LEGACY RESERVES LP
Form 10-Q
October 31, 2012

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

S QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE

SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2012

or

£ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE

SECURITIES EXCHANGE ACT OF 1934

For the transition period from to

Commission File Number 1-33249

Legacy Reserves LP
(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	16-1751069 (I.R.S. Employer Identification No.)
303 W. Wall, Suite 1400 Midland, Texas (Address of principal executive offices)	79701 (Zip code)

(432) 689-5200
(Registrant’s telephone number, including area code)

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

x Yes o No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

x Yes £ No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer x	Accelerated filer o
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

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

48,099,419 units representing limited partner interests in the registrant were outstanding as of October 30, 2012.

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GLOSSARY OF TERMS

Bbl. One stock tank barrel or 42 U.S. gallons liquid volume.

Bcf. Billion cubic feet.

Boe. One barrel of oil equivalent, determined using a ratio of six Mcf of natural gas to one Bbl of crude oil, condensate or natural gas liquids.

Boe/d. Barrels of oil equivalent per day.

Btu. British thermal unit, which is the heat required to raise the temperature of a one-pound mass of water from 58.5 to 59.5 degrees Fahrenheit.

Developed acreage. The number of acres that are allocated or assignable to productive wells or wells capable of production.

Development project. A drilling or other project which may target proven reserves, but which generally has a lower risk than that associated with exploration projects.

Development well. A well drilled within the proved area of an oil or natural gas reservoir to the depth of a stratigraphic horizon known to be productive.

Dry hole or well. A well found to be incapable of producing hydrocarbons in sufficient quantities such that proceeds from the sale of such production would exceed production expenses and taxes.

Field. An area consisting of a single reservoir or multiple reservoirs all grouped on or related to the same individual geological structural feature and/or stratigraphic condition.

Gross acres or gross wells. The total acres or wells, as the case may be, in which a working interest is owned.

Hydrocarbons. Oil, NGL and natural gas are all collectively considered hydrocarbons.

Liquids. Oil and NGLs.

MBbls. One thousand barrels of crude oil or other liquid hydrocarbons.

MBoe. One thousand barrels of crude oil equivalent, using a ratio of six Mcf of natural gas to one Bbl of crude oil, condensate or natural gas liquids.

Mcf. One thousand cubic feet.

MGal. One thousand gallons of natural gas liquids or other liquid hydrocarbons.

MMBbls. One million barrels of crude oil or other liquid hydrocarbons.

MMBoe. One million barrels of crude oil equivalent, using a ratio of six Mcf of natural gas to one Bbl of crude oil, condensate or natural gas liquids.

MMBtu. One million British thermal units.

MMcf. One million cubic feet.

Net acres or net wells. The sum of the fractional working interests owned in gross acres or gross wells, as the case may be.

NGL or natural gas liquids. The combination of ethane, propane, butane and natural gasolines that when removed from natural gas become liquid under various levels of higher pressure and lower temperature.

NYMEX. New York Mercantile Exchange.

Oil. Crude oil and condensate.

Productive well. A well that is found to be capable of producing hydrocarbons in sufficient quantities such that proceeds from the sale of such production exceed production expenses and taxes.

Proved developed reserves. Reserves that can be expected to be recovered through existing wells with existing equipment and operating methods. Additional oil and natural gas expected to be obtained through the application of fluid injection or other improved recovery techniques for supplementing the natural forces and mechanisms of primary recovery are included in “proved developed reserves” only after testing by a pilot project or after the operation of an installed program has confirmed through production response that increased recovery will be achieved.

Proved developed non-producing or PDNPs. Proved oil and natural gas reserves that are developed behind pipe, shut-in or that can be recovered through improved recovery only after the necessary equipment has been installed, or when the costs to do so are relatively minor. Shut-in reserves are expected to be recovered from (1) completion intervals which are open at the time of the estimate but which have not started producing, (2) wells that were shut-in for market conditions or pipeline connections, or (3) wells not capable of production for mechanical reasons. Behind-pipe reserves are expected to be recovered from zones in existing wells that will require additional completion work or future re-completion prior to the start of production.

Proved reserves. Proved oil and gas reserves are those quantities of oil and gas, which by analysis of geoscience and engineering data, can be estimated with reasonable certainty to be economically producible—from a given date forward, from known reservoirs, and under existing economic conditions, operating methods, and government regulations—prior to the time at which contracts providing the right to operate expire, unless evidence indicates that renewal is reasonably certain, regardless of whether deterministic or probabilistic methods are used for the estimation.

Proved undeveloped drilling location. A site on which a development well can be drilled consistent with spacing rules for purposes of recovering proved undeveloped reserves.

Proved undeveloped reserves or PUDs. Proved oil and natural gas reserves that are expected to be recovered from new wells on undrilled acreage or from existing wells where a relatively major expenditure is required for re-completion. Reserves on undrilled acreage are limited to those drilling units offsetting productive units that are reasonably certain of production when drilled. Proved reserves for other undrilled units are claimed only where it can be demonstrated with certainty that there is continuity of production from the existing productive formation. Estimates for proved undeveloped reserves are not attributed to any acreage for which an application of fluid injection or other improved recovery technique is contemplated, unless such techniques have been proven effective by actual tests in the area and in the same reservoir.

Re-completion. The completion for production of an existing wellbore in another formation from that which the well has been previously completed.

Reserve acquisition cost. The total consideration paid for an oil and natural gas property or set of properties, which includes the cash purchase price and any value ascribed to units issued to a seller adjusted for any post-closing items.

R/P ratio (reserve life). The reserves as of the end of a period divided by the production volumes for the same period.

Reserve replacement. The replacement of oil and natural gas produced with reserve additions from acquisitions, reserve additions and reserve revisions.

Reserve replacement cost. An amount per Boe equal to the sum of costs incurred relating to oil and natural gas property acquisition, exploitation, development and exploration activities (as reflected in our year-end financial statements for the relevant year) divided by the sum of all additions and revisions to estimated proved reserves, including reserve purchases. The calculation of reserve additions for each year is based upon the reserve report of our independent engineers. Management uses reserve replacement cost to compare our company to others in terms of our historical ability to increase our reserve base in an economic manner. However, past performance does not necessarily reflect future reserve replacement cost performance. For example, increases in oil and natural gas prices in recent years have increased the economic life of reserves, adding additional reserves with no required capital expenditures. On the other hand, increases in oil and natural gas prices have increased the cost of reserve purchases and reserves added through development projects. The reserve replacement cost may not be indicative of the economic value added of the reserves due to differing lease operating expenses per barrel and differing timing of production.

Reservoir. A porous and permeable underground formation containing a natural accumulation of producible oil and/or natural gas that is confined by impermeable rock or water barriers and is individual and separate from other reserves.

Standardized measure. The present value of estimated future net revenues to be generated from the production of proved reserves, determined in accordance with assumptions required by the Financial Accounting Standards Board and the Securities and Exchange Commission (using the average annual prices based on the un-weighted arithmetic average of the first-day-of-the-month price for each month) without giving effect to non-property related expenses such as general and administrative expenses, debt service and future income tax expenses or to depreciation, depletion and amortization and discounted using an annual discount rate of 10%. Because we are a limited partnership that allocates our taxable income to our unitholders, no provisions for federal or state income taxes have been provided for in the calculation of standardized measure. Standardized measure does not give effect to derivative transactions.

Undeveloped acreage. Lease acreage on which wells have not been drilled or completed to a point that would permit the production of commercial quantities of oil and natural gas regardless of whether such acreage contains proved reserves.

Working interest. The operating interest that gives the owner the right to drill, produce and conduct operating activities on the property and a share of production.

Workover. Operations on a producing well to restore or increase production.

Part I – FINANCIAL INFORMATION

Item 1. Financial Statements.

LEGACY RESERVES LP
CONDENSED CONSOLIDATED BALANCE SHEETS
(UNAUDITED)
ASSETS

	September 30, 2012	December 31, 2011
	(In thousands)	
Current assets:		
Cash and cash equivalents	$4,366	$3,151
Accounts receivable, net:		
Oil and natural gas	35,161	35,489
Joint interest owners	13,322	10,299
Other	394	204
Fair value of derivatives (Notes 5 and 6)	9,633	7,117
Prepaid expenses and other current assets	4,144	3,525
Total current assets	67,020	59,785
Oil and natural gas properties, at cost:		
Proved oil and natural gas properties using the successful efforts method of accounting	1,544,197	1,389,326
Unproved properties	28,746	20,063
Accumulated depletion, depreciation, amortization and impairment	(531,184)	(450,060)
	1,041,759	959,329
Other property and equipment, net of accumulated depreciation and amortization of $4,306 and $3,530, respectively	2,726	3,310
Deposits on pending acquisitions	930	—
Operating rights, net of amortization of $3,407 and $3,034, respectively	3,610	3,983
Fair value of derivatives (Notes 5 and 6)	19,950	10,188
Other assets, net of amortization of $7,480 and $6,337, respectively	5,930	6,611
Investment in equity method investee	369	282
Total assets	$1,142,294	$1,043,488

See accompanying notes to condensed consolidated financial statements.

LEGACY RESERVES LP
CONDENSED CONSOLIDATED BALANCE SHEETS
(UNAUDITED)
LIABILITIES AND UNITHOLDERS' EQUITY

	September 30, 2012	December 31, 2011
	(In thousands)	
Current liabilities:		
Accounts payable	$6,224	$3,286
Accrued oil and natural gas liabilities (Note 1)	52,262	45,351
Fair value of derivatives (Notes 5 and 6)	9,024	18,905
Asset retirement obligation (Note 7)	22,158	20,262
Other (Note 9)	8,596	9,646
Total current liabilities	98,264	97,450
Long-term debt (Note 2)	452,000	337,000
Asset retirement obligation (Note 7)	105,490	100,012
Fair value of derivatives (Notes 5 and 6)	7,932	18,897
Other long-term liabilities	1,628	1,794
Total liabilities	665,314	555,153
Commitments and contingencies (Note 4)		
Unitholders' equity:		
Limited partners' equity - 47,868,942 and 47,801,682 units issued and outstanding at September 30, 2012 and December 31, 2011, respectively	476,883	488,264
General partner's equity (approximately 0.04%)	97	71
Total unitholders' equity	476,980	488,335
Total liabilities and unitholders' equity	$1,142,294	$1,043,488

See accompanying notes to condensed consolidated financial statements.

LEGACY RESERVES LP
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(In thousands, except per unit data)			
Revenues:				
Oil sales	$70,173	$63,387	$212,097	$196,220
Natural gas liquids (NGL) sales	3,492	4,924	10,742	13,896
Natural gas sales	10,531	16,061	33,166	39,858
Total revenues	84,196	84,372	256,005	249,974
Expenses:				
Oil and natural gas production	30,728	24,109	82,023	71,304
Production and other taxes	5,137	5,211	15,040	15,101
General and administrative	6,993	3,817	18,604	14,630
Depletion, depreciation, amortization and accretion	24,833	22,446	73,042	64,152
Impairment of long-lived assets	7,277	4,678	22,556	5,869
(Gain) loss on disposal of assets	260	(35)	(3,064)	(680)
Total expenses	75,228	60,226	208,201	170,376
Operating income	8,968	24,146	47,804	79,598
Other income (expense):				
Interest income	3	5	11	12
Interest expense (Notes 2, 5 and 6)	(5,285)	(5,764)	(14,256)	(15,633)
Equity in income of partnership	30	35	87	107
Realized and unrealized net gains (losses) on commodity derivatives (Notes 5 and 6)	(27,177)	107,603	34,084	67,753
Other	(51)	3	(87)	(55)
Income (loss) before income taxes	(23,512)	126,028	67,643	131,782
Income tax expense	(54)	(928)	(878)	(1,198)
Net income (loss)	$(23,566)	$125,100	$66,765	$130,584
Income (loss) per unit - basic and diluted (Note 8)	$(0.49)	$2.87	$1.40	$3.00
Weighted average number of units used in computing net income (loss) per unit -				
Basic	47,869	43,587	47,840	43,560
Diluted	47,869	43,607	47,840	43,572

See accompanying notes to condensed consolidated financial statements.

LEGACY RESERVES LP
CONDENSED CONSOLIDATED STATEMENTS OF UNITHOLDERS' EQUITY
FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2012
(UNAUDITED)

	Number of Limited Partner Units (In thousands)	Limited Partner	General Partner	Total Unitholders' Equity
Balance, December 31, 2011	47,802	$488,264	$71	$488,335
Units issued to Legacy Board of Directors for services	17	497	—	497
Compensation expense on restricted unit awards issued to employees	—	1,229	—	1,229
Vesting of restricted units	50	—	—	—
Offering costs associated with the issuance of units	—	(2)	—	(2)
Distributions to unitholders, $1.665 per unit	—	(79,844)	—	(79,844)
Net income	—	66,739	26	66,765
Balance, September 30, 2012	47,869	$476,883	$97	$476,980

See accompanying notes to condensed consolidated financial statements.

LEGACY RESERVES LP
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	Nine Months Ended September 30,	
	2012	2011
	(In thousands)	
Cash flows from operating activities:		
Net income	$66,765	$130,584
Adjustments to reconcile net income to net cash provided by operating activities:		
Depletion, depreciation, amortization and accretion	73,042	64,152
Amortization of debt issuance costs	1,143	1,160
Impairment of long-lived assets	22,556	5,869
Gains on derivatives	(35,141)	(67,556)
Equity in income of partnership	(87)	(107)
Unit-based compensation	333	(410)
Gain on disposal of assets	(3,064)	(680)
Changes in assets and liabilities:		
(Increase) decrease in accounts receivable, oil and natural gas	328	(6,647)
Increase in accounts receivable, joint interest owners	(3,023)	(7,320)
Increase in accounts receivable, other	(190)	(146)
Increase in other assets	(619)	(1,508)
Increase in accounts payable	2,938	7,153
Increase in accrued oil and natural gas liabilities	6,911	21,140
Decrease in other liabilities	(2,453)	(1,512)
Total adjustments	62,674	13,588
Net cash provided by operating activities	129,439	144,172
Cash flows from investing activities:		
Investment in oil and natural gas properties	(164,322)	(147,528)
Increase in deposits on pending acquisitions	(930)	(2,638)
Proceeds from sale of assets	9,102	—
Investment in other equipment	(1,014)	(775)
Goodwill	(7,770)	—
Net cash settlements on commodity derivatives	2,018	(3,765)
Net cash used in investing activities	(162,916)	(154,706)
Cash flows from financing activities:		
Proceeds from long-term debt	335,000	267,000
Payments of long-term debt	(220,000)	(186,000)
Payments of debt issuance costs	(462)	(5,034)
Offering costs associated with the issuance of units	(2)	2,283
Distributions to unitholders	(79,844)	(69,588)
Net cash provided by financing activities	34,692	8,661
Net increase (decrease) in cash and cash equivalents	1,215	(1,873)
Cash and cash equivalents, beginning of period	3,151	3,478
Cash and cash equivalents, end of period	$4,366	$1,605

Non-cash investing and financing activities:

Asset retirement obligation costs and liabilities	$—	$(592)
Asset retirement obligations associated with property acquisitions	$6,036	$4,688

See accompanying notes to condensed consolidated financial statements.

LEGACY RESERVES LP
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

(1) Summary of Significant Accounting Policies

(a) Organization, Basis of Presentation and Description of Business

Legacy Reserves LP and its affiliated entities are referred to as Legacy, LRLP or the Partnership in these financial statements.

The accompanying condensed consolidated financial statements have been prepared on the accrual basis of accounting whereby revenues are recognized when earned, and expenses are recognized when incurred. These condensed consolidated financial statements as of September 30, 2012 and for the three and nine months ended September 30, 2012 and 2011 are unaudited. In the opinion of management, such financial statements include the adjustments and accruals, all of which are of a normal recurring nature, which are necessary for a fair presentation of the results for the interim periods. These interim results are not necessarily indicative of results for a full year.

Certain information and footnote disclosures normally included in the financial statements prepared in accordance with generally accepted accounting principles in the United States (“GAAP”) have been condensed or omitted in this Form 10-Q pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”). These condensed consolidated financial statements should be read in connection with the consolidated financial statements and notes thereto included in the Partnership’s Annual Report on Form 10-K for the year ended December 31, 2011.

LRLP, a Delaware limited partnership, was formed by its general partner, Legacy Reserves GP, LLC (“LRGPLLC”), on October 26, 2005 to own and operate oil and natural gas properties. LRGPLLC is a Delaware limited liability company formed on October 26, 2005, and owns an approximate 0.04% general partner interest in LRLP.

Significant information regarding rights of the limited partners includes the following:

- Right to receive, within 45 days after the end of each quarter, distributions of available cash, if distributions are declared.

- No limited partner shall have any management power over LRLP’s business and affairs; the general partner shall conduct, direct and manage LRLP’s activities.

- The general partner may be removed if such removal is approved by the unitholders holding at least 66 2/3 percent of the outstanding units, including units held by LRLP’s general partner and its affiliates, provided that a unit majority has elected a successor general partner.

- Right to receive information reasonably required for tax reporting purposes within 90 days after the close of the calendar year.

In the event of liquidation, all property and cash in excess of that required to discharge all liabilities will be distributed to the unitholders and LRLP’s general partner in proportion to their capital account balances, as adjusted to reflect any gain or loss upon the sale or other disposition of Legacy’s assets in liquidation.

Legacy owns and operates oil and natural gas producing properties located primarily in the Permian Basin (West Texas and Southeast New Mexico), Mid-Continent and Rocky Mountain regions of the United States. Legacy has

acquired oil and natural gas producing properties and undrilled leaseholds.

(b) Accrued Oil and Natural Gas Liabilities

Below are the components of accrued oil and natural gas liabilities as of September 30, 2012 and December 31, 2011.

	September 30, 2012	December 31, 2011
	(In thousands)	
Revenue payable to joint interest owners	$19,086	$19,972
Accrued lease operating expense	8,455	8,004
Accrued capital expenditures	8,488	6,920
Accrued ad valorem tax	12,136	5,171
Other	4,097	5,284
	$52,262	$45,351

(2) Credit Facility

Previous Credit Agreement: On March 27, 2009, Legacy entered into a three-year secured revolving credit facility with BNP Paribas as administrative agent (the “Previous Credit Agreement”). Borrowings under the Previous Credit Agreement were set to mature on April 1, 2012. The Previous Credit Agreement permitted borrowings in the lesser amount of (i) the borrowing base, or (ii) $600 million. The borrowing base under the Previous Credit Agreement, initially set at $340 million, was increased to $410 million on March 31, 2010. Under the Previous Credit Agreement, interest on debt outstanding was charged based on Legacy’s selection of a LIBOR rate plus 2.25% to 3.0%, or the alternate base rate (“ABR”) which equaled the highest of the prime rate, the Federal funds effective rate plus 0.50% or LIBOR plus 1.50%, plus an applicable margin between 0.75% and 1.50%.

Current Credit Agreement: On March 10, 2011, Legacy entered into an amended and restated five-year $1 billion secured revolving credit facility with BNP Paribas as administrative agent (the "Current Credit Agreement"). Effective April 20, 2012, Wells Fargo Bank, National Association ("Wells Fargo"), replaced BNP Paribas as administrative agent as a result of the sale of BNP Paribas' energy lending practice to Wells Fargo. Borrowings under the Current Credit Agreement mature on March 10, 2016. The amount available for borrowing at any one time is limited to the borrowing base with a $2 million sub-limit for letters of credit. The borrowing base under the Current Credit Agreement was redetermined and increased to $595 million on September 28, 2012, and was further increased to $600 million on October 1, 2012 upon the closing of an individually immaterial acquisition of oil and natural gas properties. The borrowing base is subject to semi-annual re-determinations on or around April 1 and October 1 of each year. Additionally, either Legacy or the lenders may, once during each calendar year, elect to re-determine the borrowing base between scheduled re-determinations. Legacy also has the right, once during each calendar year, to request the re-determination of the borrowing base upon the proposed acquisition of certain oil and natural gas properties where the purchase price is greater than 10% of the borrowing base. Under the Current Credit Agreement, interest on debt outstanding is charged based on Legacy's selection of a one-, two-, three- or six-month LIBOR rate plus 1.75% to 2.75%, or the ABR which equals the highest of the prime rate, the Federal funds effective rate plus 0.50% or one-month LIBOR plus 1.00%, plus an applicable margin from 0.75% to 1.75% per annum, determined by the percentage of the borrowing base then in effect that is drawn.

The borrowing base permits Legacy to issue up to $500 million in aggregate principal amount of senior notes or new debt issued to refinance senior notes, subject to specified conditions in the Current Credit Agreement, which include that upon the issuance of such senior notes or new debt, the borrowing base will be reduced by an amount equal to (i) in the case of senior notes, 25% of the stated principal amount of the senior notes and (ii) in the case of new debt, 25% of the portion of the new debt that exceeds the original principal amount of the senior notes.

As of September 30, 2012, Legacy had outstanding borrowings of $452 million at a weighted-average interest rate of 2.73% and approximately $142.9 million of availability remaining under the Current Credit Agreement. For the nine-month period ended September 30, 2012, Legacy paid in cash $9.1 million of interest expense on the Current

Credit Agreement. Legacy’s Current Credit Agreement also contains covenants that, among other things, require us to maintain specified ratios or conditions as follows:

- total debt as of the last day of the most recent quarter to EBITDA (as defined in the Current Credit Agreement) in total over the last four quarters of not more than 4.0 to 1.0; and

- consolidated current assets, as of the last day of the most recent quarter and including the unused amount of the total commitments, to consolidated current liabilities as of the last day of the most recent quarter of not less than 1.0 to 1.0,

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excluding non-cash assets and liabilities under ASC 815, which includes the current portion of oil, natural gas and interest rate derivatives.

At September 30, 2012, Legacy was in compliance with all covenants of the Current Credit Agreement.

(3) Related Party Transactions

Cary D. Brown, Chairman, President and Chief Executive Officer of Legacy's general partner, and Kyle A. McGraw, Director, Executive Vice President and Chief Development Officer of Legacy's general partner, own partnership interests in entities which, in turn, own a combined non-controlling 4.16% interest as limited partners in the partnership which owns the building that Legacy occupies. Monthly rent is $33,462, without respect to property taxes, insurance and operating expenses. The lease expires in September 2015.

Legacy uses Lynch, Chappell and Alsup for some of its legal services. Alan Brown, son of Dale Brown, a director of Legacy, and brother of Cary D. Brown, was a less than ten percent shareholder in this firm until he resigned from his position on September 1, 2011. Legacy paid legal fees, during Alan Brown's tenure, to this firm of $109,881 for the nine months ended September 30, 2011.

During the nine months ended September 30, 2012, Legacy acquired a 5% working interest in approximately 129,428 acres of prospective Cline Shale acreage from FireWheel Energy, LLC ("FireWheel"), the operator of the properties, for $7.2 million. FireWheel is a private-equity funded oil and natural gas exploration company in which Alan Brown is a principal. The interests acquired by Legacy were marketed to numerous industry participants and are governed by an industry standard Participation Agreement and Joint Operating Agreement.

(4) Commitments and Contingencies

From time to time Legacy is a party to various legal proceedings arising in the ordinary course of business. While the outcome of lawsuits cannot be predicted with certainty, except as discussed below, Legacy is not currently a party to any proceeding that it believes could have a potential material adverse effect on its financial condition, results of operations or cash flows.

On April 15, 2011, the Eleventh Court of Appeals (Case No. 11-09-00348-CV), in an appeal styled Raven Resources, LLC, Appellant v. Legacy Reserves Operating, LP, Appellee, on appeal from the 385th District Court, Midland County, Texas, reversed and rendered in part and reversed and remanded in part the trial court’s summary judgment, dated November 10, 2009 (Cause No. CV 46609) (the "Trial Court Summary Judgment"), in favor of Legacy Reserves Operating LP ("Legacy Operating"), a subsidiary of Legacy Reserves LP. As set forth below, on March 15, 2012, the Court of Appeals affirmed the Trial Court Summary Judgment in favor of Legacy Operating.

In its original petition to the trial court, filed August 15, 2008, Raven Resources, LLC ("Raven") had sought, among other things, a declaratory judgment that the purchase agreement dated July 11, 2007 (the "PSA") providing for the purchase by Legacy Operating of various non-operated oil and natural gas properties and interests primarily in the Permian Basin for $20.3 million, subject to adjustment, was void, as a matter of law, alleging an employee of Raven had forged the signature of David Stewart, Raven's managing member. Raven also asked the trial court to rescind the transaction, and to account for all proceeds received by Legacy Operating since the properties were originally conveyed. Further, Raven alleged that Legacy Operating had failed to pay the full purchase price for the properties as David Stewart had allegedly only been aware of a June 27, 2007 draft of a purchase agreement, which provided for a $26.6 million purchase price, whereas the PSA, following property due diligence and reducing the list of properties to be purchased, contained a reduced purchase price of $20.3 million. Raven alleged that David Stewart, despite having signed 35 assignments incorporating the PSA as well as a certificate acknowledging Mr. Stewart had executed the

PSA, was not aware of the revised terms of the PSA, nor the amounts of payments made to Raven until August 27, 2007, when Mr. Stewart purportedly discovered the employee's fraud. With the proceeds received from Legacy at the closing of the transaction on August 3, 2007, Raven had paid its debts and its partners. In addition, Raven alleged that Legacy Operating benefitted from the fraud promulgated by Michael Lee, and asked the trial court for damages in excess of $6 million. Raven does not claim that Legacy knew about the forgery.

Legacy Operating filed a counterclaim for declaratory relief and for money damages based upon indemnity obligations and post-closing adjustments. The trial court granted a partial summary judgment in favor of Legacy Operating, denied a partial summary judgment sought by Raven, and entered a take-nothing judgment against Raven. The trial court severed the counterclaims brought by Legacy Operating.

In its April 15, 2011 ruling (the "Original Opinion"), the Court of Appeals reversed the Trial Court Summary Judgment and rendered judgment that the PSA was void, as a matter of law, and that a void instrument is not subject to ratification. Further, while the Appeals Court held that the incorporation of the PSA into the assignments for the transfer of the properties will not void the assignments, the assignments were not complete in and of themselves in the absence of the terms of the PSA. The Court of Appeals further remanded to the trial court any issues regarding the repayment of the funds advanced by Legacy Operating, as well as any issues regarding any consideration received by Legacy Operating from or related to the properties.

Legacy Operating filed a motion for rehearing on May 11, 2011 (the "Legacy Motion for Rehearing"). On January 12, 2012, the Court of Appeals granted the Legacy Motion for Rehearing, withdrew its former opinion and judgment, and issued a new opinion and judgment which affirmed the judgment of the trial court granting a partial summary judgment in favor of Legacy Operating, denying a partial summary judgment sought by Raven, and entering a take-nothing judgment against Raven.

The Court of Appeals held that, as a matter of law, certain assignments which specifically incorporated the terms of the purchase agreement dated July 11, 2007 providing for the purchase by Legacy Operating from Raven of various non-operated oil and gas properties and interests in the Permian Basin for $20.3 million, constituted valid, enforceable agreements binding upon Raven and Legacy Operating.

Raven did not file a response to the Legacy Motion for Rehearing and the Court of Appeals did not request one. Subsequently, on January 24, 2012, Raven filed a motion for rehearing and on January 26, 2012, the Court of Appeals issued an order withdrawing its opinion and judgment dated January 12, 2012 in order to allow Raven to respond to the Legacy Motion for Rehearing on or before February 10, 2012. On February 10, 2012, Raven filed its response to the Legacy Motion for Rehearing.

On March 15, 2012, the Court of Appeals granted the Legacy Motion for Rehearing, withdrew the Original Opinion and affirmed the trial court's take nothing judgment against Raven. On April 27, 2012, Raven filed a petition for review with the Supreme Court of Texas, requesting that the Supreme Court reverse the Court of Appeals' judgment in every respect except its conclusion that forged documents are void and ineffective and render judgment that Raven was entitled to summary judgment, entitled to rescind the assignments and unwind the transaction. Alternatively, Raven requested that the Supreme Court reverse the Court of Appeals' judgment insofar as it grants Legacy's motion for partial summary judgment and remand the case to the trial court for further proceedings. The Texas Supreme Court has requested the parties to provide full briefing on the merits of the issue raised in Raven's petition for review.

At this time, Legacy cannot predict the Texas Supreme Court's action on Raven's petition for review, or the eventual outcome of this matter. Legacy currently believes that any outcome, which may include no payment, the unwinding of the transaction (which Legacy expects would have an effect of less than $6 million) or a payment of approximately $6 million to Raven, will not have a material impact on its financial condition or ability to make cash distributions at expected levels, though it could have a material adverse effect on its net income (loss).

Additionally, Legacy is subject to numerous laws and regulations governing the discharge of materials into the environment or otherwise relating to environmental protection. To the extent laws are enacted or other governmental action is taken that restricts drilling or imposes environmental protection requirements that result in increased costs to the oil and natural gas industry in general, the business and prospects of Legacy could be adversely affected.

Legacy has employment agreements with its officers that specify that if the officer is terminated by Legacy for other than cause or following a change in control, the officer shall receive severance pay ranging from 24 to 36 months salary plus bonus and COBRA benefits, respectively.

(5) Fair Value Measurements

As defined in Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") 820-10, fair value is the price that would be received upon the sale of an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. ASC 820-10 requires disclosure that establishes a framework for measuring fair value and expands disclosure about fair value measurements. The statement requires fair value measurements be classified and disclosed in one of the following categories:

Level 1:	Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities. Legacy considers active markets as those in which transactions for the assets or liabilities occur in sufficient frequency and volume to provide pricing information on an ongoing basis.
Level 2:	Quoted prices in markets that are not active, or inputs which are observable, either directly or indirectly, for substantially the full term of the asset or liability. This category includes those derivative instruments that Legacy values using observable market data. Substantially all of these inputs are observable in the marketplace throughout the term of the derivative instrument, can be derived from observable data, or are supported by observable levels at which transactions are executed in the marketplace. Instruments in this category include non-exchange traded derivatives such as over-the-counter commodity price swaps and interest rate swaps as well as long-term incentive plan liabilities calculated using the Black-Scholes model to estimate the fair value as of the measurement date.
Level 3:	Measured based on prices or valuation models that require inputs that are both significant to the fair value measurement and less observable from objective sources (i.e. supported by little or no market activity). Legacy's valuation models are primarily industry standard models that consider various inputs including: (a) quoted forward prices for commodities, (b) time value, and (c) current market and contractual prices for the underlying instruments, as well as other relevant economic measures. Level 3 instruments primarily include derivative instruments, such as natural gas derivative swaps for those derivatives indexed to the West Texas Waha, ANR-Oklahoma and CIG indices, commodity collars and oil swaptions. Although Legacy utilizes third party broker quotes to assess the reasonableness of its prices and valuation techniques, Legacy does not have sufficient corroborating evidence to support classifying these assets and liabilities as Level 2.

As required by ASC 820-10, financial assets and liabilities are classified based on the lowest level of input that is significant to the fair value measurement. Legacy's assessment of the significance of a particular input to the fair value measurement requires judgment, and may affect the valuation of the fair value of assets and liabilities and their placement within the fair value hierarchy levels.

Fair Value on a Recurring Basis

The following table sets forth by level within the fair value hierarchy Legacy's financial assets and liabilities that were accounted for at fair value on a recurring basis as of September 30, 2012:

	Fair Value Measurements at September 30, 2012 Using			
	Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs	Total Carrying Value as of
Description	(Level 1)	(Level 2)	(Level 3)	September 30, 2012
	(In thousands)			
LTIP liability (a)	$—	$(4,076)	$—	$(4,076)
Oil and natural gas derivative swaps	—	(4,894)	13,545	8,651
Oil and natural gas collars	—	—	15,607	15,607
Oil swaptions	—	—	(636)	(636)
Interest rate swaps	—	(10,995)	—	(10,995)
Total	$—	$(19,965)	$28,516	$8,551

(a) See Note 9 for further discussion on unit-based compensation expenses and the related LTIP liability for certain grants accounted for under the liability method.

Legacy estimates the fair values of the swaps based on published forward commodity price curves for the underlying commodities as of the date of the estimate for those commodities for which published forward pricing is readily available. For those commodity derivatives for which forward commodity price curves are not readily available, Legacy estimates, with the assistance of third-party pricing experts, the forward curves as of the date of the estimate. Legacy estimates the option value of the contract floors and ceilings and oil swaptions using an option pricing model which takes into account market volatility, market prices, contract parameters and discount rates based on published LIBOR rates and interest swap rates. Significant changes in the quoted forward prices for commodities and changes in market volatility generally leads to corresponding changes in the fair value measurement of our oil and natural gas derivative contracts. In order to estimate the fair value of our

interest rate swaps, Legacy uses a yield curve based on money market rates and interest rate swaps, extrapolates a forecast of future interest rates, estimates each future cash flow, derives discount factors to value the fixed and floating rate cash flows of each swap, and then discounts to present value all known (fixed) and forecasted (floating) swap cash flows. Curve building and discounting techniques used to establish the theoretical market value of interest bearing securities are based on readily available money market rates and interest swap market data. The determination of the fair values above incorporates various factors including the impact of our non-performance risk and the credit standing of the counterparties involved in the Partnership's derivative contracts. The risk of nonperformance by the majority of the Partnership's counterparties is mitigated by the fact that such counterparties (or their affiliates) are also bank lenders under the Partnership's revolving credit facility. In addition, Legacy routinely monitors the creditworthiness of its counterparties including those who are no longer lenders under the revolving credit facility.

The following table sets forth a reconciliation of changes in the fair value of financial assets and liabilities classified as Level 3 in the fair value hierarchy:

	Significant Unobservable Inputs (Level 3)			
	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(In thousands)			
Beginning balance	$41,851	$9,431	$30,054	$24,641
Total gains (losses)	(8,111)	31,749	13,260	22,708
Settlements, net	(5,224)	(3,162)	(14,798)	(9,331)
Ending balance	$28,516	$38,018	$28,516	$38,018
Change in unrealized gains (losses) included in earnings relating to derivatives still held as of September 30, 2012 and 2011	$(13,335)	$28,587	$(1,538)	$13,377

Fair Value on a Non-Recurring Basis

Legacy follows the provisions of ASC 820-10 for nonfinancial assets and liabilities measured at fair value on a non-recurring basis. As it relates to Legacy, ASC 820-10 applies to certain nonfinancial assets and liabilities as may be acquired in a business combination and thereby measured at fair value; measurements of oil and natural gas property impairments; and the initial recognition of asset retirement obligations for which fair value is used.

The asset retirement obligation estimates are derived from historical costs as well as management's expectation of future cost environments. As there is no corroborating market activity to support the assumptions used, Legacy has designated these liabilities as Level 3. A reconciliation of the beginning and ending balances of Legacy's asset retirement obligation is presented in Note 7.

Assets measured at fair value during the nine-month period ended September 30, 2012 include:

	Fair Value Measurements at September 30, 2012 Using		
Description	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	(In thousands)		
Assets:			

Impairment (a)	$—	$—	$20,377
Acquisitions (b)	$—	$—	$115,044
Total	$—	$—	$135,421

(a) Legacy utilizes ASC 360-10-35 to periodically review oil and natural gas properties for impairment when facts and circumstances indicate that their carrying value may not be recoverable. Legacy compares net capitalized costs of proved

oil and natural gas properties to estimated undiscounted future net cash flows using management’s expectations of future oil and natural gas prices. These future price scenarios reflect Legacy’s estimation of future price volatility. During the nine-month period ended September 30, 2012, Legacy incurred impairment charges of $14.8 million as oil and natural gas properties with a net cost basis of $35.2 million were written down to their fair value of $20.4 million. Inclusive in this amount is $6.5 million of impairment on an available-for-sale property which Legacy has entered into an option agreement to sell all but a minority royalty interest in the property to a third party. The option can be exercised at any time prior to January 4, 2013. As such, Legacy has impaired the property to reduce its carrying value to its estimated fair value.

The remaining $7.8 million of impairment during the nine-month period ended September 30, 2012 was impairment of goodwill recognized on an acquisition of oil and natural gas properties. During the nine-month period ended September 30, 2012, Legacy entered into a purchase and sale agreement with a third party to acquire certain oil and natural gas properties, the purchase price of which was negotiated as of the date of the agreement. During the period between the agreement date and the date of closing the acquisition, oil futures prices declined significantly, thereby reducing the fair value of the properties acquired at the date of close. As the purchase price exceeded the fair value of the properties acquired, goodwill amounting to $7.8 million was recognized and subsequently tested for impairment. As of September 30, 2012, all of the goodwill associated with this acquisition has been impaired.

The inputs used by management for the fair value measurements utilized in this review include significant unobservable inputs, and therefore, the fair value measurements employed are classified as Level 3 for these types of assets.

(b) Legacy utilizes ASC 805-10 to identify and record the fair value of assets and liabilities acquired in a business combination. During the nine-month period ended September 30, 2012, Legacy acquired oil and natural gas properties, inclusive of unproved acreage acquisitions, with a fair value of $115.0 million in 15 individually immaterial transactions. The inputs used by management for the fair value measurements of these acquired oil and natural gas properties include significant unobservable inputs, and therefore, the fair value measurements employed are classified as Level 3 for these types of assets.

The carrying amount of the revolving long-term debt of $452 million as of September 30, 2012 approximates fair value because Legacy's current borrowing rate does not materially differ from market rates for similar bank borrowings. Legacy has classified the revolving long-term debt as a Level 2 item within the fair value hierarchy.

(6) Derivative Financial Instruments

Commodity derivative transactions

Due to the volatility of oil and natural gas prices, Legacy periodically enters into price-risk management transactions (e.g., swaps, swaptions or collars) for a portion of its oil and natural gas production to achieve a more predictable cash flow, as well as to reduce exposure to price fluctuations. While the use of these arrangements limits Legacy’s ability to benefit from increases in the prices of oil and natural gas, it also reduces Legacy’s potential exposure to adverse price movements. Legacy’s arrangements, to the extent it enters into any, apply to only a portion of its production, provide only partial price protection against declines in oil and natural gas prices and limit Legacy’s potential gains from future increases in prices. None of these instruments are used for trading or speculative purposes.

All of these price risk management transactions are considered derivative instruments and are accounted for in accordance with FASB Accounting Standards Codification 815, Disclosures About Derivative Instruments and Hedging Activities ("ASC 815"). These derivative instruments are intended to reduce Legacy’s price risk and may be considered hedges for economic purposes, but Legacy has chosen not to designate them as cash flow hedges for

accounting purposes. Therefore, all derivative instruments are recorded on the balance sheet at fair value as of September 30, 2012 and December 31, 2011 with changes in fair value being recorded in earnings for the three and nine months ended September 30, 2012 and 2011.

By using derivative instruments to mitigate exposures to changes in commodity prices, Legacy is exposed to credit risk and market risk. Credit risk is the failure of the counterparty to perform under the terms of the derivative contract. When the fair value of a derivative contract is positive, the counterparty owes Legacy, which creates repayment risk. Legacy minimizes the credit or repayment risk in derivative instruments by entering into transactions with high-quality counterparties that are parties to its Current Credit Agreement.

For the three and nine months ended September 30, 2012 and 2011, Legacy recognized realized and unrealized gains and losses related to its oil and natural gas derivative transactions. The net gain (loss) from derivative activities was as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(In thousands)			
Crude oil derivative contract settlements	$2,108	$(1,857)	$(10,949)	$(11,849)
Natural gas derivative contract settlements	4,000	2,703	12,967	8,084
Total commodity derivative contract settlements	6,108	846	2,018	(3,765)
Unrealized change in fair value - oil contracts	(26,196)	104,026	43,911	71,663
Unrealized change in fair value - natural gas contracts	(7,089)	2,731	(11,845)	(145)
Total unrealized change in fair value of commodity derivative contracts	(33,285)	106,757	32,066	71,518
Total realized and unrealized gain (loss) on commodity derivative contracts	$(27,177)	$107,603	$34,084	$67,753

As of September 30, 2012, Legacy had the following NYMEX West Texas Intermediate ("WTI") crude oil swaps paying floating prices and receiving fixed prices for a portion of its future oil production as indicated below:

Calendar Year	Volumes (Bbls)	Average Price per Bbl	Price Range per Bbl
October-December 2012(a)	583,570	$89.64	$67.72 - $109.20
2013(a)	1,571,443	$90.34	$80.10 - $108.65
2014	901,014	$92.89	$87.50 - $103.75
2015	362,851	$93.73	$90.50 - $100.20
2016	45,600	$94.53	$91.00 - $99.85

(a) On October 6, 2010, as part of an oil swap transaction entered into with a counterparty, Legacy sold two call options to the counterparty that allow the counterparty to extend a swap transaction covering calendar year 2011 to either 2012, 2013 or both calendar years. The counterparty exercised the option covering calendar year 2012 on December 30, 2011 and must exercise or decline the option covering calendar year 2013 on December 31, 2012. As the option was exercised for calendar year 2012, Legacy will pay the counterparty floating prices and receive a fixed price of $98.25 per Bbl on annual notional volumes of 183,000 Bbls (46,000 Bbls remaining as of September 30, 2012). For calendar year 2013, if exercised, Legacy would pay the counterparty floating prices and receive a fixed price of $98.25 per Bbl on annual notional volumes of 182,500 Bbls in 2013. The premium paid by the counterparty to Legacy for the two call options was in the form of an increase in the fixed price that we received pursuant to the 2011 swap of $98.25 per Bbl on 182,500 Bbls, or 500 Bbls per day, rather than the prevailing market price of approximately $87.00 per Bbl. These additional potential volumes related to the unexercised 2013 option are not reflected in the above table.

As of September 30, 2012, Legacy had the following NYMEX WTI crude oil derivative collar contract that combines a long put option or “floor” with a short call option or “ceiling” as indicated below:

Calendar Year	Volumes (Bbls)	Floor Price	Ceiling Price
October-December 2012	16,400	$120.00	$156.30

As of September 30, 2012, Legacy had the following NYMEX WTI crude oil derivative three-way collar contracts that combine a long put, a short put and a short call as indicated below:

Calendar Year	Volumes (Bbls)	Average Short Put Price	Average Long Put Price	Average Short Call Price
October-December 2012	110,400	$68.13	$95.00	$113.54
2013	795,670	$66.24	$91.92	$112.25
2014	1,226,130	$65.64	$90.86	$113.29
2015	1,126,000	$65.43	$90.43	$114.76
2016	438,300	$64.78	$89.78	$110.54
2017	72,400	$60.00	$85.00	$104.20

As of September 30, 2012, Legacy had the following NYMEX West Texas Waha, ANR-OK and CIG-Rockies natural gas swaps paying floating natural gas prices and receiving fixed prices for a portion of its future natural gas production as indicated below:

Calendar Year	Volumes (MMBtu)	Average Price per MMBtu	Price Range per MMBtu
October-December 2012	1,644,610	$5.11	$2.46 - $8.70
2013	5,790,654	$4.76	$3.23 - $6.89
2014	4,251,254	$4.65	$3.61 - $6.47
2015	1,339,300	$5.65	$5.14 - $5.82
2016	219,200	$5.30	$5.30

As of September 30, 2012, Legacy had the following West Texas Waha natural gas derivative collar contract that combines a long put option or "floor" with a short call option or "ceiling" as indicated below:

Calendar Year	Volumes (MMBtu)	Floor Price	Ceiling Price
October-December 2012	90,000	$4.00	$5.45

Interest rate derivative transactions

Due to the volatility of interest rates, Legacy periodically enters into interest rate risk management transactions in the form of interest rate swaps for a portion of its outstanding debt balance. These transactions allow Legacy to reduce exposure to interest rate fluctuations. While the use of these arrangements limits Legacy’s ability to benefit from decreases in interest rates, it also reduces Legacy’s potential exposure to increases in interest rates. Legacy’s arrangements, to the extent it enters into any, apply to only a portion of its outstanding debt balance, provide only partial protection against interest rate increases and limit Legacy’s potential savings from future interest rate declines. It is never management’s intention to hold or issue derivative instruments for speculative trading purposes. Conditions sometimes arise where actual borrowings are less than notional amounts hedged, which has, and could result in overhedged amounts.

On August 29, 2007, Legacy entered into LIBOR interest rate swaps beginning in October 2007 and extending through November 2011. On January 29, 2009, Legacy revised and extended these LIBOR interest rate swaps. The revised swap transaction had Legacy paying its counterparty fixed rates ranging from 4.09% to 4.11%, per annum, and receiving floating rates on a total notional amount of $54 million. In August 2011, Legacy again revised and extended these LIBOR interest rate swaps. The current swap transaction has Legacy paying its counterparty fixed rates ranging from 3.07% to 3.13%, per annum, and receiving floating rates on the same total notional amount of $54 million. These swaps are settled on a monthly basis, beginning in August 2011 and ending in November 2015.

On March 14, 2008, Legacy entered into a LIBOR interest rate swap beginning in April 2008 and extending through April 2011. On January 28, 2009, Legacy revised this LIBOR interest rate swap extending the term through April 2013. The revised swap transaction has Legacy paying its counterparty a fixed rate of 2.65% per annum, and receiving floating rates on a notional amount of $60 million. This swap is settled on a monthly basis, beginning in April 2009 and ending in April 2013.

On October 6, 2008, Legacy entered into two LIBOR interest rate swaps beginning in October 2008 and extending through October 2011. In January 2009, Legacy revised these LIBOR interest rate swaps extending the termination date through October 2013. The revised swap transactions have Legacy paying its counterparties fixed rates ranging from 3.09% to 3.10%, per annum, and receiving floating rates on a total notional amount of $100 million. In August 2011, Legacy further revised one of the aforementioned LIBOR interest rate swaps, extending the termination date through October 2015. The revised swap transaction has Legacy paying its counterparty a fixed rate of 2.50%, per annum, revised from the previous rate of 3.09%, per annum. The revised swaps are settled on a monthly basis, beginning in August 2011 and January 2009, respectively and ending in October 2015 and October 2013, respectively.

On December 16, 2008, Legacy entered into a LIBOR interest rate swap beginning in December 2008 and extending through December 2013. The swap transaction has Legacy paying its counterparty a fixed rate of 2.295%, per annum, and receiving floating rates on a total notional amount of $50 million. The swap is settled on a quarterly basis, beginning in March 2009 and ending in December 2013.

On August 8, 2011, Legacy entered into two LIBOR interest rate swaps, beginning in August 2011 and extending through August 2014. The swap transactions have Legacy paying its counterparties fixed rates ranging from 0.702% to 0.71%, per annum, and receiving floating rates on a total notional amount of $100 million. The swaps are settled on a monthly basis, beginning in August 2011 and ending in August 2014.

Legacy accounts for these interest rate swaps pursuant to ASC 815 which establishes accounting and reporting standards requiring that derivative instruments be recorded at fair market value and included in the balance sheet as assets or liabilities.

Legacy does not specifically designate these derivative transactions as cash flow hedges, even though they reduce its exposure to changes in interest rates. Therefore, the mark-to-market of these instruments is recorded in current earnings as a component of interest expense. The total impact on interest expense from the mark-to-market and settlements was as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(In thousands)			
Interest rate swap settlements	$1,768	$1,860	$5,244	$5,583
Unrealized change in fair value - interest rate swaps	(301)	510	(1,057)	197
Total increase to interest expense, net	$1,467	$2,370	$4,187	$5,780

The table below summarizes the interest rate swap position as of September 30, 2012:

Notional Amount	Fixed Rate	Effective Date	Maturity Date	Estimated Fair Market Value at September 30, 2012
(Dollars in thousands)				
$29,000	3.070%	10/16/2007	10/16/2015	$(2,360)
$13,000	3.112%	11/16/2007	11/16/2015	(1,089)
$12,000	3.131%	11/28/2007	11/28/2015	(1,021)
$60,000	2.650%	4/1/2008	4/1/2013	(726)
$50,000	3.100%	10/10/2008	10/10/2013	(1,192)
$50,000	0.710%	8/10/2011	8/10/2014	(252)
$50,000	2.295%	12/18/2008	12/18/2013	(912)
$50,000	0.702%	8/10/2011	8/10/2014	(244)
$50,000	2.500%	10/10/2008	10/10/2015	(3,199)

Total fair market value of interest rate derivatives	$(10,995)

(7) Asset Retirement Obligation

ASC 410-20 requires that an asset retirement obligation ("ARO") associated with the retirement of a tangible long-lived asset be recognized as a liability in the period in which it is incurred and becomes determinable. Under this method, when liabilities for dismantlement and abandonment costs, excluding salvage values, are initially recorded, the carrying amount of

the related oil and natural gas properties is increased. The fair value of the ARO asset and liability is measured using expected future cash outflows discounted at Legacy’s credit-adjusted risk-free interest rate. Accretion of the liability is recognized each period using the interest method of allocation, and the capitalized cost is depleted over the useful life of the related asset.

The following table reflects the changes in the ARO during the nine months ended September 30, 2012 and year ended December 31, 2011:

	September 30, 2012	December 31, 2011
	(In thousands)	
Asset retirement obligation - beginning of period	$120,274	$111,262
Liabilities incurred with properties acquired	6,036	8,300
Liabilities incurred with properties drilled	—	1,101
Liabilities settled during the period	(1,850)	(3,775)
Liabilities associated with properties sold	(207)	—
Current period accretion	3,395	4,234
Current period revisions to previous estimates	—	(848)
Asset retirement obligation - end of period	$127,648	$120,274

(8) Earnings Per Unit

The following table sets forth the computation of basic and diluted net earnings per unit:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(In thousands)			
Income (loss) available to unitholders	$(23,566)	$125,100	$66,765	$130,584
Weighted average number of units outstanding	47,869	43,587	47,840	43,560
Effect of dilutive securities:				
Restricted units	—	20	—	12
Weighted average units and potential units outstanding	47,869	43,607	47,840	43,572
Basic and diluted earnings (loss) per unit	$(0.49)	$2.87	$1.40	$3.00

The unvested restricted units outstanding as of September 30, 2012 were anti-dilutive and therefore had no impact on diluted earnings per unit. For the three and nine months ended September 30, 2011, 77,513 and 84,538 restricted units, respectively, were excluded from the calculation of diluted earnings per unit due to their anti-dilutive effect.

(9) Unit-Based Compensation

Long-Term Incentive Plan

On March 15, 2006, a Long-Term Incentive Plan (“LTIP”) for Legacy was implemented for its employees, consultants and directors, its affiliates and its general partner. The awards under the LTIP may include unit grants, restricted units, phantom units, unit options and unit appreciation rights ("UARs"). The LTIP permits the grant of awards covering an aggregate of 2,000,000 units. As of September 30, 2012, grants of awards net of forfeitures and, in the case of UARs and phantom units, historical exercises covering 1,310,938 units had been made, comprised of 266,014 unit option awards, 439,150 unit appreciation rights awards ("UARs"), 363,879 restricted unit awards, 148,232 phantom unit awards and 93,663 unit awards. The LTIP is administered by the compensation committee (the “Compensation

Committee") of the board of directors of Legacy's general partner.

ASC 718 requires companies to measure the cost of employee services in exchange for an award of equity instruments based on a grant-date fair value of the award (with limited exceptions), and that cost must generally be recognized over the vesting period of the award. However, ASC 718 stipulates that "if an entity that nominally has the choice of settling awards by issuing stock predominately settles in cash, or if the entity usually settles in cash whenever an employee asks for cash

settlement, the entity is settling a substantive liability rather than repurchasing an equity instrument.” Due to Legacy's historical practice of settling unit options, UARs and phantom unit awards in cash, Legacy accounts for unit options, UARs, and phantom unit awards by utilizing the liability method as described in ASC 718. The liability method requires companies to measure the cost of the employee services in exchange for a cash award based on the fair value of the underlying security at the end of each reporting period. Compensation cost is recognized based on the change in the liability between periods.

Unit Appreciation Rights and Unit Options

A unit appreciation right is a notional unit that entitles the holder, upon vesting, to receive cash valued at the difference between the closing price of units on the exercise date and the exercise price, as determined on the date of grant. Because these awards are settled in cash, Legacy is accounting for the UARs by utilizing the liability method.

During the year ended December 31, 2011, Legacy issued 68,000 UARs to employees which vest ratably over a three-year period and 50,034 UARs to employees which vest at the end of a three-year period. During the nine-month period ended September 30, 2012, Legacy issued 50,500 UARs to employees which vest ratably over a three-year period. All UARs granted in 2011 and 2012 expire seven years from the grant date and are exercisable when they vest.

For the nine-month periods ended September 30, 2012 and 2011, Legacy recorded $0.5 million and $0.02 million, respectively, of compensation expense due to the change in liability from December 31, 2011 and 2010, respectively, based on its use of the Black-Scholes model to estimate the September 30, 2012 and 2011 fair value of these UARs and unit options (see Note 5). As of September 30, 2012, there was a total of approximately $1.0 million of unrecognized compensation costs related to the unexercised and non-vested portion of these UARs. At September 30, 2012, this cost was expected to be recognized over a weighted-average period of approximately 1.6 years. Compensation expense is based upon the fair value as of September 30, 2012 and is recognized as a percentage of the service period satisfied. Since Legacy's trading history does not yet match the term of the outstanding UAR and unit option awards, it has used an estimated volatility factor of approximately 50% based upon the historical trends of a representative group of publicly-traded companies in the energy industry and employed the Black-Scholes model to estimate the September 30, 2012 fair value to be realized as compensation cost based on the percentage of service period satisfied. Based on historical data, Legacy has assumed an estimated forfeiture rate of 3.8%. As required by ASC 718, Legacy will adjust the estimated forfeiture rate based upon actual experience. Legacy has assumed an annual distribution rate of $2.24 per unit.

A summary of UAR and unit option activity for the nine months ended September 30, 2012 is as follows:

	Units	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at January 1, 2012	620,031	$ 22.36		
Granted	50,500	27.99		
Exercised	(173,315)	19.84		
Forfeited	(58,066)	24.68		
Outstanding at September 30, 2012	439,150	$ 23.77	4.6	$2,291,151
UARs and unit options exercisable at September 30, 2012	172,736	$ 20.33	3.1	$1,487,654

The following table summarizes the status of Legacy’s non-vested UARs since January 1, 2012:

	Non-Vested UARs	
	Number of Units	Weighted-Average Exercise Price
Non-vested at January 1, 2012	387,766	$ 22.80
Granted	50,500	27.99
Vested - Unexercised	(91,319)	19.81
Vested - Exercised	(49,467)	16.43
Forfeited	(31,066)	22.69
Non-vested at September 30, 2012	266,414	$ 25.99

Legacy has used a weighted-average risk-free interest rate of 0.9% in its Black-Scholes calculation of fair value, which approximates the U.S. Treasury interest rates at September 30, 2012 whose terms are consistent with the expected life of the UARs and unit options. Expected life represents the period of time that UARs and unit options are expected to be outstanding and is based on Legacy's best estimate. The following table represents the weighted-average assumptions used for the Black-Scholes option-pricing model.

	Nine Months Ended September 30, 2012
Expected life (years)	4.60
Risk free interest rate	0.9 %
Annual distribution rate per unit	$2.24
Volatility	50 %

Phantom Units

Legacy has also issued phantom units under the LTIP to both executive officers, as described below, and certain other employees. A phantom unit is a notional unit that entitles the holder, upon vesting, to receive cash valued at the closing price of units on the vesting date, or, at the discretion of the Compensation Committee, the same number of Partnership units. Because Legacy's current intent is to settle these awards in cash, Legacy is accounting for the phantom units by utilizing the liability method.

On September 21, 2009, the board of directors of Legacy's general partner, upon the recommendation of the Compensation Committee, implemented the current equity-based incentive compensation policy applicable to the executive officers of Legacy. In addition to cash bonus awards, under the compensation plan, the executives are eligible for both subjective and objective grants of phantom units. The subjective, or service-based, grants may be awarded up to a maximum percentage of annual salary ranging from 30% to 110% as determined by the Compensation Committee. Once granted, these phantom units vest ratably over a three-year period. The objective, or performance-based, grants may be awarded up to a maximum percentage of annual salary ranging from 45% to 165%, as determined by the Compensation Committee. However, the amount to vest each year for the three-year vesting period will be determined on each vesting date based on a three-step process, with the first two steps each comprising 50% of the total vesting amount while the third step is the sum of the first two steps. The first step in the process will be a function of Total Unitholder Return ("TUR") for the Partnership and the percentage rank of the Legacy TUR among a peer group of upstream master limited partnerships, as determined by the Compensation Committee at the beginning of each year. The percentage of the 50% performance-based award to vest under this step is determined within a matrix which ranges from 0% to 100% and will increase from 0% to 100% as each of the Legacy TUR and the percentage rank of the Legacy TUR among the peer group increase. The applicable Legacy TUR range is from less than 8% (where 0% to 25% of the amount will vest, depending upon the Legacy TUR ranking among its peer group) to more than 20% (where 50% to 100% of the amount will vest, depending upon the Legacy TUR ranking among its peer group). In the second step, the Legacy TUR will be compared to the TUR of a group of master limited

partnerships included in the Alerian MLP Index. The percentage of the 50% of the performance-based award to vest under this step is determined within a matrix which ranges from 0% to 100% and will increase from 0% to 100% as the Legacy TUR and the percentile rank of the Legacy TUR among the Adjusted Alerian MLP Index increases. The applicable Legacy TUR range is from less than 8% (where 0% to 30% of the amount will vest, depending upon the Legacy TUR percentile ranking among the Adjusted Alerian MLP Index) to more than 20% (where 50% to 100% of the amount will vest, depending upon the Legacy TUR percentile ranking among the

Adjusted Alerian MLP Index). The third step is the addition of the above two steps to determine the total performance-based awards to vest. Performance based phantom units subject to vesting which do not vest in a given year will be forfeited. With respect to both the subjective and objective units awarded under this compensation policy, distribution equivalent rights ("DERs") will accumulate and accrue based on the total number of actual amounts vested and will be payable at the date of vesting.

On February 18, 2011, the Compensation Committee approved the award of 32,806 subjective, or service-based, phantom units and 53,487 objective, or performance based, phantom units to Legacy's executive officers. On February 1, 2012 and February 2, 2012, the Compensation Committee approved the award of 30,828 subjective, or service-based, phantom units and 57,189 objective, or performance based, phantom units to Legacy's executive officers. Upon his resignation effective March 16, 2012, Legacy's former President and Chief Financial Officer forfeited all of his unvested phantom unit awards.

Compensation expense related to the phantom units and associated DERs was $1.5 million and $1.3 million for the nine months ended September 30, 2012 and 2011, respectively.

Restricted Units

During the year ended December 31, 2011, Legacy issued an aggregate of 51,365 restricted units to non-executive employees. The restricted units awarded vest ratably over a three-year period, beginning on the date of grant. During the nine-month period ended September 30, 2012, Legacy issued an aggregate of 170,645 restricted units to both non-executive employees and certain executive employees not previously covered under the aforementioned executive compensation plan. The restricted units awarded vest either ratably over a three-year period, ratably over a two-year period or cliff vest at the end of a five year period, all beginning on the date of grant. Compensation expense related to restricted units was $1.2 million and $0.6 million for the nine months ended September 30, 2012 and 2011, respectively. As of September 30, 2012, there was a total of $5.5 million of unrecognized compensation expense related to the unvested portion of these restricted units. At September 30, 2012, this cost was expected to be recognized over a weighted-average period of 3.3 years. Pursuant to the provisions of ASC 718, Legacy’s issued units, as reflected in the accompanying consolidated balance sheet at September 30, 2012, do not include 227,477 units related to unvested restricted unit awards.

Board and Additional Executive Units

On May 11, 2011, Legacy granted and issued 1,630 units to each of its five non-employee directors as part of their annual compensation for serving on the board of directors of Legacy's general partner. The value of each unit was $30.24 at the time of issuance. On August 26, 2011, Legacy granted and issued 1,885 units to each of its five non-employee directors as part of their annual compensation for serving on the board of directors of Legacy's general partner. The value of each unit was $26.94 at the time of issuance. On May 9, 2012, Legacy granted and issued 3,509 units to each of its five non-employee directors and 2,500 units to an executive employee. The value of each unit was $28.34 at the time of issuance.

(10) Subsidiary Guarantors

Legacy and Legacy Reserves Finance Corporation, a wholly owned finance subsidiary, filed an automatic registration statement on Form S-3 on May 23, 2011. Securities that may be offered and sold include debt securities which may be guaranteed by Legacy's subsidiaries and are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933. Legacy, as the parent company, has no independent assets or operations. Legacy contemplates that if it offers guaranteed debt securities pursuant to the registration statement, all guarantees will be full and unconditional and joint and several, and any subsidiaries of Legacy other than the subsidiary guarantors will be minor. In addition, there are no restrictions on the ability of Legacy to obtain funds from its subsidiaries by dividend or loan.

(11) Equity Distribution Agreement

Legacy currently has an Equity Distribution Agreement with Knight Capital Americas, L.P. ("KCA") under which Legacy may offer and sell units from time to time through KCA, as Legacy's sales agent. During the year ended December 31, 2011, Legacy received proceeds from 87,364 units issued pursuant to this agreement of approximately $2.4 million gross and $2.3 million net of commissions, which proceeds were used for general partnership purposes. No sales were made during the nine months ended September 30, 2012.

(12) Subsequent Events

On October 22, 2012, Legacy’s board of directors approved a distribution of $0.565 per unit payable on November 14, 2012 to unitholders of record on November 1, 2012, representing an increase of $0.005 per unit over the last quarterly

distribution.

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

Cautionary Statement Regarding Forward-Looking Information

This document contains forward-looking statements that are subject to a number of risks and uncertainties, many of which are beyond our control, which may include statements about:

- our business strategy;
- the amount of oil and natural gas we produce;
- the price at which we are able to sell our oil and natural gas production;
- our ability to acquire additional oil and natural gas properties at economically attractive prices;
- our drilling locations and our ability to continue our development activities at economically attractive costs;
- the level of our lease operating expenses, general and administrative costs and finding and development costs, including payments to our general partner;
- the level of capital expenditures;
- the level of cash distributions to our unitholders;
- our future operating results; and
- our plans, objectives, expectations and intentions.

All of these types of statements, other than statements of historical fact included in this document, are forward-looking statements. In some cases, you can identify forward-looking statements by terminology such as “may,” “could,” “should,” “expect,” “plan,” “project,” “intend,” “anticipate,” “believe,” “estimate,” “predict,” “potential,” “pursue,” “target,” “continue,” such terms or other comparable terminology.

The forward-looking statements contained in this document are largely based on our expectations, which reflect estimates and assumptions made by our management. These estimates and assumptions reflect our best judgment based on currently known market conditions and other factors. Although we believe such estimates and assumptions to be reasonable, they are inherently uncertain and involve a number of risks and uncertainties that are beyond our control. In addition, management’s assumptions about future events may prove to be inaccurate. All readers are cautioned that the forward-looking statements contained in this document are not guarantees of future performance, and our expectations may not be realized or the forward-looking events and circumstances may not occur. Actual results may differ materially from those anticipated or implied in the forward-looking statements due to factors described in Legacy’s Annual Report on Form 10-K for the year ended December 31, 2011 in Item 1A under “Risk Factors” and Legacy's Quarterly Report on Form 10-Q for the quarter ended June 30, 2012 in Part II, Item 1A under "Risk Factors." The forward-looking statements in this document speak only as of the date of this document; we disclaim any obligation to update these statements unless required by securities law, and we caution you not to rely on them unduly.

Overview

Because of our rapid growth through acquisitions and development of properties, historical results of operations and period-to-period comparisons of these results and certain financial data may not be meaningful or indicative of future results.

Acquisitions have been financed with a combination of proceeds from bank borrowings, issuances of units and cash flow from operations. Post-acquisition activities are focused on evaluating and developing the acquired properties and evaluating potential add-on acquisitions.

Our revenues, cash flow from operations and future growth depend substantially on factors beyond our control, such as economic, political and regulatory developments and competition from other sources of energy. Oil and natural gas prices historically have been volatile and may fluctuate widely in the future.

Sustained periods of low prices for oil or natural gas could materially and adversely affect our financial position, our results of operations, the quantities of oil and natural gas reserves that we can economically produce, our access to capital and the amount of our cash distributions.

We face the challenge of natural production declines. As initial reservoir pressures are depleted, oil and natural gas production from a given well or formation decreases. We attempt to overcome this natural decline by acquiring more reserves than we produce, drilling to find additional reserves, utilizing multiple types of recovery techniques such as secondary (waterflood) and tertiary (CO_2 and nitrogen) recovery methods to re-pressure the reservoir and recover additional oil, re-completing or adding pay in existing wellbores and improving artificial lift. Our future growth will depend on our ability to continue to add reserves in excess of production. We will maintain our focus on adding reserves through acquisitions and exploitation projects. Our ability to add reserves through acquisitions and exploitation projects is dependent upon many factors including our ability to raise capital, competitively bid on acquisitions, obtain regulatory approvals and contract drilling rigs and personnel.

Our revenues are highly sensitive to changes in oil and natural gas prices and to levels of production. As set forth under “Investing Activities” below, we have entered into oil and natural gas derivatives designed to mitigate the effects of price fluctuations covering a significant portion of our expected production, which allows us to mitigate, but not eliminate, oil and natural gas price risk. We continuously conduct financial sensitivity analyses to assess the effect of changes in pricing and production. These analyses allow us to determine how changes in oil and natural gas prices will affect our ability to execute our capital investment programs and to meet future financial obligations. Further, the financial analyses allow us to monitor any impact such changes in oil and natural gas prices may have on the value of our proved reserves and their impact, if any, on any redetermination of our borrowing base under our revolving credit facility.

Legacy does not specifically designate derivative instruments as cash flow hedges; therefore, the mark-to-market adjustment reflecting the unrealized gain or loss associated with these instruments is recorded in current earnings.

Production and Operating Costs Reporting

We strive to increase our production levels to maximize our revenue and cash available for distribution. Additionally, we continuously monitor our operations to ensure that we are incurring operating costs at the optimal level and determine if any wells or properties should be shut-in or re-completed.

Such costs include, but are not limited to, the cost of electricity to lift produced fluids, chemicals to treat wells, field personnel to monitor the wells, well repair expenses to restore production, well workover expenses intended to increase production, and ad valorem taxes. We incur and separately report severance taxes paid to the states in which our properties are located. These taxes are reported as production taxes and are a percentage of oil and natural gas revenue. Ad valorem taxes are a percentage of property valuation and are reported with production costs. Gathering and transportation costs are generally borne by the purchasers of our oil and natural gas as the price paid for our products reflects these costs. We do not consider royalties paid to mineral owners an expense as we deduct hydrocarbon volumes owned by mineral owners from the reported hydrocarbon sales volumes.

Operating Data

The following table sets forth selected unaudited financial and operating data of Legacy for the periods indicated.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(In thousands, except per unit data)			
Revenues:				
Oil sales	$70,173	$63,387	$212,097	$196,220
Natural gas liquid sales	3,492	4,924	10,742	13,896
Natural gas sales	10,531	16,061	33,166	39,858
Total revenue	$84,196	$84,372	$256,005	$249,974
Expenses:				
Oil and natural gas production	$28,207	$22,093	$75,067	$64,572
Ad valorem taxes	2,521	2,016	$6,956	$6,732
Total oil and natural gas production	$30,728	$24,109	$82,023	$71,304
Production and other taxes	$5,137	$5,211	$15,040	$15,101
General and administrative	$6,993	$3,817	$18,604	$14,630
Depletion, depreciation, amortization and accretion	$24,833	$22,446	$73,042	$64,152
Realized commodity derivative settlements:				
Realized gains (losses) on oil derivatives	$2,108	$(1,857)	$(10,949)	$(11,849)
Realized gains on natural gas derivatives	$4,000	$2,703	$12,967	$8,084
Production:				
Oil (MBbls)	840	755	2,418	2,190
Natural gas liquids (MGal)	3,821	3,735	10,938	10,509
Natural gas (MMcf)	2,571	2,548	7,774	6,397
Total (MBoe)	1,359	1,269	3,974	3,506
Average daily production (Boe/d)	14,772	13,793	14,504	12,842
Average sales price per unit (excluding derivatives):				
Oil price (per Bbl)	$83.54	$83.96	$87.72	$89.60
Natural gas liquid price (per Gal)	$0.91	$1.32	$0.98	$1.32
Natural gas price (per Mcf)	$4.10	$6.30	$4.27	$6.23
Combined (per Boe)	$61.95	$66.49	$64.42	$71.30
Average sales price per unit (including realized derivative gains/losses):				
Oil price (per Bbl)	$86.05	$81.50	$83.19	$84.19
Natural gas liquid price (per Gal)	$0.91	$1.32	$0.98	$1.32
Natural gas price (per Mcf)	$5.65	$7.36	$5.93	$7.49
Combined (per Boe)	$66.45	$67.15	$64.93	$70.23
NYMEX oil index prices per Bbl:				
Beginning of period	$84.96	$95.42	$98.83	$91.38
End of period	$92.19	$79.20	$92.19	$79.20