordinated collectively units representing approximately 35.7% of our outstanding limited partnership units. Our general partner is a wholly-owned subsidiary of Martin Resource Management. Our general partner owns a 2.0% general partner interest in us and our incentive distribution rights. Our general partner s ability, as general partner, to manage and operate us, and Martin Resource Management s ownership of approximately 35.7% of our outstanding limited partnership units, effectively gives Martin Resource Management the ability to veto some of our actions and to control our management.

Distributions and Payments to the General Partner and its Affiliates

The following table summarizes the distributions and payments to be made by us to our general partner and its affiliates in connection with our formation, ongoing operation and liquidation. These distributions and payments were determined by and among affiliated entities and, consequently, are not the result of arm s-length negotiations.

Formation Stage

The consideration received by our general partner and Martin Resource Management for the transfer of assets to us	4,253,362 subordinated units; (A total 2,552,016 of the original subordinated units issued to Martin Resource Management have been converted into common units on a one-for-one basis since the formation of the Partnership. (850,672 subordinated units were converted on each of November 14, 2005, 2006 and 2007, respectively). 2% general partner interest; and the incentive distribution rights.

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Operational Stage	
Distributions of available cash to our general partner	We will generally make cash distributions 98% to our unitholders, including Martin Resource Management as holder of all of the subordinated units, and 2% to our general partner. In addition, if distributions exceed the minimum quarterly distribution and other higher target levels, our general partner will be entitled to increasing percentages of the distributions, up to 50% of the distributions above the highest target level as a result of its incentive distribution rights. Assuming we have sufficient available cash to pay the full minimum quarterly distribution on all of our outstanding units for four quarters, our general partner would receive distributions of approximately $1.2 million on its 2.0% general partner interest and Martin Resource Management would receive an aggregate annual distribution of approximately $6.3 million on its subordinated units.
Payments to our general partner and its affiliates	Martin Resource Management is entitled to reimbursement for all direct expenses it or our general partner incurs on our behalf. The direct expenses include the salaries and benefit costs employees of Martin Resource Management who provide services to us. Our general partner has sole discretion in determining the amount of these expenses. In addition to the direct expenses, Martin Resource Management is entitled to reimbursement for a portion of indirect general and administrative and corporate overhead expenses. Under the omnibus agreement, the reimbursement amount that we are required to pay to Martin Resource Management with respect to indirect general and administrative and corporate overhead expenses was capped at $2.0 million. This cap expired on November 1, 2007. Effective January 1, 2008, the Conflicts Committee of our general partner approved a reimbursement amount of $2.7 million for the year ending December 31, 2008, which is not expected to cover all of the indirect general and administrative and corporate overhead expenses attributable to the services provided to us. Please read Agreements Omnibus Agreement below.
Withdrawal or removal of our general partner	If our general partner withdraws or is removed, its general partner interest and its incentive distribution rights will either be sold to the new general partner for cash or converted into common units, in each case for an amount equal to the fair market value of those interests.
Liquidation Stage	
Liquidation	Upon our liquidation, the partners, including our general partner, will be entitled to receive liquidating distributions according to their particular capital account balances.

Agreements

We and Martin Resource Management have entered into various agreements that are not the result of arm s-length negotiations and consequently may not be as favorable to us as they might have been if we had negotiated them with unaffiliated third parties.

Omnibus Agreement

We and our general partner are parties to an omnibus agreement with Martin Resource Management that governs, among other things, potential competition and indemnification obligations among the parties to the agreement, related party transactions, the provision of general administration and support services by Martin Resource Management and our use of certain of Martin Resource Management s trade names and trademarks.

Non-Competition Provisions. Martin Resource Management agrees for so long as Martin Resource Management controls the general partner not to engage in the business of

providing terminalling and storage services for hydrocarbon products and by-products;

providing marine transportation of hydrocarbon products and by-products

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- distributing NGLs; and
- manufacturing and selling sulfur-based fertilizer products and other sulfur-related products.

This restriction does not apply to:

- the operation on our behalf of any asset or group of assets owned by us or our affiliates;
- any business operated by Martin Resource Management, including the following:
  - providing land transportation of various liquids,
  - distributing fuel oil, asphalt, sulfuric acid, marine fuel and other liquids,
  - providing marine bunkering and other shore-based marine services in Alabama, Louisiana, Mississippi and Texas,
  - operating a small crude oil gathering business in Stephens, Arkansas,
  - operating a small lube oil processing business in Smackover, Arkansas,
  - operating an underground NGL storage facility in Arcadia, Louisiana,
  - developing an underground natural gas storage facility in Arcadia, Louisiana,
  - operating, solely for our account, an NGL truck loading and unloading and pipeline distribution terminal in Mont Belvieu, Texas.
- any business that Martin Resource Management acquires or constructs that has a fair market value of less than $5.0 million;
- any business that Martin Resource Management acquires or constructs that has a fair market value of $5.0 million or more if we have been offered the opportunity to purchase the business for fair market value, and we decline to do so with the concurrence of our conflicts committee; and
- any business that Martin Resource Management acquires or constructs where a portion of such business includes a restricted business and the fair market value of the restricted business is $5.0 million or more and represents less than 20% of the aggregate value of the entire business to be acquired or constructed; provided that, following completion of the acquisition or construction, we are provided the opportunity to purchase the restricted business.

Indemnification Provisions. Under the omnibus agreement, Martin Resource Management was obligated to indemnify us for five years after the closing of our initial public offering for:

- certain potential environmental liabilities associated with the operation of the assets contributed to us, and assets retained, by Martin Resource Management that relate to events or conditions occurring or existing before November 1, 2002, and
- any payments we were required to make, as a successor in interest to affiliates of Martin Resource Management, under environmental indemnity provisions contained in the contribution agreement associated with the contribution of assets by Martin Resource Management to CF Martin Sulphur in November 2000.

These environmental indemnity provisions expired on November 1, 2007.

Services. Under the omnibus agreement, Martin Resource Management provides us with corporate staff and support services that are substantially identical in nature and quality to the services previously provided by Martin Resource Management in connection with its management and operation of our assets during the one-year period prior to the date of the agreement. The omnibus agreement requires us to reimburse Martin Resource Management for all direct expenses it incurs or payments it makes on our behalf or in connection with the operation of our business. There is no monetary limitation on the amount we are required to reimburse Martin Resource Management for direct expenses. In addition to the direct expenses, Martin Resource Management is entitled to reimbursement for a portion of indirect general and administrative and corporate overhead expenses. Under the omnibus agreement, the reimbursement amount that we are required to pay Martin Resource Management with respect to indirect general and administrative and corporate overhead expenses was capped at $2.0 million. This cap expired on November 1, 2007. Effective January 1, 2008, the Conflicts Committee of our general partner approved a reimbursement amount of $2.7 million for the year ending December 31, 2008, which is not expected to cover all of the indirect general and administrative and corporate overhead expenses attributable to the services provided to us.

These indirect expenses cover all of the centralized corporate functions Martin Resource Management provides for us, such as accounting, treasury, clerical billing, information technology, administration of insurance, general office expenses and employee benefit plans and other general corporate overhead functions we share with Martin Resource Management retained businesses. The provisions of the omnibus agreement regarding Martin Resource Management s services will terminate if Martin Resource Management ceases to control our general partner.

Related Party Transactions. The omnibus agreement prohibits us from entering into any material agreement with Martin Resource Management without the prior approval of the conflicts committee of our general partner s board of directors. For purposes of the omnibus agreement, the term material agreements means any agreement between us and Martin Resource Management that requires aggregate annual payments in excess of then-applicable limitation on the reimbursable amount of indirect general and administrative expenses. Please read Services above.

License Provisions. Under the omnibus agreement, Martin Resource Management has granted us a nontransferable, nonexclusive, royalty-free right and license to use certain of its trade names and marks, as well as the trade names and marks used by some of its affiliates.

Amendment and Termination. The omnibus agreement may be amended by written agreement of the parties; provided, however that it may not be amended without the approval of the conflicts committee of our general partner if such amendment would adversely affect the unitholders. The omnibus agreement, other than the indemnification provisions and the provisions limiting the amount for which we will reimburse Martin Resource Management for general and administrative services performed on our behalf, will terminate if we are no longer an affiliate of Martin Resource Management.

Motor Carrier Agreement

We are a party to a motor carrier agreement effective January 1, 2006 with Martin Transport, Inc., a wholly owned subsidiary of Martin Resource Management through which Martin Resource Management operates its land transportation operations. This agreement replaced a prior agreement between us and Martin Transport, Inc. for land transportation services. Under the agreement, Martin Transport agreed to ship our NGL shipments as well as other liquid products.

Term and Pricing. This agreement was amended in November 2006, January 2007 and January 2008 to add additional point-to-point rates and to lower certain fuel and insurance surcharges being charged to us. The agreement has an initial term that expired in December 2007 but which automatically renewed through December 2008. This agreement will continue to automatically renew for consecutive one-year periods unless either party terminates the agreement by giving written notice to the other party at least 30 days prior to the expiration of the then-applicable term. We have the right to terminate this agreement at anytime by providing 90 days prior notice. Under this agreement, Martin Transport transports our NGL shipments as well as other liquid products. Our shipping rates were fixed for the first year of the agreement, subject to certain cost adjustments. These rates are subject to any adjustment to which we mutually agree or in accordance with a price index. Additionally, during the term of the agreement, shipping charges are also subject to fuel surcharges determined on a weekly basis in accordance with the U.S. Department of Energy s national diesel price list.

Indemnification. Martin Transport has indemnified us against all claims arising out of the negligence or willful misconduct of Martin Transport and its officers, employees, agents, representatives and subcontractors. We indemnified Martin Transport against all claims arising out of the negligence or willful misconduct of us and our officers, employees, agents, representatives and subcontractors. In the event a claim is the result of the joint negligence or misconduct of Martin Transport and us, our indemnification obligations will be shared in proportion to each party s allocable share of such joint negligence or misconduct.

Other Agreements

Terminal Services Agreement. We are a party to a terminal services agreement with Martin Resource Management under which we provide the following services for Martin Resource Management at our terminals:

we unload, transfer and store products received from vessels or trucks at the terminal; and

we transfer products stored at the terminal to vessels or trucks.

Effective each December 1, this agreement will automatically renew on a month-to- month basis until either party terminates the agreement by giving written notice to the other party at least 60 days prior to the expiration of the then-applicable term.

Marine Transportation Agreement. We are a party to a marine transportation agreement effective January 1, 2006 under which we provide marine transportation services to Martin Resource Management on a spot-contract basis at applicable market rates. This agreement replaced a prior agreement between us and Martin Resource Management covering marine transportation services which expired November 2005. Effective each January 1, this agreement automatically renews for consecutive one-year periods unless either party terminates the agreement by giving written notice to the other party at least 60 days prior to the expiration of the then- applicable term. The fees we charge Martin Resource Management are based on applicable market rates.

Product Storage Agreement. We are a party to a product storage agreement with Martin Resource Management under which we lease storage space at Martin Resource Management s underground storage facility located in Arcadia, Louisiana. Effective each November 1, this agreement automatically renews for consecutive one-year periods unless either party terminates the agreement by giving written notice to the other party at least 30 days prior to the expiration of the then-applicable term. Our per-unit cost under this agreement may be adjusted annually based on a price index. We indemnified Martin Resource Management from any damages resulting from our delivery of products that are contaminated or otherwise fail to conform to the product specifications established in the agreement, as well as any damages resulting from our transportation, storage, use or handling of products.

Marine Fuel. We are a party to an agreement with Martin Resource Management under which Martin Resource Management provides us with marine fuel at its docks located in Mobile, Alabama, Theodore, Alabama, Pascagoula, Mississippi and Tampa, Florida. We agreed to purchase all of our marine fuel requirements that occur in the areas serviced by these docks under this agreement. Martin Resource Management provides fuel at an established margin above its cost on a spot-contract basis. This agreement had an initial term that expired in October 2005 and automatically renews for consecutive one-year periods unless either party terminates the agreement by giving written notice to the other party at least 30 days prior to the expiration of the then-applicable term. Effective January 1, 2006 a new agreement was entered into under which Martin Resource Management provides us with marine fuel from its locations in the Gulf of Mexico at a fixed rate over the Platt s U.S. Gulf Coast Index for #2 Fuel Oil.

Sulfuric Acid. We are a party to an agreement with Martin Resource Management under which Martin Resource Management provides sulfuric acid for our Plainview facility. We agreed to purchase all of our sulfuric acid requirements for our Plainview facility under this agreement. Martin Resource Management provides sulfuric acid at a set margin of $4.00 per short ton above its cost on a spot-contract basis. This agreement had an initial term that expired in October 2005 and, subsequently, it was automatically renewed for consecutive one-year periods through September 30, 2007 when the agreement was terminated upon the completion of our sulfuric acid production plant in Plainview, Texas.

Throughput Agreement. We are a party to an agreement under which Martin Resource Management agreed to provide us with sole access to and use of a NGL truck loading and unloading and pipeline distribution terminal located at Mont Belvieu, Texas. Effective each November 1, this agreement automatically renews for consecutive one-year periods unless either party terminates the agreement by giving written notice to the other party at least 30 days prior to the expiration of the then-applicable term. Our throughput fee may be adjusted annually based on a price index.

Purchaser Use Easement, Ingress-Egress Easement, and Utility Facilities Easement. We entered into a Purchaser Use Easement, Ingress-Egress Easement and Utility Facilities Easement with Martin Resource Management under which we have complete, non-exclusive access to, and use of, all marine terminal facilities, all loading and unloading facilities for vessels, barges and trucks and other common use facilities located at the Stanolind terminal. This easement has a perpetual duration. We did not incur any expenses, costs or other financial obligations under the easement. Martin Resource Management is obligated to maintain, and repair all common use areas and facilities located at this terminal. We share the use of these common use areas and facilities only with Martin Resource Management who also have tanks located at the Stanolind facility. See Item 1. Business Terminalling and Storage Business Marine Terminals Specialty Petroleum Terminals.

Terminal Services Agreement. We entered into a terminal services agreement under which we provide terminalling services to Martin Resource Management. Effective each December 1, this agreement will automatically renew on a month-to- month basis until either party terminates the agreement by giving written notice to the other party at least 60 days prior to the expiration of the then-applicable term. The per gallon throughput fee we charge under this agreement may be adjusted annually based on a price index.

Transportation Services Agreement. We entered into a transportation services agreement under which we provide marine transportation services to Martin Resource Management. This agreement has a three-year term, which began in December 2003, and will automatically renew for successive one-year terms unless either party terminates the agreement by giving written notice to the other party at least 30 days prior to the expiration of the then-applicable term. In addition, within 30 days of the expiration of the then-applicable term, both parties have the right to renegotiate the rate for the use of our vessels. If no agreement is reached as to a new rate by the end of the then-applicable term, the agreement will terminate. The hourly rate we charge under this agreement may be adjusted annually based upon mutual agreement of the parties or in accordance with a price index. This agreement was not renewed and the marine transportation services previously provided under this agreement are now being provided to Martin Resource Management under the terms of the Marine Transportation Agreement executed with us effective January 1, 2006.

Specialty Terminal Services Agreement. We entered into an agreement under which Martin Resource Management provides terminal services to us. Effective each November 1, this agreement automatically renews for consecutive one-year periods unless either party terminates the agreement by giving written notice to the other party at least 30 days prior to the expiration of the then-applicable term. The fees we charge under this agreement are adjusted annually based on a price index.

Terminal Services Agreement under which we provide terminalling services to Martin Resource Management. This agreement was set to expire in December 2006, but automatically renewed and will continue to automatically renew on a month-to- month basis until either party terminates the agreement by giving 60 days written notice. The per gallon throughput fee we charge under this agreement may be adjusted annually based on a price index.

Product Supply Agreements under which Martin Resource Management provides us with marine fuel and sulfuric acid. Effective each November 1, these agreements automatically renew for consecutive one-year periods unless either party terminates the agreement by giving written notice to the other party at least 30 days prior to the expiration of the then-applicable term. We purchase products at a set margin above Martin Resource Management s cost for such products during the term of the agreements.

Lubricants and Drilling Fluids Terminal Services Agreement under which Martin Resource Management provides terminal services to us. Effective each January 1, this agreement automatically renews for successive one-year terms until either party terminates the agreement by giving written notice to the other party at

least 60 days prior to the end of the then-applicable term. The per gallon handling fee and the percentage of our commissions we are charged under this agreement may be adjusted annually based on a price index.

Cross Terminalling Agreement under which we provide terminalling services to Cross Oil Refining & Marketing, Inc., an affiliate of Martin Resource Management, through October 27, 2008. The per gallon throughput fee we charge under this agreement may be adjusted during each year of the agreement.

Sulfuric Acid Sales Agency Agreement under which Martin Resource Management purchases and markets the sulfuric acid produced by our sulfuric acid production plant at Plainview, Texas, and which is not consumed by our internal operations. This agreement will remain in place until we terminate it by providing 180 days written notice. Under this agreement, we sell all of our excess sulfuric acid to Martin Resource Management. Martin Resource Management then markets such acid to third-parties and we share in the profit of Martin Resource Management s sales of the excess acid to such third parties.

Miscellaneous Agreements From time to time we enter into other miscellaneous agreements with Martin Resource Management for the provision of other services or the purchase of other goods.

Other Related Party Transactions

2007 Public Offering. In May 2007, we completed a public offering of 1,380,000 common units, resulting in proceeds of $55.9 million, after payment of underwriters discounts, commissions and offering expenses. Our general partner contributed $1.2 million in cash to us in conjunction with the offering in order to maintain its 2% general partner interest in us. The net proceeds were used to used to pay down revolving debt under our credit facility and to provide working capital.

Issuance of Common Units. In December 2006, we issued 470,484 common units to Martin Product Sales LLC, an affiliate of Martin Resource Management, for approximately $15.3 million, including a capital contribution of approximately $0.3 million made by our general partner in order to maintain its 2% general partner interest in us. These funds were used to pay down our revolving line of credit.

2006 Public Offering. In January 2006, we completed a follow-on public offering of 3,450,000 common units, resulting in proceeds of $95.4 million, after payment of underwriters discounts, commissions and offering expenses. Our general partner contributed $2.1 million in cash to us in conjunction with the offering in order to maintain its 2% general partner interest in us. Of the net proceeds, $62.0 million was used to pay then current balances under our revolving credit facility and $7.5 million was used to fund a portion of the redemption price for our U.S. Government Guaranteed Ship Financing Bonds. The remainder of the net proceeds has been or will be used to fund future organic growth projects.

Miscellaneous. Certain of directors, officers and employees of our general partner and Martin Resource Management maintain margin accounts with broker-dealers with respect to our common units held by such persons. Margin account transactions for such directors, officers and employees were conducted by such broker-dealers in the ordinary course of business.

Waskom Agreements. Prism Gas is a party to a product purchase agreement and a gas processing agreement with Waskom whereby Prism Gas purchases product from and supplies product to Waskom. These intercompany transactions totaled approximately $54.4 million for the year ended December 31, 2007. In addition, Prism Gas provides certain administrative services for Waskom pursuant to Waskom s partnership agreement.

Approval and Review of Related Party Transactions

If we contemplate entering into a transaction, other than a routine or in the ordinary course of business transaction, in which a related person will have a direct or indirect material interest, the proposed transaction is submitted for consideration to the board of directors of our general partner or to our management, as appropriate. If the board of directors is involved in the approval process, it determines whether to refer the matter to the Conflicts Committee of our general partner s board of directors, as constituted under our limited partnership agreement. If a matter is referred to the Conflicts Committee, it obtains information regarding the proposed transaction from

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management and determines whether to engage independent legal counsel or an independent financial advisor to advise the members of the committee regarding the transaction. If the Conflicts Committee retains such counsel or financial advisor, it considers such advice and, in the case of a financial advisor, such advisor s opinion as to whether the transaction is fair and reasonable to us and to our unitholders.

Item 14. Principal Accounting Fees and Services

KPMG LLP served as our independent auditors for the fiscal year ended December 31, 2007 and 2006. The following fees were paid to KPMG LLP for services rendered during our last two fiscal years:

	2007	2006
Audit fees	$ 850,000(1)	$ 728,200(2)
Audit related fees	15,175(3)	16,500(3)
Audit and audit related fees	865,175	744,700
Tax fees	101,483(4)	189,000(4)
All other fees		
Total fees	$ 966,658	$ 933,700

(1) 2007 audit fees include fees for the annual integrated audit, the audit of Waskom Gas Processing Company, the audit of Martin Midstream GP LLC, issuance of the comfort letter related to the May 2007 equity offering and the review of registration statements and issuing related consents.

(2) 2006 audit fees include fees for the annual integrated audit, the audit of Waskom Gas Processing

Company, the audit of Martin Midstream GP LLC, issuance of the comfort letter related to the January 2006 equity offering and the review of registration statements and issuing related consents.

(3) Audit related fees include fees for accounting consultations on various transactions occurring in 2007 and 2006.

(4) Tax fees are for services related to review of our partnership K-1 s returns, and research and consultations on other tax related matters.

Under policies and procedures established by the board of directors and the Audit Committee, the Audit Committee is required to pre-approve all audit and non-audit services performed by our independent auditor to ensure that the provisions of such services do not impair the auditor s independence. All of the services described above that were provided by KPMG LLP in years ended December 31, 2007 and December 31, 2006 were approved in advance by the Audit Committee.

PART IV

Item 15. Exhibits and Financial Statement Schedules

(a) Financial Statements and Schedules

(1) The following financial statements of Martin Midstream Partners L.P. and are included in Part II, Item 8:

Reports of Independent Registered Public Accounting Firm

Consolidated Balance Sheets as of December 31, 2007 and 2006

Consolidated Statements of Operations for the years ended December 31, 2007, 2006 and 2005

Consolidated Statements of Changes in Capital for the years ended December 31, 2007, 2006 and 2005

Consolidated Statements of Comprehensive Income for the years ended December 31, 2007 and 2006.

Consolidated Statements of Cash Flows for the years ended December 31, 2007, 2006 and 2005

Notes to the Consolidated Financial Statements

(2) Financial Statements of Waskom Gas Processing Company for the year ended December 31, 2007, an affiliate accounted for by the equity method, which constituted a significant subsidiary.

(b) Exhibits

Reference is made to the Index to Exhibits beginning on page 127 for a list of all exhibits filed as part of this report.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, we have duly caused this Report to be signed on our behalf by the undersigned, thereunto duly authorized representative.

Martin Midstream Partners L.P.
(Registrant)

By: Martin Midstream GP LLC
It s General Partner

Date: March 5, 2008

By: /s/ Ruben S. Martin

Ruben S. Martin
President and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this Report has been signed below by the following persons on behalf of the registrant and in the capacities indicated on the 5th day of March, 2007.

Signature	Title
/s/ Ruben S. Martin Ruben S. Martin	President, Chief Executive Officer and Director of Martin Midstream GP LLC (Principal Executive Officer)
/s/ Robert D. Bondurant Robert D. Bondurant	Executive Vice President and Chief Financial Officer of Martin Midstream GP LLC (Principal Financial Officer)
/s/ Wesley M. Skelton Wesley M. Skelton	Executive Vice President, Chief Administrative Officer, Secretary and Controller of Martin Midstream GP LLC (Principal Accounting Officer)
/s/ Scott D. Martin Scott D. Martin	Director of Martin Midstream GP LLC
/s/ John P. Gaylord John P. Gaylord	Director of Martin Midstream GP LLC
/s/ C. Scott Massey C. Scott Massey	Director of Martin Midstream GP LLC
/s/ Howard Hackney Howard Hackney	Director of Martin Midstream GP LLC

INDEX TO EXHIBITS

Exhibit Number	Exhibit Name
3.1	Certificate of Limited Partnership of Martin Midstream Partners L.P. (the Partnership), dated June 21, 2002 (filed as Exhibit 3.1 to the Partnership s Registration Statement on Form S-1 (Reg. No. 333-91706), filed July 1, 2002, and incorporated herein by reference).
3.2	First Amended and Restated Agreement of Limited Partnership of the Partnership, dated November 6, 2002 (filed as Exhibit 3.1 to the Partnership s Current Report on Form 8-K, filed November 19, 2002, and incorporated herein by reference).
3.3	Amendment No. 1 to First Amended and Restated Agreement of Limited Partnership of Martin Midstream Partners L.P., dated November 1, 2007 (filed as Exhibit 3.1 to the Partnership s Current Report on Form 8-K, filed November 2, 2007, and incorporated herein by reference).
3.4	Certificate of Limited Partnership of Martin Operating Partnership L.P. (the Operating Partnership), dated June 21, 2002 (filed as Exhibit 3.3 to the Partnership s Registration Statement on Form S-1 (Reg. No. 333-91706), filed July 1, 2002, and incorporated herein by reference).
3.5	Amended and Restated Agreement of Limited Partnership of the Operating Partnership, dated November 6, 2002 (filed as Exhibit 3.2 to the Partnership s Current Report on Form 8-K, filed November 19, 2002, and incorporated herein by reference).
3.6	Certificate of Formation of Martin Midstream GP LLC (the General Partner), dated June 21, 2002 (filed as Exhibit 3.5 to the Partnership s Registration Statement on Form S-1 (Reg. No. 333-91706), filed July 1, 2002, and incorporated herein by reference).
3.7	Limited Liability Company Agreement of the General Partner, dated June 21, 2002 (filed as Exhibit 3.6 to the Partnership s Registration Statement on Form S-1 (Red. No. 33-91706), filed July 1, 2002, and incorporated herein by reference).
3.8	Certificate of Formation of Martin Operating GP LLC (the Operating General Partner), dated June 21, 2002 (filed as Exhibit 3.7 to the Partnership s Registration Statement on Form S-1 (Reg. No. 333-91706), filed July 1, 2002, and incorporated herein by reference).
3.9	Limited Liability Company Agreement of the Operating General Partner, dated June 21, 2002 (filed as Exhibit 3.8 to the Partnership s Registration Statement on Form S-1 (Reg. No. 333-91706), filed July 1, 2002, and incorporated herein by reference).
4.1	Specimen Unit Certificate for Common Units (contained in Exhibit 3.2).
4.2	Specimen Unit Certificate for Subordinated Units (filed as Exhibit 4.2 to Amendment No. 4 to the Partnership s Registration Statement on Form S-1 (Reg. No. 333-91706), filed October 25, 2002, and incorporated herein by reference).
10.1	Amended and Restated Credit Agreement, dated October 29, 2004, among the Partnership, the Operating Partnership, Royal Bank of Canada and the other Lenders set forth therein (filed as Exhibit 10.1 to the

Partnership s Current Report on Form 8-K, filed November 11, 2004, and incorporated herein by reference).

10.2	First Amendment to Credit Agreement, dated May 3, 2005, among the Partnership, the Operating Partnership, Royal Bank of Canada and the other Lenders set forth therein (filed as Exhibit 10.1 to the Partnership s Current Report on Form 8-K, filed May 4, 2005, and incorporated herein by reference).
10.3	Second Amendment to Second Amended and Restated Credit Agreement, dated as of December 28, 2007, among the Operating Partnership, the Partnership, the Operating General Partner, Prism Gas Systems I, L.P., Prism Gas Systems GP, L.L.C., Prism Gulf Coast Systems, L.L.C., McLeod Gas Gathering and Processing Company, L.L.C., Woodlawn Pipeline Co., Inc., the financial institution parties to the Credit Agreement and Royal Bank of Canada, as administrative agent and collateral agent. (filed as Exhibit 10.1 to the Partnership s Current Report on Form 8-K, filed January 2, 2008, and incorporated herein by reference).
10.4	Second Amended and Restated Credit Agreement, dated November 10, 2005, among the Partnership, the Operating Partnership, Royal Bank of Canada and the other Lenders set forth therein (filed as Exhibit 10.1 to the Partnership s Current Report on Form 8-K, filed November 14, 2005, and incorporated herein by reference).
10.5	Omnibus Agreement dated November 1, 2002, by and among Martin Resource Management, the General Partner, the Partnership and the Operating Partnership (filed as Exhibit 10.3 to the Partnership s Current Report on Form 8-K, filed November 19, 2002, and incorporated herein by reference).
10.6	Motor Carrier Agreement dated November 1, 2002, by and between the Operating Partnership and Transport (filed as Exhibit 10.4 to the Partnership s Current Report on Form 8-K, filed November 19, 2002, and incorporated herein by reference).

Exhibit Number	Exhibit Name
10.7	Terminal Services Agreement dated November 1, 2002, by and between the Operating Partnership and Martin Gas Sales LLC (MGSLLC) (filed as Exhibit 10.5 to the Partnership s Current Report on Form 8-K, filed November 19, 2002, and incorporated herein by reference).
10.8	Throughput Agreement dated November 1, 2002, by and between MGSLLC and the Operating Partnership (filed as Exhibit 10.6 to the Partnership s Current Report on Form 8-K, filed November 19, 2002, and incorporated herein by reference).
10.9	Contract for Marine Transportation dated November 1, 2002, by and between the Operating Partnership and Martin Resource Management (filed as Exhibit 10.7 to the Partnership s Current Report on Form 8-K, filed November 19, 2002, and incorporated herein by reference).
10.10	Product Storage Agreement dated November 1, 2002, by and between Martin Underground Storage, Inc. and the Operating Partnership (filed as Exhibit 10.8 to the Partnership s Current Report on Form 8-K, filed November 19, 2002, and incorporated herein by reference).
10.11	Marine Fuel Agreement dated November 1, 2002, by and between Martin Fuel Service LLC and the Operating Partnership (filed as Exhibit 10.9 to the Partnership s Current Report on Form 8-K, filed November 19, 2002, and incorporated herein by reference).
10.12	Product Supply Agreement dated November 1, 2002, by and between MGSLLC and the Operating Partnership (filed as Exhibit 10.10 to the Partnership s Current Report on Form 8-K, filed November 19, 2002, and incorporated herein by reference).
10.13	Martin Midstream Partners L.P. Long-Term Incentive Plan (filed as Exhibit 10.11 to the Partnership s Current Report on Form 8-K, filed November 19, 2002, and incorporated herein by reference).
10.14	Martin Midstream Partners L.P. Amended and Restated Long-Term Incentive Plan (filed as Exhibit 10.1 to the Partnership s Current Report on Form 8-K, filed January 26, 2006, and incorporated herein by reference).
10.15	Form of Restricted Common Unit Award Notice (filed as Exhibit 10.2 to the Partnership s Current Report on Form 8-K, filed January 26, 2006, and incorporated herein by reference).
10.16	Assignment and Assumption of Lease and Sublease dated November 1, 2002, by and between the Operating Partnership and MGSLLC (filed as Exhibit 10.12 to the Partnership s Current Report on Form 8-K, filed November 19, 2002, and incorporated herein by reference).
10.17	Purchaser Use Easement, Ingress-Egress Easement, and Utility Facilities Easement dated November 1, 2002, by and between MGSLLC and the Operating Partnership (filed as Exhibit 10.13 to the Partnership s Current Report on Form 8-K, filed November 19, 2002, and incorporated herein by reference).
10.18	Marine Transportation Agreement, by and between the Operating Partnership and Cross Oil Refining & Marketing, Inc., dated October 27, 2003 (filed as Exhibit 10.14 to the Partnership s Quarterly Report of Form 10-Q, filed November 10, 2003, and incorporated herein by reference).

10.19	Terminalling Agreement, by and between the Operating Partnership and Cross Oil Refining & Marketing, Inc., dated October 27, 2003 (filed as Exhibit 10.15 to the Partnership s Quarterly Report of Form 10-Q, filed November 10, 2003, and incorporated herein by reference).
10.20	Asset Purchase Agreement by and among the Partnership, the Operating Partnership and Tesoro Marine Services, L.L.C., dated October 27, 2003 (filed as Exhibit 10.1 to the Partnership s Amendment No. 1 to Current Report on Form 8-K, filed January 23, 2004, and incorporated herein by reference).
10.21	Purchase Agreement by and among the Operating Partnership, Prism Gas Systems I, L.P., Natural Gas Partners V, L.P., Robert E. Dunn, William J. Diehnelt, Gene A. Adams, Philip D. Gettig, Sharon C. Taylor and Scott A. Southard, dated September 6, 2005 (filed as Exhibit 10.1 to the Partnership s Current Report on Form 8-K, filed September 6, 2005, and incorporated herein by reference).
10.22	Amended and Restated Terminal Services Agreement by and between the Operating Partnership and MFSLLC, dated October 27, 2004 (filed as Exhibit 10.1 to the Partnership s Current Report on Form 8-K, filed October 28, 2004, and incorporated herein by reference).
10.23	Transportation Services Agreement by and between the Operating Partnership and MFSLLC, dated December 23, 2003 (filed as Exhibit 10.3 to the Partnership s Amendment No. 1 to Current Report on Form 8-K, filed January 23, 2004, and incorporated herein by reference).
10.24	Lubricants and Drilling Fluids Terminal Services Agreement by and between the Operating Partnership and MFSLLC, dated December 23, 2003 (filed as Exhibit 10.4 to the Partnership s Amendment No. 1 to Current Report on Form 8-K, filed January 23, 2004, and incorporated herein by reference).

Exhibit Number	Exhibit Name
10.25	Martin Resource Management Corporation Purchase Plan for Units of Martin Midstream Partners L.P. (filed as Exhibit 10.1 to the Partnership s registration statement on Form S-8 (Reg. No. 333-140152), filed January 23, 2007, and incorporated herein by reference).
10.26	Stock Purchase Agreement, dated April 27, 2007, by and among Woodlawn Pipeline Co., Inc., Lantern Resources, L.P., David P. Deison and Prism Gas Systems I, L.P. (filed as Exhibit 10.1 to the Partnership s Current Report on Form 8-K, filed May 2, 2007, and incorporated herein by reference).
10.27	Asset Purchase Agreement, dated April 27, 2007, by and among Peak Gas Gathering L.P. and Prism Gas Systems I, L.P. (filed as Exhibit 10.2 to the Partnership s Current Report on Form 8-K, filed May 2, 2007, and incorporated herein by reference).
21.1*	List of Subsidiaries.
23.1*	Consent of KPMG LLP.
23.2*	Consent of KPMG LLP.
23.3*	Consent of KPMG LLP.
31.1*	Certifications of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2*	Certifications of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1*	Certification of Chief Executive Officer pursuant to 18 U.S.C., Section 1350, as adopted pursuant to Section 9.06 of the Sarbanes-Oxley Act of 2002. Pursuant to SEC Release 34-47551, this Exhibit is furnished to the SEC and shall not be deemed to be filed.
32.2*	Certification of Chief Financial Officer pursuant to 18 U.S.C., Section 1350, as adopted pursuant to Section 9.06 of the Sarbanes-Oxley Act of 2002. Pursuant to SEC Release 34-47551, this Exhibit is furnished to the SEC and shall not be deemed to be filed.
99.1*	Balance Sheets as of December 31, 2007 and 2006 (audited) of Martin Midstream GP LLC.

* Filed or furnished herewith.

As required by Item 15(a)(3) of Form 10-K, this exhibit is identified as a compensatory plan or

arrangement.

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Financial Statement Schedule
Pursuant to Item 15(a)(2)

Waskom Gas
Processing Company
Financial Statements as of and for the Year Ended
December 31, 2007 and 2006, (with Independent
Auditors Report Thereon)

INDEPENDENT AUDITORS REPORT

To the Partners of
Waskom Gas Processing Company:

We have audited the accompanying balance sheet of Waskom Gas Processing Company (the Partnership) as of December 31, 2007 and 2006 and the related statement of income, partners capital, and cash flows for the years then ended. These financial statements are the responsibility of the Partnership s management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit also includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Partnership s internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Partnership as of December 31, 2007 and 2006, and the results of its operations and its cash flows for the years then ended December 31, 2007, in conformity with U.S. generally accepted accounting principles.

/s/ KPMG LLP

Shreveport, LA
March 5, 2008

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AS OF DECEMBER 31, 2007 AND 2006

	2007	2006
ASSETS		
CURRENT ASSETS:		
Cash	$ 265,786	$ 324,979
Accounts receivable	613,648	326,753
Accounts receivable partners	9,775,681	11,227,687
Inventories	433,273	436,419
Total current assets	11,088,388	12,315,838
PROPERTY AND EQUIPMENT:		
Gas plant asset and gas gathering equipment	67,931,309	51,331,046
Other fixed assets	584,747	564,736
Accumulated depreciation and amortization	(12,832,563)	(10,952,030)
Net property and equipment	55,683,493	40,943,752
TOTAL	$ 66,771,881	$ 53,259,590
LIABILITIES AND PARTNERS EQUITY		
CURRENT LIABILITIES:		
Accounts payable and accrued liabilities	$ 6,939,543	$ 5,916,140
Accounts payable partners	2,485,286	1,706,545
Total current liabilities	9,424,829	7,622,685
LONG-TERM LIABILITIES Asset retirement obligation	197,740	186,989
COMMITMENTS AND CONTINGENCIES		
PARTNERS CAPITAL	57,149,312	45,449,916
TOTAL	$ 66,771,881	$ 53,259,590

See accompanying notes to financial statements.

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	2007	2006
Natural gas liquid sales	56,494,167	45,884,172
Gain/(loss) on sale of assets	(159,724)	500
Total operating revenues	81,796,586	65,600,521
OPERATING COSTS AND EXPENSES:		
Cost of sales natural gas liquids	53,014,173	42,505,653
Operating costs	4,595,878	4,355,646
Depreciation and amortization	1,925,840	1,493,499
Total operating costs and expenses	59,535,891	48,354,798
OPERATING INCOME BEFORE TAXES	22,260,695	17,245,723
Income tax expense	241,864	
NET INCOME	$ 22,018,831	$ 17,245,723

See accompanying notes to financial statements.

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WASKOM GAS PROCESSING COMPANY
STATEMENT OF PARTNERS CAPITAL
FOR THE YEARS ENDED DECEMBER 31, 2007 AND 2006

	Total Partners Capital
BALANCE December 31, 2005	$ 22,649,871
Cash contributions for capital expenditures	19,980,733
Cash contributions for working capital	2,494,939
Cash distributions	(300,000)
Distributions in-kind	(16,621,349)
Net income	17,245,723
BALANCE December 31, 2006	45,449,916
Cash contributions for capital expenditures	17,733,619
Cash distributions in excess of working capital	(4,128,057)
Cash distributions	(5,250,000)
Distributions in-kind	(18,674,997)
Net income	22,018,831
BALANCE December 31, 2007	$ 57,149,312

See accompanying notes to financial statements.

WASKOM GAS PROCESSING COMPANY
STATEMENT OF CASH FLOWS
FOR THE YEAR ENDED DECEMBER 31, 2007 AND 2006

	2007	2006
OPERATING ACTIVITIES:		
Net income	$ 22,018,831	$ 17,245,723
Adjustments to reconcile net income to cash used in operating activities:		
Depreciation and amortization	1,925,840	1,493,499
Distributions in-kind to partners	(18,674,997)	(16,621,349)
Loss/(Gain) on sale of asset	159,724	(500)
Changes in operating assets and liabilities:		
Accounts receivable	(286,895)	(391,548)
Accounts receivable partners	1,452,006	(5,560,870)
Inventory	3,146	(412,779)
Accounts payable and accrued liabilites	1,023,403	805,279
Accounts payable partners	778,741	1,275,364
Net cash provided by operating activities	8,399,799	(2,167,181)
INVESTING ACTIVITIES:		
Additions to gas plant and gathering system assets	(16,809,743)	(20,834,411)
Additions to other fixed assets	(20,011)	
Proceeds from sale of an asset	15,200	500
Net cash used in investing activities	(16,814,554)	(20,833,911)
FINANCING ACTIVITIES:		
Contributions from partners	17,733,619	22,475,672
Distributions to partners	(9,378,057)	(300,000)
Net cash provided by financing activities	8,355,562	22,175,672
NET DECREASE IN CASH	(59,193)	(825,420)
CASH Beginning of year	324,979	1,150,399
CASH End of year	$ 265,786	$ 324,979
SUPPLEMENTAL CASH FLOW DISCLOSURES:		
Interest paid	$	$

Taxes paid	$	$

See accompanying notes to financial statements.
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WASKOM GAS PROCESSING COMPANY
NOTES TO FINANCIAL STATEMENTS
AS OF AND FOR THE YEAR ENDED DECEMBER 31, 2007 AND 2006

1. NATURE OF BUSINESS

Waskom Gas Processing Company (the Partnership), a Texas General Partnership, was formed on November 1, 1995 to construct and operate the Waskom Processing Plant (the Plant). As of December 31, 2007 the partners are CenterPoint Energy Gas Processing Company (50%) and Prism Gas Systems I, L.P. (50%). Prism Gas Systems I, L.P. serves as operator. The Partnership is engaged in the processing and marketing of natural gas and natural gas liquids (NGL s), predominantly in Texas and northwest Louisiana. The Plant is a 250 MMcfd cryogenic turboexpander gas plant located in Harrison County, Texas. The Plant has full NGL fractionation, treating and stabilization capabilities. Fractionation is a process used to separate the mixture of NGL s into individual products for sale. Expansions to the processing plant were completed in March and June of 2007 increasing the capacity from 150 MMcfd to 250 MMcfd. In January 2007 the Waskom fractionator was expanded to a capacity of 12,500 barrels per day from 9,500 barrels per day. In addition, an increase in the processing capacity of the plant to 265 MMCfd is expected to be completed by the end of the second quarter 2008.

The natural gas supply for the Plant is derived primarily from natural gas wells located in the Cotton Valley formation of East Texas and Northwest Louisiana.

The primary suppliers of natural gas to the Plant include BP American Production Company, Centerpoint Energy Gas Transmission Company and Devon Energy Corporation, which collectively represent approximately 72% of the 229 MMcfd of natural gas supplied for the year ended December 31, 2007 and 61% of the 183 MMcfd of natural gas supplied for the year ended December 31, 2006. The Partnership s processing contracts are predominately percent-of-liquids (POL) contracts, in which the Partnership retains a portion of the NGL s recovered as a processing fee. The Partnership also operates under percent-of-proceeds (POP) contracts in which it retains a portion of both the residue gas and the NGL s as payment for services. There is currently one contract for processing on a keep-whole basis. The Partnership is not contractually required to process these keep-whole volumes and, therefore, only processes natural gas related to these contracts under profitable conditions.

Sales of third party gas and fractionated NGL s are predominately to the partners and occur at the tailgate of the Plant.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Accounts Receivable Accounts receivable include trade receivables, recorded at invoiced amounts.

Property and Equipment Property and equipment are stated at cost and depreciated using the straight-line method over the estimated useful lives of the classes of assets, as follows:

	Years
Gas gathering equipment	10
Gas plant	20
Furniture and fixtures	1
Computer equipment	3
Computer software	3

Depreciation expense was $1,915,089 in 2007 and $1,483,332 in 2006. Repairs and maintenance are charged to operations as incurred. Renewals and betterments are capitalized. ***Inventories*** Substantially all inventory at December 31, 2007 and 2006 represents pipe used for future projects. Such pipe was valued at acquisition cost.

Asset Retirement Obligations Under SFAS No. 143, Accounting for Asset Retirement Obligations (Statement No. 143) which provides accounting requirements for costs associated with legal obligations to

retire tangible, long-lived assets, the Partnership records as an offset to the Asset Retirement Obligation (ARO), an asset at fair value in the period in which it is incurred by increasing the carrying amount of the related long-lived asset. In each subsequent period, the liability is accreted over time towards the ultimate obligation amount and the capitalized costs are depreciated over the useful life of the related asset. The Partnership asset retirement obligations include, purging, plugging and remediation costs. Accretion expense for 2007 and 2006 was $10,751 and $10,167, respectively.

Financial Accounting Standards Board issued Interpretation No. 47, Accounting for Conditional Asset Retirement Obligations (FIN 47), an interpretation of SFAS 143 clarifies that the recognition and measurement provisions of SFAS 143 apply to asset retirement obligations in which the timing or method of settlement may be conditional on a future event that may or may not be within the control of the entity. No conditional asset retirement obligations associated with the Partnership s long-lived assets have been identified.

Impairment of Long-Lived Assets In accordance with SFAS No. 144, long-lived assets, such as property, plant and equipment, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset.

Revenue Recognition Revenues are recognized when title passes or service is performed. The Partnership s business consists largely of the ownership and operation of physical assets. End sales from these businesses result in physical deliveries of commodities.

Federal Income Taxes The Partnership is a Texas General Partnership and as such has no liability for Federal Income Taxes. Each partner is responsible for its share of federal income tax. On May 18, 2006, the Texas Governor signed into law a Texas margin tax (H.B. No. 3) which restructures the state business tax by replacing the taxable capital and earned surplus components of the current franchise tax with a new taxable margin component. Since the tax base on the Texas margin tax is derived from an income-based measure, the margin tax is construed as an income tax and, therefore, the provisions of SFAS 109 regarding the recognition of deferred taxes apply to the new margin tax. In accordance with SFAS 109, the effect on deferred tax assets of a change in tax law should be included in tax expense attributable to continuing operations in the period that includes the enactment date. Therefore, the Partnership has calculated its deferred tax assets and liabilities for Texas based on the new margin tax. The cumulative effect of the change was immaterial. The impact of the change in deferred tax assets does not have a material impact on tax expense. Texas margin tax expense for 2007 was $241,864. There was no income tax expense recorded for the year ended December 31, 2006.

Environmental Liabilities The Partnership s policy is to accrue for losses associated with environmental remediation obligations when such losses are probably and reasonably estimable. Accruals for estimated losses for environmental remediation obligations generally are recognized no later than completion of the remedial feasibility study. Such accruals are adjusted as further information develops or circumstances change. Costs of future expenditures for environmental remediation obligations are not discounted to their present value.

Use of Estimates The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts at the date of the financial statements and the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities, revenues and expenses during the reporting period. Actual results could differ from those estimates.

Recently Issued Accounting Pronouncements In September 2006, the FASB issued SFAS No. 157 (SFAS 157), Fair Value Measurements, which defines fair value, establishes guidelines for measuring fair value and expands disclosures regarding fair value measurements. SFAS 157 does not require any new fair value measurements but rather eliminates inconsistencies in guidance found in various prior accounting pronouncements. SFAS 157 is effective for fiscal years beginning after November 15, 2007. However, on December 14, 2007, the FASB issued proposed FSP FAS 157-b which would delay the effective date of SFAS 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a

recurring basis (at least annually). This proposed FSP partially defers the effective date of Statement 157 to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years for items within the scope of this FSP. Effective for fiscal 2008, we will adopt SFAS 157 except as it applies to those nonfinancial assets and nonfinancial liabilities as noted in proposed FSP FAS 157-

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b. The partial adoption of SFAS 157 will not have a material impact on our consolidated financial position, results of operations or cash flows.

In July 2006, the Financial Account Standards Board (FASB) issued FASB Interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes . FIN 48 is an interpretation of FASB Statement No. 109, Accounting for Income Taxes . FIN 48 prescribes a comprehensive model for recognizing, measuring, presenting and disclosing in the financial statements uncertain tax positions taken or expected to be taken. The Partnership adopted FIN 48 effective January 1, 2007. There was no impact to the Partnership s financial statements as a result of adopting FIN 48.

3. RELATED-PARTY TRANSACTIONS

During 2007 and 2006, the Partnership engaged in certain material transactions with the partners. The Partnership believes that the terms of these transactions were comparable to those that could have been negotiated with unrelated third parties. As of December 31, 2007 and 2006, the Partnership had receivables of approximately $9.8 million and $11.2 million, respectively, and payables of approximately $2.5 million and $1.7 million, respectively, due from and due to the partners. Per the Partnership agreement, cash contributions are made by the partners for capital expenditures and working capital. Contributions for capital expenditures totaled $17,733,619 and $19,980,733 for 2007 and 2006, respectively. Cash contributions for working capital totaled $2,494,939 in 2006. The partnership agreement allows for cash distributions to be made to the partners of any cash available in excess of working capital requirements, generally equal to two months of historical operating expenses. Such cash distributions totaled $4,128,057 in 2007. Other cash distributions totaled $5,250,000 and $300,000 for 2007 and 2006, respectively. The Partnership purchases gas from third party producers and processes this gas based on processing contracts, which are primarily percent-of-liquids (POL) contracts. The percentage of liquids retained by the Partnership is distributed to the partners as distributions of products-in-kind based on the partners equity interest. Distributions of products in-kind of $18,674,997 and $16,621,349 in 2007 and 2006, respectively, were made to the partners. Distributions of products in-kind are valued at prevailing market prices at the time of distribution. In some instances, the fractionated NGL s (less any retained portions) are returned to the third party producers, but in most cases, the third party producers enter into agreements with the partners to market their product. In such instances, the Partnership will sell the product to the partners. Such sales amounted to $53,365,845 and $43,678,571 in 2007 and 2006, respectively, and are included as natural gas liquid sales in the income statement.

4. COMMITMENTS AND CONTINGENCIES

The Partnership is subject to extensive federal, state and local environmental laws and regulations. These laws, which are constantly changing, regulate the discharge of materials into the environment and may require the Partnership to remove or mitigate the environmental effects of the disposal or release of petroleum or chemical substances at various sites. Environmental expenditures are expensed or capitalized depending on their future economic benefit. Expenditures that relate to an existing condition caused by past operations and that have no future economic benefits are expensed. Liabilities for expenditures of a noncapital nature are recorded when environmental assessment and/or remediation is probable, and the costs can be reasonably estimated. Management believes that any future costs should not have a material adverse effect on the Partnership s liquidity or financial position.

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