

NATURAL GAS SERVICES GROUP INC  
Form 10-K/A  
June 08, 2007

**SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
FORM 10-K/A**

Annual Report Pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934  
For the fiscal year ended December 31, 2006  
 Transition Report Pursuant to Section 13 of 15(d) of the Securities  
Exchange Act of 1934  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 1-31398

NATURAL GAS SERVICES GROUP, INC.  
(Exact Name of Registrant as Specified in its Charter)

Colorado 75-2811855  
(State or Other Jurisdiction of (I.R.S. Employer Identification  
Incorporation or Organization) No.)

2911 South County Road 1260 79706  
Midland, Texas (Zip Code)  
(Address of Principal Executive  
Offices)

Registrant's Telephone Number, Including Area Code: (432) 563-3974

Securities Registered Pursuant to Section 12(b) of the Act:  
Name of Each Exchange on Which  
Registered  
Title of Each Class  
Common Stock, \$.01 par value American Stock Exchange  
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  No

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

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  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements

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incorporated by reference in Part III of this Form 10-K/A or any amendment to this Form 10-K/A. [ ]

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  Accelerated  
Filer  Non-Accelerated Filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

The aggregate market value of voting and non-voting common equity held by non-affiliates of the Registrant as of March 12, 2007 was approximately \$144,669,863, based on the closing price of the common stock on the same date.

At March 12, 2007 there were 12,067,166 shares of common stock outstanding.

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Explanatory Note

We originally filed our Annual Report on Form 10-K for the fiscal year ended December 31, 2006 on March 15, 2007 (the "Original Filing"). This Amendment No. 1 on Form 10-K/A ("Form 10-K/A") is being filed to revise certain disclosures we made under Items 6 and 7 of the Original Filing. Generally, the Items amended relate to our presentation of gross profit (exclusive of depreciation), our cash flow from operations, our accrued liabilities, the related party nature of our subordinated notes, and our presentation of revenue from the sale of rental equipment.

In addition to the amendments described above, Item 15 of the Original Filing has also been amended to contain (1) the currently dated certifications from our Chief Executive Officer and Chief Accounting Officer required under Section 302 of the Sarbanes-Oxley Act of 2002, revised to reflect the exact wording required by Regulation S-K Item 601(b)(31), (2) the currently dated certifications from our Chief Executive Officer and Chief Accounting Officer required under Section 906 of the Sarbanes-Oxley Act of 2002, revised to identify the Form 10-K for the year ended December 31, 2006, as amended by this Amendment, as the period report covered thereby, and (3) the currently dated, consent of our independent registered public accounting firm to the use of its report on our consolidated balance sheets as of December 31, 2005 and December 31, 2006 and the related consolidated statements of income, stockholders' equity and cash flows for the years ended December 31, 2004, 2005 and 2006 in the specified registration statements. The updated certifications are attached to this Form 10-K/A as Exhibits 31.1, 31.2, 32.1 and 32.2, and the updated consent is attached to this Form 10-K/A as Exhibit 23.1.

As described above, this Form 10-K/A amends Items 6, 7 and 15 of the Original Filing. We did not make any revisions to Items 1, 1A, 1B, 2, 3, 4, 5, 7A, 8, 9, 9A, 9B, 10, 11, 12, 13 or 14 of the Original Filing, and thus, these Items remain in effect as of the date of the Original Filing and are not included as part of this Form 10-K/A.

**ITEM 6. SELECTED FINANCIAL DATA**

In the table below, we provide you with selected historical financial data. We have derived this information from our audited consolidated financial statements for each of the years in the five-year period ended December 31, 2006. This information is only a summary and it is important that you read this information along with our audited consolidated financial statements and related notes, and “Management’s Discussion and Analysis of Financial Condition and Results of Operations” under Item 7 below, which discusses factors affecting the comparability of the information presented. The selected financial information provided is not necessarily indicative of our future results of operations or financial performance.

	Year Ended December 31,				
	2002	2003	2004	2005 <sup>(1)</sup>	2006
<i>(in thousands, except per share amounts)</i>					
<b>CONSOLIDATED STATEMENTS OF INCOME AND OTHER INFORMATION:</b>					
Revenues	\$ 10,297	\$ 12,750	\$ 15,958	\$ 49,311	\$ 62,729
Costs of revenue, exclusive of depreciation shown separately below	5,572	6,057	6,951	31,338	39,308
Gross margin <sup>(2)</sup>	4,725	6,693	9,007	17,973	23,421
Depreciation and amortization	1,166	1,726	2,444	4,224	6,020
Other operating expenses	1,718	2,292	2,652	4,890	5,270
Operating income	1,841	2,675	3,911	8,859	12,131
Total other income (expense) <sup>(3)</sup>	(471)	(671)	603	(1,798)	(256)
Income before income taxes	1,370	2,004	4,514	7,061	11,875
Income tax expense	584	697	1,140	2,615	4,287
Net income	786	1,307	3,374	4,446	7,588
Preferred dividends	107	121	53		
Net income available to common stockholders	\$ 679	\$ 1,186	\$ 3,321	\$ 4,446	\$ 7,588
Net income per common share:					
Basic	\$ 0.19	\$ 0.24	\$ 0.59	\$ 0.59	\$ 0.67
Diluted	\$ 0.16	\$ 0.23	\$ 0.52	\$ 0.52	\$ 0.66
Weighted average shares of common stock outstanding:					
Basic	3,649	4,947	5,591	7,564	11,405
Diluted	4,305	5,253	6,383	8,481	11,472
EBITDA <sup>(4)</sup>	\$ 3,511	\$ 4,397	\$ 7,796	\$ 13,282	\$ 19,541
As of December 31,					
	2002	2003	2004	2005	2006
<i>(in thousands)</i>					

**BALANCE SHEET INFORMATION:**

Current assets	\$ 5,084	\$ 3,654	\$ 7,295	\$ 24,642	\$ 55,170
Total assets	23,937	28,270	43,255	86,369	135,552
Long-term debt (including current portion)	8,847	10,724	15,017	28,205	18,392
Stockholders' equity	13,001	14,425	22,903	45,690	101,201

- (1) The information for the periods presented may not be comparable because of our acquisition of SCS in January 2005. For additional information regarding this acquisition, you should read the information under “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations” and “Item 13. Certain Relationships, Related Transactions and Director Independence– Acquisition of Screw Compression Systems, Inc.” in this Annual Report on Form 10-K.
- (2) Gross margin is defined, reconciled to net income and discussed further in Part II, Item 6 (“Selected Financial Data-Non-GAAP Financial Measures”) of this report.
- (3) Total other income (expense) for the year ended December 31, 2004 includes \$1.5 million in life insurance proceeds paid to us upon the death of our former Chief Executive Officer.
- (4) EBITDA, is defined, reconciled to net income and discussed further in Part II, Item 6 (“Selected Financial Data-Non-GAAP Financial Measures”) of this report.

#### *Non-GAAP Financial Measures*

##### Our definition and use of EBITDA

“EBITDA” is a non-GAAP financial measure of earnings (net income) from continuing operations before interest, taxes, depreciation, and amortization. This term, as used and defined by us, may not be comparable to similarly titled measures employed by other companies and is not a measure of performance calculated in accordance with GAAP. EBITDA should not be considered in isolation or as a substitute for operating income, net income or loss, cash flows provided by operating, investing and financing activities, or other income or cash flow statement data prepared in accordance with GAAP. However, management believes EBITDA is useful to an investor in evaluating our operating performance because:

- it is widely used by investors in the energy industry to measure a company’s operating performance without regard to items excluded from the calculation of EBITDA, which can vary substantially from company to company depending upon accounting methods and book value of assets, capital structure and the method by which assets were acquired, among other factors;
- it helps investors to more meaningfully evaluate and compare the results of our operations from period to period by removing the impact of our capital structure and asset base from our operating structure; and
- it is used by our management for various purposes, including as a measure of operating performance, in presentations to our Board of Directors, as a basis for strategic planning and forecasting, and as a component for setting incentive compensation.

There are material limitations to using EBITDA as a measure of performance, including the inability to analyze the impact of certain recurring items that materially affect our net income or loss, and the lack of comparability of results of operations of different companies.

##### Our definition and use of gross margin

We define gross margin as total revenue less cost of sales (excluding depreciation and amortization expense). Gross margin is included as a supplemental disclosure because it is a primary measure used by our management as it represents the results of revenue and cost of sales (excluding depreciation and amortization expense), which are key components of our operations. Gross margin differs from gross profit which includes depreciation expense. We believe gross margin is important because it focuses on the current operating performance of our operations and excludes the impact of the prior historical costs of the assets acquired or constructed that are utilized in those operations, the indirect costs associated with our selling, general and administrative activities, the impact of our financing methods and income taxes. Depreciation expense may not accurately reflect the costs required to maintain

and replenish the operational usage of our assets and therefore may not portray the costs from current operating activity. Rather, depreciation expense reflects the systematic allocation of historical fixed asset values over the estimated useful lives.

Gross margin has certain material limitations associated with its use as compared to net income. These limitations are primarily due to the exclusion of certain expenses. Each of these excluded expenses is material to our consolidated results of operations. Because we use capital assets, depreciation expense is a necessary element of our costs and our ability to generate revenue and selling, general and administrative expense is a necessary cost to support our operations and required corporate activities. In order to compensate for these limitations, management uses this non-GAAP measure as a supplemental measure to other GAAP results to provide a more complete understanding of our performance.

As an indicator of our operating performance, gross margin should not be considered an alternative to, or more meaningful than, net income as determined in accordance with GAAP. Our gross margin may not be comparable to a similarly titled measure of another company because other entities may not calculate gross margin in the same manner.

#### Reconciliation

The following table reconciles net income to EBITDA and gross margin, the most directly comparable GAAP financial measure:

	Year Ended December 31,				
	2002	2003	2004	2005	2006
	<i>(in thousands)</i>				
Net income	\$ 786	\$ 1,307	\$ 3,374	\$ 4,446	\$ 7,588
Interest expense, net	975	667	838	1,997	1,646
Income taxes	584	697	1,140	2,615	4,287
Depreciation and amortization	1,166	1,726	2,444	4,224	6,020
EBITDA	\$ 3,511	\$ 4,397	\$ 7,796	\$ 13,282	\$ 19,541
Other operating expenses	1,718	2,292	2,652	4,890	5,270
Other income (expense)	(504)	4	(1,441)	(199)	(1,390)
Gross Margin	\$ 4,725	\$ 6,693	\$ 9,007	\$ 17,973	\$ 23,421

#### ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion is intended to assist you in understanding our financial position and results of operations for each year in the three-year period ended December 31, 2006. You should read the following discussion and analysis in conjunction with our audited consolidated financial statements and the related notes.

The following discussion contains forward-looking statements. For a description of limitations inherent in forward-looking statements, see "Special Note Regarding Forward-Looking Statements" on page (ii).

##### Overview

We fabricate, manufacture, rent and sell natural gas compressors and related equipment. Our primary focus is on the rental of natural gas compressors. Our rental contracts generally provide for initial terms of six to 24 months. After the initial term of our rental contracts, most of our customers have continued to rent our compressors on a month-to-month basis. Rental amounts are paid monthly in advance and include maintenance of the rented compressors. As of December 31, 2006, we had 974 natural gas compressors totaling approximately 112,718 horsepower rented to 84 third parties, compared to 820 natural gas compressors totaling approximately 90,486 horsepower rented to 75 third parties at December 31, 2005.

We also fabricate natural gas compressors for sale to our customers, designing compressors to meet unique specifications dictated by well pressures, production characteristics and particular applications for which compression is sought. Fabrication of compressors involves the purchase by us of engines, compressors, coolers and other



components, and then assembling these components on skids for delivery to customer locations. These major components of our compressors are acquired through periodic purchase orders placed with third-party suppliers on an “as needed” basis, which presently requires a three to four month lead time with delivery dates scheduled to coincide with our estimated production schedules. Although we do not have formal continuing supply contracts with any major supplier, we believe we have adequate alternative sources available. In the past, we have not experienced any sudden and dramatic increases in the prices of the major components for our compressors. However, the occurrence of such an event could have a material adverse effect on the results of our operations and financial condition, particularly if we were unable to increase our rental rates and sales prices proportionate to any such component price increases.

We also manufacture a proprietary line of compressor frames, cylinders and parts, known as our CiP (Cylinder-in-Plane) product line. We use finished CiP component products in the fabrication of compressor units for sale or rental by us or sell the finished component products to other compressor fabricators. We also design, fabricate, sell, install and service flare stacks and related ignition and control devices for onshore and offshore incineration of gas compounds such as hydrogen sulfide, carbon dioxide, natural gas and liquefied petroleum gases. To provide customer support for our compressor and flare sales businesses, we stock varying levels of replacement parts at our Midland, Texas facility and at field service locations. We also provide an exchange and rebuild program for screw compressors and maintain an inventory of new and used compressors to facilitate this business.

We provide service and maintenance to our customers under written maintenance contracts or on an as required basis in the absence of a service contract. Maintenance agreements typically have terms of six months to one year and require payment of a monthly fee.

The following table sets forth our revenues from each of our three business segments for the periods presented:

	Year Ended December 31,				
	2002	2003	2004	2005	2006
	(in thousands)				
Sales	\$ 4,336	\$ 3,865	\$ 3,593	\$ 30,278	\$ 38,214
Service and maintenance	1,563	1,773	1,874	2,424	979
Rental	4,398	7,112	10,491	16,609	23,536
Total	\$ 10,297	\$ 12,750	\$ 15,958	\$ 49,311	\$ 62,729

On January 3, 2005, we completed the acquisition of Screw Compression Systems, Inc., or "SCS," for consideration consisting of \$8.0 million in cash, subordinated promissory notes payable by us to the former stockholders of SCS in the aggregate principal amount of \$3.0 million, and approximately 610 thousand shares of our common stock. As a result of this acquisition, our results of operations for periods before and after the completion of the acquisition may not be comparable.

Historically, the majority of our revenues and income from operations has come from our compressor rental business. The acquisition of SCS, which is engaged primarily in the business of custom fabrication of compressors for sale to third parties, significantly altered the mix of our revenues, with compressor sales now contributing the largest percentage of our revenues. Margins for our rental business have recently averaged 60% to 65%, while margins for the compressor sales business have recently averaged approximately 18% to 20%. Our strategy for growth is focused on our compressor rental business, and we intend to use the additional fabrication capacity now available through SCS to expand our rental fleet while continuing SCS's core custom fabrication business. As our rental business grows and contributes a larger percentage of our total revenues, we expect our overall margins to improve from those experienced in 2006.

The oil and gas equipment rental and services industry is cyclical in nature. The most critical factor in assessing the outlook for the industry is the worldwide supply and demand for natural gas and the corresponding changes in commodity prices. As demand and prices increase, oil and gas producers increase their capital expenditures for drilling, development and production activities. Generally, the increased capital expenditures ultimately result in greater revenues and profits for services and equipment companies.

In general, we expect our overall business activity and revenues to track the level of activity in the natural gas industry, with changes in domestic natural gas production and consumption levels and prices more significantly affecting our business than changes in crude oil and condensate production and consumption levels and prices. We

also believe that demand for compression services and products is driven by declining reservoir pressure in maturing natural gas producing fields and, more recently, by increased focus by producers on non-conventional natural gas production, such as coalbed methane, gas shales and tight gas, which typically requires more compression than production from conventional natural gas reservoirs.

Demand for our products and services have been strong throughout 2005 and 2006. We believe demand will remain strong throughout 2007 due to high oil and natural gas prices and increased demand for natural gas. Because of these market fundamentals for natural gas, we believe the long-term trend of activity in our markets is favorable. However, these factors could be more than offset by other developments affecting the worldwide supply and demand for natural gas. Additionally, activity created by recent increases in the price of natural gas may make it difficult to meet the demands of our markets.

For fiscal year 2007, our forecasted capital expenditures are approximately \$27 to \$32 million, primarily for additions to our compressor rental fleet. We believe that the proceeds from our public offering of common stock we completed in March 2006, together with funds available to us under our bank credit facility and cash flows from operations will be sufficient to satisfy our capital and liquidity requirements through 2007. We may further require additional capital to fund any unanticipated expenditures, including any acquisitions of other businesses. Additional capital may not be available to us when we need it or on acceptable terms.

## Results of Operations

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

The table below shows our revenues, percentage of total revenues, gross margin, exclusive of depreciation, and gross margin percentage of each of our segments for the years ended December 31, 2006 and December 31, 2005. Gross margin is the difference between revenue and cost of sales, exclusive of depreciation.

	Revenue		Gross Margin, Exclusive of Depreciation <sup>(1)</sup>	
	Year Ended December 31, 2005	Year Ended December 31, 2006	Year Ended December 31, 2005	Year Ended December 31, 2006
	<i>(dollars in thousands)</i>			
Sales	\$ 30,278	61% \$ 38,214	61% \$ 6,947	23% \$ 8,585
Service and Maintenance	2,424	5% 979	1% 945	39% 244
Rental	16,609	34% 23,536	38% 10,081	61% 14,592
Total	\$ 49,311	\$ 62,729	\$ 17,973	36% \$ 23,421

(1) For a reconciliation of gross margin to its most directly comparable financial measure calculated and presented in accordance with GAAP, please read Part II, Item 6 ("Selected Financial Data-Non-GAAP Financial Measures") of this report.

Total revenues for the year ended December 31, 2006 increased 27.2% to \$62.7 million, as compared to \$49.3 million for the year ended December 31, 2005. The increase in revenue reflects the increase in our rental revenue and unit sales to third parties offset by the decline in service revenue.

Sales revenue increased from \$30.3 million to \$38.2 million, or 26.2%, for the year ended December 31, 2006, compared to the year ended December 31, 2005. This increase was mainly the result of \$4.1 million in sales of rental equipment to an existing rental customer and additional sales of compressor units from our Tulsa, Oklahoma location. Sales to third parties included (1) compressor unit sales (including used rental equipment), (2) flare sales, (3) parts sales, (4) compressor rebuilds and (5) sale of rental units.

Service and maintenance revenue decreased from \$2.4 million to \$979 thousand, or 59.6%, for the year ended December 31, 2006, compared to the year ended December 31, 2005. This decrease was mainly the result of the change in our maintenance contract with Dominion Exploration & Production, Inc. beginning January 1, 2006. Our five-year rental and maintenance agreement with Dominion Exploration expired on December 31, 2005. In August 2005, we were advised by Dominion Exploration that it would seek competing proposals from us as well as other third parties to continue the rental and maintenance services required for its northern Michigan operations. We submitted a bid to rent screw compressors to Dominion Exploration and to provide maintenance and service on certain screw compressors owned by Dominion Exploration. We also submitted a proposal to continue service and maintenance of reciprocating compressors owned by Dominion Exploration. In October 2005, we were advised by Dominion

Exploration that we would retain the screw compressor rental, maintenance and service businesses, but that a third party was successful in bidding for the maintenance and service of Dominion Exploration's reciprocating compressors.

Rental revenue increased from \$16.6 million to \$23.5 million, or 41.7%, for the year ended December 31, 2006, compared to the year ended December 31, 2005. The increase is mainly the result of units added to our rental fleet and rented to third parties. At December 31, 2006, we had 1,111 compressor packages in our rental fleet, up from 865 units at December 31, 2005. The average monthly rental rate per unit at December 31, 2006 was \$2.3 thousand, as compared to \$2.1 thousand at December 31, 2005. This increase resulted from normal price increases throughout the year and the addition of larger units to our rental fleet which command higher rental rates.

The overall gross margin percentage, exclusive of depreciation, increased to 37.3% for the year ended December 31, 2006, as compared to 36.4% for the year ended December 31, 2005. This increase resulted mainly from the relative increase in compressor rental revenue as a percentage of the total revenue. Our rental fleet carried a gross margin averaging 62.0% for 2006, and compressor and parts sales margins averaged 22.5%.

Selling expense increased from \$1.0 million to \$1.3 million, or 23.1%, for the year ended December 31, 2006, as compared to the year ended December 31, 2005. This increase is mainly the result of increased commissions paid to salesmen for the increase in rental activity.

General and administrative expenses remained relatively flat at \$4.0 million for the year ended December 31, 2006, as compared to \$3.9 million for the year ended December 31, 2005. While there was an increase in the expense to comply with SOX 404, this was offset by a decrease in officer salary and bonus expenses due to the departure of personnel.

Depreciation and amortization expense increased 42.5% from \$4.2 million to \$6.0 million for the year ended December 31, 2006, compared to the year ended December 31, 2005. There was a net increase of 246 natural gas compressor units to our rental fleet between December 31, 2005 and 2006, thus increasing our depreciable base.

Other income increased approximately \$1.2 million for the year ended December 31, 2006, compared to the same period in 2005. This increase was mainly the result of additional interest income from our short-term investment account as a result of increased cash balances from our March 2006 public offering.

Interest expense decreased by \$351 thousand, or 17.6%, for the year ended December 31, 2006, compared to the year ended December 31, 2005, mainly due to decreases in our loan balances. In March 2006, we reduced our bank debt by \$5.0 million with proceeds from our March 2006 public offering of common stock and continued our normal amortization of the remaining debt.

Provision for income tax increased by \$1.7 million, or 64.0%, and is the result of the increase in taxable income.

***Year Ended December 31, 2005 Compared to the Year Ended December 31, 2004***

The table below shows our revenues, percentage of total revenues, gross margin, exclusive of depreciation, and gross margin percentage of each of our segments for the years ended December 31, 2005 and December 31, 2004. Gross margin is the difference between revenue and cost of sales, exclusive of depreciation

	Revenue				Gross Margin, Exclusive of Depreciation <sup>(1)</sup>			
	Year Ended December 31, 2004		Year Ended December 31, 2005		Year Ended December 31, 2004		Year Ended December 31, 2005	
	<i>(dollars in thousands)</i>							
Sales	\$ 3,593	23%	\$ 30,278	61%	\$ 1,037	29%	\$ 6,947	23%
Service and Maintenance	1,874	11%	2,424	5%	517	28%	945	39%
Rental	10,491	66%	16,609	34%	7,453	71%	10,081	61%
Total	\$ 15,958		\$ 49,311		\$ 9,007	56%	\$ 17,973	36%

(1) For a reconciliation of gross margin to its most directly comparable financial measure calculated and presented in accordance with GAAP, please read Part II, Item 6 ("Selected Financial Data-Non-GAAP Financial Measures") of this report.

Total revenues for the year ended December 31, 2005 increased 209.0% to \$49.3 million, as compared to \$16.0 million for the year ended December 31, 2004. The increase in revenue reflects the increase in our rental revenue and the addition of revenue from our acquisition of SCS.

Sales revenue increased from \$3.6 million to \$30.3 million, or 742.7%, for the year ended December 31, 2005, compared to the year ended December 31, 2004. The increase was mainly the result of the sale of compressor units to outside third parties by SCS.

Service and maintenance revenue increased from \$1.9 million to \$2.4 million, or 29.3%, for the year ended December 31, 2005, compared to the year ended December 31, 2004. The increase was mainly the result of additional third party labor sales in our New Mexico area and Michigan branches.

Rental revenue increased from \$10.5 million to \$16.6 million, or 58.3%, for the year ended December 31, 2005, compared to the year ended December 31, 2004. The increase was mainly the result of units added to our rental fleet and rented to third parties. At December 31, 2005, we had 865 compressor packages in our rental fleet, up from 586 units at December 31, 2004. The average monthly rental rate per unit at December 31, 2005 was \$2.1 thousand, as compared to \$2.0 thousand at December 31, 2004.

The overall gross margin percentage, exclusive of depreciation, decreased to 36.4% for the year ended December 31, 2005, as compared to 56.4% for the year ended December 31, 2004. This decrease resulted mainly from the relative increase in compressor sales revenue as a percentage of the total revenue. Our rental fleet carried a gross margin averaging 60.7% for 2005, and compressor and parts sales margins averaged 23.0%.

Selling, general and administrative expense increased from \$2.7 million to \$4.9 million, or 84.4%, for the year ended December 31, 2005, as compared to the year ended December 31, 2004. This was mainly the result of the increased expenses attributed to our acquisition of SCS. SCS accounted for approximately \$1.5 million of the total selling, general and administrative expenses for the year ended December 31, 2005.

Depreciation and amortization expense increased 72.8% from \$2.4 million to \$4.2 million for the year ended December 31, 2005, compared to the year ended December 31, 2004. This increase was the result of 279 new gas compressor rental units being added to rental equipment from December 31, 2004 to December 31, 2005, thus increasing the depreciable base.

Other income decreased approximately \$1.2 million for the year ended December 31, 2005, compared to the same period in 2004. This decrease was due mainly to the \$1.5 million that was received in the year ended December 31, 2004 as life insurance proceeds from the death of our former Chief Executive Officer, offset by additional interest income from our money market accounts in 2005.

Interest expense increased by \$1.2 million, or 138%, for the year ended December 31, 2005, compared to the same period ended December 31, 2004, mainly due to increased debt incurred to finance rental equipment additions, debt related to our acquisition of SCS and increased interest rates.

Provision for income tax increased by \$1.5 million, or 129.4%, because taxable income increased after giving effect to the non-taxable life insurance proceeds received in 2004.

### **Critical Accounting Policies and Practices**

We have identified the policies below as critical to our business operations and the understanding of our results of operations. In the ordinary course of business, we have made a number of estimates and assumptions relating to the reporting of results of operations and financial condition in the preparation of our consolidated financial statements in conformity with accounting principles generally accepted in the United States. Actual results could differ significantly from those estimates under different assumptions and conditions. We believe that the following discussion addresses our most critical accounting policies, which are those that are most important to the portrayal of our financial condition and results of operations and require our most difficult, subjective, and complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain.

Our critical accounting policies are as follows:

revenue recognition;

estimating the allowance for doubtful accounts;



· accounting for income taxes;

· valuation of long-lived and intangible assets and goodwill; and

· valuation of inventory

### *Revenue Recognition*

Revenue from the sales of custom and fabricated compressors, and flare systems is recognized upon shipment of the equipment to customers. Revenue from sale of rental units is included in sales revenue when equipment is shipped or title is transferred to the customer. Exchange and rebuild compressor revenue is recognized when both the replacement compressor has been delivered and the rebuild assessment has been completed. Revenue from compressor services is recognized upon providing services to the customer. Maintenance agreement revenue is recognized as services are rendered. Rental revenue is recognized over the terms of the respective rental agreements based upon the classification of the rental agreement. Deferred income represents payments received before a product is shipped.

### *Allowance for Doubtful Accounts Receivable*

We perform ongoing credit evaluations of our customers and adjust credit limits based upon payment history and the customer's current credit worthiness, as determined by our review of their current credit information. We continuously monitor collections and payments from our customers and maintain a provision for estimated credit losses based upon our historical experience and any specific customer collection issues that we have identified. While such credit losses have historically been within our expectations and the provisions established, we cannot guarantee that we will continue to experience the same credit loss rates that we have in the past. At December 31, 2006 and December 31, 2005, XTO Energy, Inc. accounted for approximately 54% and 44%, respectively, of our accounts receivable. A significant change in the liquidity or financial position of this customer could have a material adverse impact on the collectibility of our accounts receivables and our future operating results.

### *Accounting for Income Taxes*

As part of the process of preparing our consolidated financial statements we are required to estimate our federal income taxes as well as income taxes in each of the states in which we operate. This process involves us estimating our actual current tax exposure together with assessing temporary differences resulting from differing treatment of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included in our consolidated balance sheet. We must then assess the likelihood that our deferred tax assets will be recovered from future taxable income and to the extent we believe that recovery is not probable, we must establish a valuation allowance. To the extent we establish a valuation allowance or increase this allowance in a period, we must include an expense in the tax provision in the statement of operations.

Significant management judgment is required in determining our provision for income taxes, our deferred tax assets and liabilities and any valuation allowance recorded against our net deferred tax assets.

### *Valuation of Long-Lived and Intangible Assets and Goodwill*

We assess the impairment of identifiable intangibles, long-lived assets and related goodwill whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Factors we consider important which could trigger an impairment review include the following:

- significant underperformance relative to expected historical or projected future operating results;
- significant changes in the manner of our use of the acquired assets or the strategy for our overall business; and
- significant negative industry or economic trends.

When we determine that the carrying value of intangibles, long-lived assets and related goodwill may not be recoverable based upon the existence of one or more of the above indicators of impairment, we measure any impairment based on a projected discounted cash flow method using a discount rate determined by our management to be commensurate with the risk inherent in our current business model.

We adopted FAS 142 as of January 1, 2002. Based on an independent valuation in June 2006 and an internal evaluation in December 2004 and June 2005 of our reporting units with goodwill, adoption of FAS 142 did not have a material adverse effect on us in 2004, 2005 or 2006. In the future, it could result in impairments of our intangible assets or goodwill. We expect to continue to amortize our intangible assets with finite lives over the same time periods as previously used, and we will test our intangible assets with indefinite lives for impairment at least once each year. In addition, we are required to assess the consumptive life, or longevity, of our intangible assets with finite lives and adjust their amortization periods accordingly. Our net intangible assets, including goodwill, were recorded on our balance sheet at approximately \$14.0 million as of December 31, 2005, and at December 31, 2006, the carrying value of net intangible assets, including goodwill, decreased to approximately \$13.7 million. Our intangibles are amortized at a rate of \$299 thousand per year. Any impairment in future periods of those assets, or a reduction in their consumptive lives, could materially and adversely affect our consolidated statements of income and financial position.

### *Inventories*

We value our inventory at the lower of the actual cost to purchase and/or manufacture the inventory or the current estimated market value of the inventory. We regularly review inventory quantities on hand and record a provision for excess and obsolete inventory based primarily on our estimated forecast of product demand and production requirements.

### **Recently Issued Accounting Pronouncements**

On December 16, 2004, the FASB published FASB Statement No. 123 (revised 2004), *Share-Based Payment* ("Statement 123R"), requiring that the compensation cost relating to share-based payment transactions be recognized in financial statements. That cost will be measured based on the fair value of the equity or liability instruments issued. We were required to apply Statement 123R as of January 1, 2006. Statement 123R replaces FASB Statement No. 123, *Accounting for Stock-Based Compensation*, and supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*. Statement 123, as originally issued in 1995, established as preferable a fair-value-based method of accounting for share-based payment transactions with employees. However, that Statement permitted entities the option of continuing to apply the guidance in Opinion 25, as long as the footnotes to financial statements disclosed what net income would have been had the preferable fair-value-based method been used.

The Company has adopted Statement 123(R) effective January 1, 2006 using the modified prospective method. The Company recognized \$376 thousand in expense in 2006 as a result of stock options vesting during 2006.

In November 2004, the FASB issued SFAS No 151, *Inventory Costs — an Amendment of ARB No. 43, Chapter 4* ("SFAS 151"). This standard provides clarification that abnormal amounts of idle facility expense, freight, handling costs, and spoilage should be recognized as current-period charges. Additionally, this standard requires that allocation of fixed production overhead to the costs of conversion be based on the normal capacity of the production facilities. The provisions of this standard are effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The adoption of the new standard did not have a material effect on our consolidated results of operations, cash flows or financial position in 2006.

In July 2006 the FASB issued FASB Interpretation ("FIN") No. 48, *Accounting for Uncertainty in Income Taxes — an interpretation of FASB Statement 109*. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. FIN 48 prescribes a comprehensive model for recognizing, measuring, presenting and disclosing in the financial statements tax positions taken or expected to be taken on a tax return. FIN 48 is effective for fiscal years beginning after December 15, 2006. If there are changes in net assets as a result of application of FIN 48 these will be accounted for as an adjustment to retained earnings. We adopted FIN 48 on January 1, 2007 and have determined its adoption will not have a material impact on our consolidated financial position and results of operations.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements" ("SAB 108"). SAB 108 provides guidance on how to evaluate prior period financial statement misstatements for purposes of assessing their materiality in the current period. If the prior period effect is material to the current period, then the prior period is required to be corrected. Correcting prior year financial statements would not require an amendment of prior year financial statements, but such corrections would be made the next time the company files the prior year financial statements. Upon adoption, SAB 108 allows a one-time transitional cumulative effect adjustment to retained earnings for corrections of prior period misstatements required under this statement. SAB 108 is effective for fiscal year ending December 31, 2006.

## Environmental Regulations

Various federal, state and local laws and regulations covering the discharge of materials into the environment, or otherwise relating to protection of human safety and health and the environment, affect our operations and costs. Compliance with these laws and regulations could cause us to incur remediation or other corrective action costs or result in the assessment of administrative, civil and criminal penalties and the issuance of injunctions delaying or prohibiting operations. In addition, we have acquired certain properties and plant facilities from third parties whose actions with respect to the management and disposal or release of hydrocarbons or other wastes were not under our control. Under environmental laws and regulations, we could be required to remove or remediate wastes disposed of or released by prior owners. In addition, we could be responsible under environmental laws and regulations for properties and plant facilities we lease, but do not own. Compliance with such laws and regulations increases our overall cost of business, but has not had a material adverse effect on our operations or financial condition. It is not anticipated, based on current laws and regulations, that we will be required in the near future to expend amounts that are material in relation to our total expenditure budget in order to comply with environmental laws and regulations but, such laws and regulations are frequently changed and we are unable to predict the ultimate cost of compliance. We also could incur costs related to the clean up of sites to which we send equipment and for damages to natural resources or other claims related to releases of regulated substances at such sites.

## Liquidity and Capital Resources

The following represents the Company's working capital position as of December 31, 2005 and 2006

	December 31, 2005	December 31, 2006
Current Assets:		
Cash & cash equivalents	\$ 3,271	\$ 4,391
Short-term investments		25,052
Trade accounts receivable, net	6,192	8,463
Inventory, net	14,723	16,943
Prepaid expenses and other	456	321
Total current assets	24,642	55,170
Current Liabilities:		
Current portion of long-term debt and subordinated notes	5,680	4,442
Line of credit	300	
Accounts payable	3,180	2,837
Accrued liabilities	1,737	2,077
Current portion of tax liability	207	1,056
Deferred income	103	225
Total current liabilities	11,207	10,637
Total working capital	\$ 13,435	\$ 44,533

Historically, we have funded our operations through public and private offerings of our equity securities, subordinated debt, bank borrowings and cash flow from operations. Proceeds of financings have been primarily used to repay debt, to fund the manufacture and fabrication of additional units for our rental fleet of natural gas compressors and for acquisitions.

For the year ended December 31, 2006, we invested approximately \$27.7 million in equipment for our rental fleet and in service vehicles. We financed this activity with the proceeds from our March 2006 public offering of common stock and funds from operations. We borrowed approximately \$1.4 million from our bank in 2006. We also repaid approximately \$11.3 million of our existing debt during 2006.

*Cash flows*

At December 31, 2005, we had cash and cash equivalents of approximately \$3.3 million, working capital of \$13.4 million and total debt of \$28.2 million, of which approximately \$6.0 million was classified as current. At that same date, we also had letters of credit outstanding in the aggregate face amount of \$2.0 million which secured payment of our subordinated debt in the amount of \$3.0 million. We had positive net cash flow from operating activities of approximately \$3.8 million during 2005. This was primarily from net income of \$4.4 million, plus depreciation and amortization of \$4.2 million, an increase in deferred taxes of \$2.4 million, an increase in accounts payable and accrued liabilities of \$0.4 million, offset by an increase in trade accounts receivable of \$1.4 million, deferred income of \$0.9 million, and an increase in inventory of \$5.7 million.

At December 31, 2006, we had cash and cash equivalents of approximately \$4.4 million, working capital of \$44.5 million and total debt of \$18.4 million, of which approximately \$4.4 million was classified as current. At that same date, we also had letters of credit outstanding in the aggregate face amount of \$2.0 million. We had positive net cash flow from operating activities of approximately \$16.1 million during 2006. This was primarily from net income of \$7.6 million, plus depreciation and amortization of \$6.0 million, an increase in deferred taxes of \$2.5 million and offset by an increase in trade accounts receivable of \$2.3 million.

Short term investments increased to \$25.1 million from December 31, 2005 to December 31, 2006. This increase is the remaining proceeds from our March 2006 secondary public offering. The initial net proceeds from the offering were \$47.1 million, from this we paid down \$5.0 million of debt and the remainder was used for capital expenditures to build additional units for our compressor rental fleet.

Trade accounts receivable increased \$2.3 million to \$8.5 million at December 31, 2006 as compared to \$6.2 million at December 31, 2005, largely reflecting the impact of higher sales.

Inventory increased \$2.2 million to \$16.9 million as of the end of 2006 as compared to \$14.7 million as of the end of 2005. This increase is mainly a reflection of increased sales activity. Inventory turnover was 7.97 at December 31, 2005 and 7.41 at December 31, 2006.

Long term debt decreased \$9.8 million to \$18.4 million at December 31, 2006 compared to \$28.2 million at December 31, 2005. The current portion of long term debt decreased \$1.5 million to \$4.4 million at December 31, 2006 compared to \$6.0 million at December 31, 2005, mainly the result of normal amortization of debt and a one time payment of \$5 million from offering proceeds.

***Contractual Obligations and Commitments***

We have contractual obligations and commitments that affect our consolidated results of operations, financial condition and liquidity. The following table is a summary of our significant cash contractual obligations:

Cash Contractual Obligations	Obligation Due in Period						Total
	2007	2008	2009	2010	2011	Thereafter	
	<i>(in thousands)</i>						
Credit facility (secured)	\$ 3,442	\$ 3,378	\$ 3,378	\$ 3,378	\$ 2,816	\$	\$ 16,392
	1,160	865	591	338	211		3,165



Interest on credit facility							
Subordinated debt	1,000	1,000					2,000
Facilities and office leases	129	62	29	29	30	76	355
Purchase obligations							
Total	\$ 5,731	\$ 5,305	\$ 3,998	\$ 3,745	\$ 3,057	\$ 76	\$ 21,912

### ***Senior Bank Borrowings***

On October 15, 2006, we entered into a Seventh Amended and Restated Loan Agreement, or “Loan Agreement,” with Western National Bank, Midland, Texas. This Loan Agreement (1) consolidated our previously existing advancing line of credit and term loan facilities into one term loan facility, and (2) extended, renewed and increased our revolving line of credit facility. Our revolving line of credit and multiple advance term loan facilities are described below.

*Revolving Line of Credit Facility.* Our revolving line of credit facility allows us to borrow, repay and reborrow funds drawn under this facility. After entering into the Seventh Amended and Restated Loan Agreement, the total amount that we could borrow and have outstanding at any one time is the lesser of \$40.0 million or the amount available for advances under a “borrowing base” calculation established by the bank. As of December 31, 2006, the amount available for revolving line of credit advances under our borrowing base was \$40.0 million, and there was no principal amount outstanding under the revolving line of credit at that same date. The amount of the borrowing base is based primarily upon our receivables, equipment and inventory. The borrowing base is redetermined by the bank on a monthly basis. If, as a result of the redetermination of the borrowing base, the aggregate outstanding principal amount of the notes payable to the bank under the Loan Agreement exceeds the borrowing base, we must prepay the principal of the revolving line of credit note in an amount equal to such excess. Interest only on borrowings under our revolving line of credit facility is payable monthly on the first day of each month. All outstanding principal and unpaid interest is due on October 1, 2008. As of December 31, 2006, our interest rate on the revolving line of credit was 7.5%.

*\$16.9 Million Multiple Advance Term Loan Facility.* This multiple advance term loan facility represents the consolidation of our previously existing advancing line of credit and term loan facilities. Reborrowings are not permitted under this facility. Principal under this credit facility is due and payable in 59 monthly installments of \$282 thousand each, commencing November 1, 2006 and continuing through September 1, 2011. The interest rate is fixed at 7.5% for this loan facility. Interest on the unpaid principal balance is due and payable on the same dates as principal payments. All outstanding principal and unpaid interest is due on October 1, 2011. As of December 31, 2006 this term loan facility had a principal balance of \$16.4 million.

During the year ended December 31, 2006, we made principal payments in the aggregate amount of approximately \$8.5 million on our term loan facilities.

SCS has guaranteed payment of our loans.

Our obligations under the Loan Agreement are secured by substantially all of our properties and assets, including our equipment, trade accounts receivable and other personal property, the stock we own in SCS, and by the real estate and related plant facilities owned by SCS.

The maturity dates of the loan facilities may be accelerated by the bank upon the occurrence of an event of default under the Loan Agreement.

The Loan Agreement contains various restrictive covenants and compliance requirements. These requirements provide that we must have:

- at the end of each month, a consolidated current ratio (as defined in the Loan Agreement) of at least 1.4 to 1.0;
- at the end of each month, consolidated tangible net worth (as defined in the Loan Agreement) of at least \$70.0 million;
-

at the end of each fiscal quarter, a debt service coverage ratio (as defined in the Loan Agreement) of at least 1.50 to 1.00; and

· at the end of each month, a ratio of consolidated debt to consolidated tangible net worth (as such terms are defined in the Loan Agreement) of less than 2.0 to 1.0.

The Loan Agreement also contains restrictions on incurring additional debt and paying dividends.

As of December 31, 2006, we were in compliance with all material covenants in our Loan Agreement. A default under our bank credit facility could trigger the acceleration of our bank debt so that it is immediately due and payable. Such default would have a material adverse effect on our liquidity, financial position and operations.

***Subordinated Debt and Related Letters of Credit***

The principal amounts of the promissory notes issued to the three stockholders of SCS in the SCS acquisition are payable in three equal annual installments, commencing on January 3, 2006. Accrued and unpaid interest on the unpaid principal balance of the notes is payable on the same dates as, and in addition to, the installments of principal. Subject to the consent of the holder of each respective note, principal payments may be made by us in shares of our common stock valued at the average daily closing prices of the common stock on the American Stock Exchange for the twenty consecutive trading days commencing thirty trading days before the due date of the principal payment, or by combination of cash and shares of common stock. Under the terms of our Loan Agreement with our bank lender, we are prohibited from making payments on these notes if at the time of any such payment we are then in default under the Loan Agreement or if any such payment would cause or result in a default under the Loan Agreement.

To secure payment of these notes, our bank lender issued for our account three separate letters of credit for the benefit of the holders of the notes in the initial aggregate face amount of \$2.0 million. The letters of credit expire February 3, 2008. Drafts for payment under the letters of credit may be made by the beneficiaries only upon our default in payment of the notes. On February 3, 2007, the face amount of the letters of credit automatically reduced to \$1.0 million.

***Components of Our Principal Capital Expenditures***

The table below sets out components of our principal capital expenditures for the three years ended December 31, 2006, along with the total budgeted for 2007, excluding acquisitions:

Expenditure Category	Actual			Budgeted 2007 (excluding acquisitions)
	2004	2005	2006	
	<i>(in thousands)</i>			
Rental equipment, vehicles and shop equipment	\$ 11,596	\$ 17,708	\$ 27,684	\$ 30,000 to \$ 35,000

The level of our expenditures will vary in future periods depending on energy market conditions and other related economic factors. Based upon existing economic and market conditions, we believe that the proceeds from our March 2006 public offering of common stock, our operating cash flow and available bank borrowings will be sufficient to fully fund our net investing cash requirements for 2007. We also believe we have significant flexibility with respect to our financing alternatives and adjustment of our expenditure plans if circumstances warrant. When considered in relation to our total financial capacity, we do not have any material continuing commitments associated with expenditure plans related to our current operations.

***Off-Balance Sheet Arrangements***

From time-to-time, we enter into off-balance sheet arrangements and transactions that can give rise to off-balance sheet obligations. As of December 31, 2006, the off-balance sheet arrangements and transactions that we have entered into include an undrawn letter of credit and operating lease agreements. The Company does not believe that these arrangements are reasonably likely to materially affect its liquidity or availability of, or requirements for, capital resources.



**PART IV**

**ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES**

The following documents are filed as part of this Annual Report on Form 10-K/A:

(a)(1) and (a)(2) Financial Statement and Financial Statement Schedules

For a list of Consolidated Financial Statements and Schedules, see "Index to Financial Statements" on page F-1, and incorporated herein by reference.

(a)(3) Exhibits

See Item 15(b) below.

(b) Exhibits:

A list of exhibits to this Annual Report on Form 10-K/A is set forth below:

<u>Exhibit No.</u>	<u>Description</u>
3.1	Articles of Incorporation, as amended (Incorporated by reference to Exhibit 3.1 of the 10QSB filed and dated November 10, 2004)
3.2	Bylaws (Incorporated by reference to Exhibit 3.4 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
4.1	Form of warrant certificate (Incorporated by reference to Exhibit 4.1 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
4.2	Form of warrant agent agreement (Incorporated by reference to Exhibit 4.2 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
4.3	Form of representative's option for the purchase of common stock (Incorporated by reference to Exhibit 4.4 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
4.4	Form of representative's option for the purchase of warrants (Incorporated by reference to Exhibit 4.5 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
4.5	Stockholders Agreement, dated January 3, 2005 among Paul D. Hensley, Tony Vohjesus, Jim Hazlett and Natural Gas Services Group, Inc. (Incorporated by reference to Exhibit 4.3 of the Registrant's Form 8-K Report, dated January 3, 2005, as filed with the Securities and Exchange Commission on January 7, 2005)
	Executive Compensation Plans and Arrangements (Exhibits 10.1, 10.14, 10.15, 10.16, 10.23, 10.24, 10.26 and 10.27)
10.1	1998 Stock Option Plan, as amended (Incorporated by reference to Exhibit 10.1 of the Registrant's Form 8-K Report dated June 20, 2006 on file with the SEC June 26, 2006)
10.2	Form of Series A 10% Subordinated Notes due December 31, 2006 (Incorporated by reference to Exhibit 10.8 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)

10.3 Form of Five-Year Warrants to Purchase Common Stock (Incorporated by reference to Exhibit 10.9 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)

10.4 Warrants issued to Berry-Shino Securities, Inc. (Incorporated by reference to Exhibit 10.10 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)

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<u>Exhibit No.</u>	<u>Description</u>
10.5	Warrants issued to Neidiger, Tucker, Bruner, Inc. (Incorporated by reference to Exhibit 10.11 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
10.6	Form of warrant issued in March 2001 for guaranteeing debt (Incorporated by reference to Exhibit 10.12 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
10.7	Form of warrant issued in April 2002 for guaranteeing debt (Incorporated by reference to Exhibit 10.13 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
10.8	First Amended and Restated Loan Agreement between the Registrant and Western National Bank (Incorporated by reference to Exhibit 10.1 of the Registrant's Current Report on Form 8-K, dated March 27, 2003 and filed with the Securities and Exchange Commission on April 14, 2003)
10.9	Lease Agreement, dated March 1, 2004, between the Registrant and the City of Midland, Texas (Incorporated by reference to Exhibit 10.19 of the Registrant's Form 10-QSB for the fiscal quarter ended June 30, 2004)
10.10	Second Amended and Restated Loan Agreement, dated November 3, 2003, between the Registrant and Western National Bank (Incorporated by reference to Exhibit 10.20 of the Registrant's Form 10-QSB for the fiscal quarter ended June 30, 2004)
10.11	Securities Purchase Agreement, dated July 20, 2004, between the Registrant and CBarney Investments, Ltd. (Incorporated by reference to Exhibit 4.1 of the Registrant's Current Report on Form 8-K dated July 20, 2004 and filed with the Securities and Exchange Commission on July 27, 2004)
10.12	Stock Purchase Agreement, dated October 18, 2004, by and among the Registrant, Screw Compression Systems, Inc., Paul D. Hensley, Jim Hazlett and Tony Vohjesus (Incorporated by reference to Exhibit 4.1 of the Registrant's Current Report on Form 8-K dated October 18, 2004 and filed with the Securities and Exchange Commission on October 21, 2004)
10.13	Third Amended and Restated Loan Agreement, dated as of January 3, 2005, among Natural Gas Services Group, Inc., Screw Compression Systems, Inc. and Western National Bank (Incorporated by reference to Exhibit 10.1 of the Registrant's Current Report on Form 8-K, dated January 3, 2005, and filed with the Securities and Exchange Commission on January 7, 2005)
10.14	Employment Agreement between Paul D. Hensley and Natural Gas Services Group, Inc. (Incorporated by reference to Exhibit 10.1 of the Registrant's Form 8-K Report, dated January 3, 2005, as filed with the Securities and Exchange Commission on January 7, 2005)
10.15	Employment Agreement between William R. Larkin and Natural Gas Services Group, Inc. (Incorporated by reference to Exhibit 10.25 of the Registrant's Form 10-KSB for the fiscal year ended December 31, 2004, and filed with the Securities and Exchange Commission on March 30, 2005)
10.16	Promissory Note, dated January 3, 2005, in the original principal amount of \$2.1 million made by Natural Gas Services Group, Inc. payable to Paul D. Hensley (Incorporated by reference to Exhibit 10.26 of the Registrant's Form 10-KSB for the fiscal year ended December 31, 2004, and filed with the Securities and Exchange Commission on March 30, 2005)



- 10.17 Fourth Amended and Restated Loan Agreement (Incorporated by reference to Exhibit 10.1 of the Registrant's Current Report on Form 8-K, dated March 14, 2005, and filed with the Securities and Exchange Commission on March 18, 2005)
- 10.18 Modification Agreement, dated as of January 3, 2005, by and between Natural Gas Services Group, Inc. and Western National Bank (Incorporated by reference to Exhibit 10.2 of the Registrant's Current Report on Form 8-K, dated January 3, 2005, and filed with the Securities and Exchange Commission on January 7, 2005)

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<u>Exhibit No.</u>	<u>Description</u>
10.19	Guaranty Agreement, dated as of January 3, 2005, made by Natural Gas Service Group, Inc., for the benefit of Western National Bank (Incorporated by reference to Exhibit 10.3 of the Registrant's Current Report on Form 8-K, dated January 3, 2005, and filed with the Securities and Exchange Commission on January 7, 2005)
10.20	Guaranty Agreement, dated as of January 3, 2005, made by Screw Compression Systems, Inc., for the benefit of Western National Bank (Incorporated by reference to Exhibit 10.4 of the Registrant's Current Report on Form 8-K, dated January 3, 2005, and filed with the Securities and Exchange Commission on January 7, 2005)
10.21	Fifth Amended and Restated Loan Agreement (Incorporated by reference to Exhibit 10.2 of the Registrant's Form 8-K dated January 3, 2006 and filed with the Securities and Exchange Commission January 6, 2006)
10.22	First Modification to Fourth Amended and Restated Loan Agreement (Incorporated by reference Exhibit 10.1 of the Registrant's Form 8-K dated May 1, 2005 and filed with Securities and Exchange Commission May 13, 2005)
10.23	Employment Agreement between Stephen C. Taylor and Natural Gas Services Group, Inc. (Incorporated by reference to Exhibit 10.1 of the Registrant's Form 8-K Report, dated August 24, 2005, and filed with the Securities and Exchange Commission on August 30, 2005)
10.24	Employment Agreement between James R. Hazlett and Natural Gas Services Group, Inc. (Incorporated by reference to Exhibit 10.1 of the Registrant's Form 8-K Report, dated June 14, 2005, and filed with the Securities and Exchange Commission on November 14, 2005)
10.25	Stockholders Agreement, dated January 3, 2005 among Paul D. Hensley, Tony Vohjesus, Jim Hazlett and Natural Gas Services Group, Inc. (Incorporated by reference to Exhibit 4.3 of the Registrant's Form 8-K Report, dated January 3, 2005, and filed with the Securities and Exchange Commission on January 7, 2005)
10.26	Promissory Note, dated January 3, 2005, in the original principal amount of \$300 thousand made by Natural Gas Services Group, Inc. payable to Jim Hazlett (Incorporated by reference to Exhibit 10.3 of the Registrant's Form 8-K Report, dated June 14, 2005, and filed with the Securities and Exchange Commission on November 14, 2005)
10.27	Retirement Agreement, dated December 14, 2005, between Wallace C. Sparkman and Natural Gas Services Group, Inc. (Incorporated by reference to Exhibit 10.1 of the Registrant's Form 8-K Report, dated December 14, 2005, and filed with the Securities and Exchange Commission on December 15, 2005)
10.28	Sixth Amended and Restated Loan Agreement, dated as of January 3, 2006 (Incorporated by reference to Exhibit 10.3 of the Registrant's Current Report on Form 8-K, dated January 3, 2006, and filed with the Securities and Exchange Commission on January 6, 2006)
10.29	Guaranty Agreement, dated as of January 3, 2006, and made by Screw Compression Systems, Inc. for the benefit of Western National Bank (Incorporated by reference to Exhibit 10.4 of the Registrant's Current Report on Form 8-K, dated January 3, 2006, and filed with the Securities and Exchange Commission on January 6, 2006)
10.30	Seventh Amended and Restated Loan Agreement (Incorporated by reference to Exhibit 10.1 of the Registrant's Form 8-K dated October 26, 2006 and filed with the Securities and Exchange Commission on November 1, 2006)

14.0 Code of Ethics (Incorporated by reference to Exhibit 14.0 of the Registrant's Form 10-KSB for the fiscal year ended December 31, 2004, and filed with the Securities and Exchange Commission on March 30, 2005)

21.0 Subsidiaries (Incorporated by reference to Exhibit 21.0 of the Registrant's Form 10-KSB for the fiscal year ended December 31, 2004, and filed with the Securities and Exchange Commission on March 30, 2005)

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<u>Exhibit No.</u>	<u>Description</u>
*23.1	Consent of Hein & Associates LLP
*31.1	Certifications
*31.2	Certifications
*32.1	Certification required by Section 906 of the Sarbanes-Oxley Act of 2002
*32.2	Certification required by Section 906 of the Sarbanes-Oxley Act of 2002

\* Filed herewith.

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**SIGNATURES**

In accordance with Section 13 or 15(d) of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**Natural Gas Service Group, Inc.**

Date: June 8, 2007

By: /s/ Stephen C. Taylor  
Stephen C. Taylor  
Chairman of the Board of  
Directors, Chief Executive Officer  
and  
President (Principal Executive  
Officer)

In accordance with the Exchange Act, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated:

Signature	Title	Date
/s/ Stephen C. Taylor Stephen C. Taylor	Chairman of the Board of Directors, Chief Executive Officer and President (Principal Executive Officer)	June 8, 2007
/s/ Earl R. Wait Earl R. Wait	Vice President – Accounting (Principal Financial Officer)	June 8, 2007

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors  
Natural Gas Services Group, Inc.

We have audited the consolidated balance sheets of Natural Gas Services Group, Inc. and Subsidiaries (the “Company”) as of December 31, 2005 and 2006, and the related consolidated statements of income, stockholders' equity and cash flows for each of the years in the three-year period ended December 31, 2006. These consolidated financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits 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 financial position of the Company as of December 31, 2005 and 2006, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2006, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Natural Gas Services Group, Inc. and Subsidiaries internal control over financial reporting as of December 31, 2006, 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 12, 2007 expressed an unqualified opinion on management’s assessment of the effectiveness of the Company’s internal control over financial reporting and an unqualified opinion on the effectiveness of the Company’s internal control over financial reporting.

/s/**HEIN & ASSOCIATES LLP**  
Dallas, Texas  
March 12, 2007

**NATURAL GAS SERVICES GROUP, INC. AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**

(amounts in thousands, except per share data)

	<b>December 31,</b>	
	<b>2005</b>	<b>2006</b>
<b>ASSETS</b>		
<b>Current Assets:</b>		
Cash and cash equivalents	\$ 3,271	\$ 4,391
Short-term investments	—	25,052
Trade accounts receivable, net of doubtful accounts of \$75 and \$110, respectively	6,192	8,463
Inventory, net of allowance for obsolescence of \$361 and \$347, respectively	14,723	16,943
Prepaid expenses and other	456	321
Total current assets	24,642	55,170
Rental equipment, net of accumulated depreciation of \$7,598 and \$11,320, respectively	41,201	59,866
Property and equipment, net of accumulated depreciation of \$2,458 and \$3,679, respectively	6,424	6,714
Goodwill, net of accumulated amortization of \$325	10,039	10,039
Intangibles, net of accumulated amortization of \$492 and \$819, respectively	3,978	3,650
Other assets	85	113
Total assets	\$ 86,369	\$ 135,552
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>Current Liabilities:</b>		
Current portion of long-term debt and subordinated notes	\$ 5,680	\$ 4,442
Line of credit	300	—
Accounts payable	3,180	2,837
Accrued liabilities	1,737	2,077
Current income tax liability	207	1,056
Deferred income	103	225
Total current liabilities	11,207	10,637
Long term debt, less current portion	20,225	12,950
Subordinated notes-related parties, less current portion	2,000	1,000
Deferred income tax payable	7,247	9,764
Commitments (Note 11)		
Stockholders' equity:		
Common stock, 30,000 shares authorized, par value \$0.01; 9,022 and 12,046 shares issued and outstanding, respectively	90	120
Additional paid-in capital	34,667	82,560
Retained earnings	10,933	18,521
Total stockholders' equity	45,690	101,201



Total liabilities and stockholders' equity	\$ 86,369	\$ 135,552
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See accompanying notes to these consolidated financial statements.

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**NATURAL GAS SERVICES GROUP, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF INCOME**

(amounts in thousands, except per share data)

	<b>For the Years Ended December 31,</b>		
	<b>2004</b>	<b>2005</b>	<b>2006</b>
<b>Revenue:</b>			
Sales, net	\$ 3,593	\$ 30,278	\$ 38,214
Service and maintenance income	1,874	2,424	979
Rental income	10,491	16,609	23,536
Total revenue	15,958	49,311	62,729
<b>Operating costs and expenses:</b>			
Cost of sales, exclusive of depreciation stated separately below	2,556	23,331	29,629
Cost of service, exclusive of depreciation stated separately below	1,357	1,479	735
Cost of rental, exclusive of depreciation stated separately below	3,038	6,528	8,944
Selling expenses	875	1,034	1,273
General and administrative	1,777	3,856	3,997
Depreciation and amortization	2,444	4,224	6,020
Total operating costs and expenses	12,047	40,452	50,598
<b>Operating income</b>	<b>3,911</b>	<b>8,859</b>	<b>12,131</b>
<b>Other income (expense):</b>			
Interest expense	(838)	(1,997)	(1,646)
Other income	1,441	199	1,390
Total other income (expense)	603	(1,798)	(256)
<b>Income before provision for income taxes</b>	<b>4,514</b>	<b>7,061</b>	<b>11,875</b>
<b>Provision for income taxes:</b>			
Current	20	207	1,743
Deferred	1,120	2,408	2,544
Total income tax expense	1,140	2,615	4,287
<b>Net income</b>	<b>3,374</b>	<b>4,446</b>	<b>7,588</b>
Preferred dividends	53	—	—
<b>Income available to common stockholders</b>	<b>\$ 3,321</b>	<b>\$ 4,446</b>	<b>\$ 7,588</b>
<b>Earnings per common share:</b>			
Basic	\$ 0.59	\$ 0.59	\$ 0.67
Diluted	\$ 0.52	\$ 0.52	\$ 0.66
<b>Weighted average common shares outstanding:</b>			
Basic	5,591	7,564	11,405

Diluted	6,383	8,481	11,472
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See accompanying notes to these consolidated financial statements.

**NATURAL GAS SERVICES GROUP, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY**  
**For the Years Ended December 31, 2004, 2005 and 2006**  
(amounts in thousands)

	Preferred Stock		Common Stock		Additional Paid-In Capital	Retained Earnings	Total Stockholders' Equity
	Shares	Amount	Shares	Amount			
<b>BALANCES, January 1, 2004</b>	344	\$ 4	5,031	\$ 50	\$ 11,205	\$ 3,166	\$ 14,425
Exercise of common stock options and warrants	—	—	80	1	245	—	246
Conversion of preferred stock to common stock	(344)	(4)	344	4	—	—	—
Transaction costs of private placement of common stock	—	—	—	—	(39)	—	(39)
Issuance of common stock	—	—	649	6	4,944	—	4,950
Dividends on preferred stock	—	—	—	—	—	(53)	(53)
Net income	—	—	—	—	—	3,374	3,374
<b>BALANCES, January 1, 2005</b>	—	\$ —	6,104	\$ 61	\$ 16,355	\$ 6,487	\$ 22,903
Exercise of common stock options and warrants	—	—	2,308	23	13,063	—	13,086
Compensation expense on issuance of common stock options	—	—	—	—	135	—	135
Issuance of common stock for acquisition	—	—	610	6	5,114	—	5,120
Net income	—	—	—	—	—	4,446	4,446
<b>BALANCES, January 1, 2006</b>	—	\$ —	9,022	\$ 90	\$ 34,667	\$ 10,933	\$ 45,690
Exercise of common stock options and warrants	—	—	129	1	356	—	357
Compensation expense on issuance of common stock options	—	—	—	—	376	—	376
Income tax benefit realized from the exercise of employee stock options	—	—	—	—	27	—	27
Issuance of common stock, net of offering costs	—	—	2,895	29	47,134	—	47,163
Net income	—	—	—	—	—	7,588	7,588
<b>BALANCES, December 31, 2006</b>	—	\$ —	12,046	\$ 120	\$ 82,560	\$ 18,521	\$ 101,201

See accompanying notes to these consolidated financial statements.

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**NATURAL GAS SERVICES GROUP, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

(amounts in thousands)

	For the Years Ended December 31,		
	2004	2005	2006
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net income	\$ 3,374	\$ 4,446	\$ 7,588
<b>Adjustments to reconcile net income to net cash provided by operating activities:</b>			
Depreciation and amortization	2,444	4,224	6,020
Deferred taxes	1,120	2,408	2,544
Employee stock option expense	—	135	376
Loss (gain) on disposal of assets	71	(28)	13
<b>Changes in current assets:</b>			
Trade accounts and other receivables	(1,182)	(1,352)	(2,271)
Inventory	(1,915)	(5,699)	749
Prepaid expenses and other	(34)	(362)	135
<b>Changes in current liabilities:</b>			
Accounts payable and accrued liabilities	1,264	337	(3)
Current income tax liability	20	187	849
Deferred income	(185)	(855)	122
Other assets	(279)	348	(46)
<b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>	<b>4,698</b>	<b>3,789</b>	<b>16,076</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Purchase of property and equipment	(11,596)	(17,708)	(27,684)
Purchase of short-term investments	—	—	(38,252)
Redemption of short-term investments	—	—	13,200
Assets acquired, net of cash	—	(7,584)	—
Proceeds from sale of property and equipment	50	264	73
Changes in restricted cash	(2,000)	2,000	—
<b>NET CASH USED IN INVESTING ACTIVITIES</b>	<b>(13,546)</b>	<b>(23,028)</b>	<b>(52,663)</b>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Net proceeds from line of credit	550	300	1,375
Proceeds from long-term debt	6,592	21,517	68
Repayments of long-term debt	(2,589)	(13,077)	(9,581)
Repayment of line of credit	(300)	—	(1,675)
Dividends paid on preferred stock	(53)	—	—
Proceeds from exercise of stock options and warrants	5,157	13,085	357
Proceeds from sale of stock, net of transaction costs	—	—	47,163
<b>NET CASH PROVIDED BY FINANCING ACTIVITIES</b>	<b>9,357</b>	<b>21,825</b>	<b>37,707</b>

<b>NET CHANGE IN CASH</b>	509	2,586	1,120
<b>CASH AT BEGINNING OF PERIOD</b>	176	685	3,271
<b>CASH AT END OF PERIOD</b>	\$ 685	\$ 3,271	\$ 4,391

**SUPPLEMENTAL DISCLOSURES OF CASH  
FLOW INFORMATION:**

Interest paid	\$ 775	\$ 1,877	\$ 1,692
Income taxes paid	\$ 31	\$ 24	\$ 894

**SUPPLEMENTAL DISCLOSURE OF  
NON-CASH INVESTING AND FINANCING  
ACTIVITIES:**

Assets acquired for issuance of subordinated debt	—	3,000	—
Assets acquired for issuance of common stock	—	5,120	—

See accompanying notes to these consolidated financial statements.

## NATURAL GAS SERVICES GROUP, INC. AND SUBSIDIARIES

### 1. Summary of Significant Accounting Policies

#### *Organization and Principles of Consolidation*

These notes apply to the consolidated financial statements of Natural Gas Services Group, Inc. (the "Company", "Natural Gas Services Group", "we" or "our") (a Colorado corporation). Natural Gas Services Group, Inc. was formed on December 18, 1998 for the purposes of combining the operations of certain manufacturing, service and leasing entities.

Effective January 1, 2004, Rotary Gas Systems, Inc., Great Lakes Compression, Inc., and NGE Leasing, Inc., were merged into NGSG.

On January 3, 2005, the Company purchased all of the outstanding shares of capital stock of Screw Compression System, Inc. ("SCS") a manufacturer of natural gas compressors, with its principal offices located in Tulsa, Oklahoma for the purpose of expanding the product line, production capacity and customer base. SCS operates as a wholly owned subsidiary. See Note 2.

The accompanying consolidated financial statements include the Company and its subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

All amounts are stated in thousands of dollars except per share data.

#### *Nature of Operations*

The Company is a leading provider of small to medium horsepower compression equipment to the natural gas industry. The Company focuses primarily on the non-conventional natural gas production business in the United States (such as coalbed methane, gas shales and tight gas). The Company manufactures, fabricates and rents natural gas compressors that enhance the production of natural gas wells and provide maintenance services for those compressors. In addition, the Company sells custom fabricated natural gas compressors to meet customer specifications dictated by well pressures, production characteristics and particular applications. We also manufacture and sell flare systems for oil and gas plant and production facilities.

#### *Use of Estimates*

The preparation of the Company's consolidated financial statements in conformity with generally accepted accounting principles requires the Company's management to make estimates and assumptions that affect the amounts reported in these consolidated financial statements and accompanying notes. Actual results could differ from those estimates. Significant estimates include the valuation of identifiable intangible assets and goodwill acquired in acquisitions, bad debt allowance and the inventory reserve. It is at least reasonably possible these estimates could be revised in the near term and the revisions could be material.

#### *Cash Equivalents*

For purposes of reporting cash flows, the Company considers all short-term investments with an original maturity of three months or less to be cash equivalents.

#### *Short-term Investments*



The Company has the short-term investments invested primarily in high grade short term commercial paper for the maximum return on investment that will coincide with our projected cash requirements and have a maturity of less than one year.

***Accounts Receivable***

The Company's trade receivables consist of customer obligations for the sale of compressors and flare systems due under normal trade terms, and operating leases for the use of the Company's compressors. The receivables are not collateralized except as provided for under lease agreements. However, the Company requires deposits of as much as 50% for large custom contracts. The Company extends credit based on management's assessment of the customer's financial condition, receivable aging, customer disputes and general business and economic conditions. Management believes the allowance for doubtful accounts for trade receivables of \$75 thousand and \$110 thousand at December 31, 2005 and 2006, respectively, is adequate.

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**Revenue Recognition**

Revenue from the sales of custom and fabricated compressors, and flare systems is recognized upon shipment of the equipment to customers. Exchange and rebuilt compressor revenue is recognized when both the replacement compressor has been delivered and the rebuild assessment has been completed. Revenue from compressor service and retrofitting services is recognized upon providing services to the customer. Maintenance agreement revenue is recognized as services are rendered. Rental revenue is recognized over the terms of the respective rental agreements. Deferred income represents payments received before a product is shipped. Revenue from the sale of rental units is included in sales revenue when equipment is shipped or title is transferred to the customer.

**Description of Rental Arrangements**

The Company's rental operations principally consist of the rental of natural gas compressor packages and flare stacks. These arrangements are classified as operating leases. See Note 3.

**Major Customers and Concentration of Credit Risk**

Sales to two customers in the year ended December 31, 2004 amounted to 21% and 17% of consolidated revenue. Sales to one customer in the year ended December 31, 2005 amounted to a total of 36% of consolidated revenue. Sales to two customers in the year ended December 31, 2006 amounted to a total of 39% and 12% of consolidated revenue. No other single customer accounted for more than 10% of the Company's revenues in 2004, 2005 or 2006. At December 31, 2006, one customer amounted to 54% of our accounts receivable and no other customer amounted to more than 10% of our consolidated accounts receivable. At December 31, 2005, one customer accounted for 44% of our consolidated accounts receivable. The Company generally does not obtain collateral, but requires deposits of as much as 50% on large custom contracts. The Company extends credit based on management's assessment of the customer's financial condition, receivable aging, customer disputes and general business and economic conditions.

**Inventory**

Inventory is valued at the lower of cost or market. The cost of inventories is determined by the weighted average method. A reserve is recorded against inventory balances for estimated obsolescence. This reserve is based on specific identification and historical experience and totaled \$361 thousand and \$347 thousand at December 31, 2005 and 2006, respectively. At December 31, 2005 and 2006, respectively, inventory consisted of the following (in thousands):

	2005	2006
Raw materials	\$ 11,771	\$ 12,154
Finished goods	—	1,084
Work in process	2,952	3,705
	\$ 14,723	\$ 16,943

**Property and Equipment**

Property and equipment is recorded at cost less accumulated depreciation and amortization. Depreciation and amortization are computed using the straight-line method over the estimated useful lives of the assets, which range from three to forty years. Rental equipment has an estimated useful life of fifteen years.

Gains and losses resulting from sales and dispositions of property and equipment are included in current operations. Maintenance and repairs are charged to operations as incurred.

***Goodwill***

Goodwill represents the cost in excess of fair value of the identifiable net assets acquired in three acquisitions. Goodwill was being amortized on a straight-line basis over 20 years, but the Company ceased amortization of goodwill effective January 1, 2002 in accordance with Statement of Financial Accounting Standards ("FAS") No. 142.

The Company recognized goodwill in the amount of \$6.9 million with the acquisition of "SCS" in 2005. See Note 2.

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FAS 142 requires that goodwill be tested for impairment at least annually. The Company completed its most recent test for goodwill impairment as of June 30, 2006, at which time no impairment was indicated.

### ***Intangibles***

At December 31, 2006, the Company has intangible assets (excluding patents) with a gross carrying value of \$4.2 million, which relate to developed technology, acquired customer contracts, distribution agreements and non-compete agreements. The carrying amount net of accumulated amortization at December 31, 2006 was \$3.6 million. Intangible assets (excluding patents) are amortized on a straight-line basis with useful lives ranging from 5 to 20 years with a weighted average life remaining of approximately fifteen years as of December 31, 2006. Amortization expense recognized in each of the years ending December 31, 2005 and 2006 was \$299 thousand. In addition, the Company has an intangible asset with a gross carrying value of \$0.7 million at December 31, 2006 related to the trade name of SCS. This asset is not being amortized as it has been deemed to have an indefinite life.

The following table represents estimated future amortization expense for the years ending December 31, (in thousands).

2007	299
2008	299
2009	299
2010	260
2011	179
Thereafter	1,629
	\$ 2,965

The Company's policy is to periodically review the net realizable value of its intangibles, other than goodwill and patents, through an assessment of the estimated future cash flows related to such assets. In the event that assets are found to be carried at amounts in excess of estimated undiscounted future cash flows, then the assets will be adjusted for impairment to a level commensurate with a discounted cash flow analysis of the underlying assets. Based upon its most recent analysis, the Company believes no impairment of intangible assets exists at December 31, 2006.

### ***Patents***

The Company has patents for a flare tip ignition device and flare tip burner pilot. The costs of the patents are being amortized on a straight-line basis over nine years, the remaining life of the patents when acquired. Amortization expense for patents of \$27 thousand was recognized for each of the years ended December 31, 2005 and 2006. The net value of patents was \$31 thousand as of December 31, 2006.

### ***Restricted Cash***

The Company held a certificate of deposit in the amount of \$2 million which was used to secure certain promissory notes issued in the aggregate principal amount of \$3 million maturing three years from the date of closing of the acquisition of Screw Compression Systems, Inc. ("SCS") on January 3, 2005 and secured by a letter of credit with a face amount of \$2 million. On October 20, 2005, the Company modified our existing loan agreement, which allowed the Company to lift the restriction on the certificate of deposit.

### ***Other Assets***

Included in other assets are debt issuance costs, net of accumulated amortization, and deposits totaling approximately \$85 thousand and \$113 thousand at December 31, 2005 and 2006, respectively. Such costs are amortized over the period of the respective debt agreements on a straight-line method which approximates the effective interest method.

***Warranty***

The Company accrues amounts for estimated warranty claims based upon current and historical product warranty costs and any other related information known. The warranty reserve was \$50 thousand and \$305 thousand at December 31, 2005 and 2006, respectively.

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**Financial Instruments**

Management believes that generally the fair value of the Company's cash, trade receivables, payables and notes payable at December 31, 2005 and 2006 approximate their carrying values due to the short-term nature of the instruments or the use of prevailing market interest rates.

**Advertising Costs**

Advertising costs are expensed as incurred. Total advertising expense was \$38 thousand, \$23 thousand and \$41 thousand in 2004, 2005 and 2006, respectively.

**Per Share Data**

Basic earnings per common share is computed using the weighted average number of common shares outstanding during the period. Diluted earnings per common share is computed using the weighted average number of common stock and common stock equivalent shares outstanding during the period. There was no anti-dilutive effect in 2004 and 2005. There was an anti-dilutive effective in 2006 of 10 thousand common stock options.

The following table sets forth the computation of basic and diluted earnings per share (in thousands, except per share amounts):

	<b>Year Ended December 31,</b>		
	<b>2004</b>	<b>2005</b>	<b>2006</b>
Numerator:			
Net income	\$ 3,374	\$ 4,446	\$ 7,588
Less preferred dividends	53	—	—
Income available to common stockholders	3,321	4,446	7,588
Denominator for basic net income per common share:			
Weighted average common shares outstanding	5,591	7,564	11,405
Denominator for diluted net income per share:			
Weighted average common shares outstanding	5,591	7,564	11,405
Dilutive effect of stock options and warrants	792	917	67
Diluted weighted average shares	6,383	8,481	11,472
Earnings per common share:			
Basic	\$ 0.59	\$ 0.59	\$ 0.67
Diluted	\$ 0.52	\$ 0.52	\$ 0.66

**Income Taxes**

The Company files a consolidated tax return with its subsidiaries. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to temporary differences between the financial statement carrying amounts of

assets and liabilities and their respective tax bases, and operating losses and tax credit carry-forwards. 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.

***Reclassification***

Certain amounts in prior period financial statements have been reclassified to conform to the 2006 financial statement classification.

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### ***Recently Issued Accounting Pronouncements***

On December 16, 2004, the FASB published FASB Statement No. 123 (revised 2004), *Share-Based Payment*. Statement 123(R) requiring that the compensation cost relating to share-based payment transactions be recognized in financial statements. That cost will be measured based on the fair value of the equity or liability instruments issued. Public entities are required to apply Statement 123(R) in the first interim or annual reporting period that began after December 15, 2005. Statement 123(R) replaces FASB Statement No. 123, *Accounting for Stock-Based Compensation*, and supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*. Statement 123, as originally issued in 1995, established as preferable a fair-value-based method of accounting for share-based payment transactions with employees. However, that Statement permitted entities the option of continuing to apply the guidance in Opinion 25, as long as the footnotes to financial statements disclosed what net income would have been had the preferable fair-value-based method been used.

The Company has adopted Statement 123(R) effective January 1, 2006 using the modified prospective method. The Company had \$376 thousand in expenses in 2006 as a result of options vesting during 2006.

In July 2006 the FASB issued FASB Interpretation ("FIN") No. 48, *Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement 109*. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. FIN 48 prescribes a comprehensive model for recognizing, measuring, presenting and disclosing in the financial statements tax positions taken or expected to be taken on a tax return. FIN 48 is effective for fiscal years beginning after December 15, 2006. If there are changes in net assets as a result of application of FIN 48 these will be accounted for as an adjustment to retained earnings. The Company adopted FIN 48 on January 1, 2007 and has determined its adoption will not have a material impact on its consolidated financial position and results of operations.

## **2. Acquisitions**

On October 18, 2004, Natural Gas Services Group, Inc. entered into a Stock Purchase Agreement with Screw Compression Systems, Inc., or "SCS", and the stockholders of SCS. Under this agreement, Natural Gas Services Group, Inc. agreed to purchase all of the outstanding shares of capital stock of SCS for the purpose of expanding our product line, production capacity and customer base.

SCS was a privately owned manufacturer of natural gas compressors, with its principal offices located in Tulsa, Oklahoma.

The stockholders of SCS received, in proportionate amounts (based on their stock ownership of SCS), total consideration consisting of \$16.1 million:

\$8 million in cash;

· Promissory notes issued by Natural Gas Services Group, Inc. in the aggregate principal amount of \$3 million bearing interest at the rate of 4.00% per annum, maturing three years from the date of closing and secured by a letter of credit in the face amount of \$2 million; and

· 609,756 shares of Natural Gas Services Group, Inc. common stock valued at \$5.1 million based upon the closing price of the Company's stock at the time of the transaction. All of the shares are "restricted" securities within the meaning of Rule 144 under the Securities Act of 1933, as amended, and bear a legend to that effect.

This transaction was completed January 3, 2005 and Natural Gas Services Group, Inc. began reporting combined financial information with SCS in January 2005. The total purchase price was \$16.1 million and the Company



recorded goodwill of approximately \$6.9 million, of which none is expected to be deductible for tax purposes and intangible assets of approximately \$4.2 million, reflecting the additional value to our previously existing operations achieved with this acquisition's ability to expand production capacity and product line. Intangible assets relate to developed technology, acquired customer contracts, distribution agreements, non-compete agreements and the trade name of SCS. The trade name of SCS was valued at \$0.7 million and will not be amortized as it was deemed to have an indefinite life. The remaining intangible assets of \$3.5 million had a weighted average life on the date of acquisition of sixteen years.

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The following table represents the combined results of operations on a pro-forma basis with Natural Gas Services Group, Inc. and Screw Compression Systems, Inc. as if the acquisition had occurred on January 1, 2004.

<b>(Unaudited)</b> <b>Pro Forma Results</b> (in thousands, except per share data)	Twelve Months Ended December 31, 2004
Revenue	\$ 37,382
Net income available to common stockholders	4,148
Net income per common share, basic	0.67
Net income per common share, diluted	0.59
Summary of net assets acquired is as follows:	
Current assets	\$ 8,274
Other assets	3,047
Intangibles	4,218
Goodwill	7,468
Total assets	\$ 23,007
Current liabilities	\$ 3,180
Notes payable	1,403
Other liabilities	1,884
Total liabilities	\$ 6,467
Net assets	16,540
Acquisition expenses	(418)
Purchase price	\$ 16,122

### 3. Rental Activity

The Company rents natural gas compressor packages to entities in the petroleum industry. The Company's cost less the accumulated depreciation of \$7.6 million for the rented compressors as of December 31, 2005 was \$41.2 million. The Company's cost less the accumulated depreciation of \$11.3 million for the rented compressors as of December 31, 2006 was \$59.9 million. These rental arrangements are classified as operating leases and generally have original terms of six months to two years and continue on a month-to-month basis thereafter. Future minimum rent payments for arrangements not on a month-to-month basis at December 31, 2006 are as follows (in thousands):

<b>Years Ended</b> <b>December 31,</b>	
2007	\$ 1,624
2008	74
Total	\$ 1,698



#### 4. Property and Equipment

Property and equipment consists of the following at December 31, 2005 and 2006 (in thousands):

	2005	2006
Land and building	\$ 3,365	\$ 3,365
Leashold improvements	283	398
Office equipment and furniture	424	501
Software	268	360
Machinery and equipment	1,153	1,447
Vehicles	3,389	4,322
Less accumulated depreciation	(2,458)	(3,679)
<b>Total</b>	<b>\$ 6,424</b>	<b>\$ 6,714</b>

Depreciation expense for property and equipment and the compressors described in Note 3 was \$2.4 million, \$3.9 million and \$5.7 million for the years ended December 31, 2004, 2005 and 2006, respectively.

#### 5. Line of Credit

The Company entered into a new line of credit on October 15, 2006 which allows for borrowings up to \$40.0 million, bears a fixed interest rate of 7.5% and requires monthly interest payments beginning November 1, 2006 and principal payments as of October 1, 2008. The line of credit is collateralized by substantially all of the assets of the Company. As of December 31, 2006, there was not an outstanding balance with this line of credit.

The line of credit and first four notes listed in Note 6 below are with the same bank and include certain covenants, the most restrictive of which require the Company to maintain certain working capital, debt to equity and cash flow ratios and certain minimum net worth. The Company was in compliance with covenants at December 31, 2005 and 2006, respectively.

**6. Long-term Debt**

Long-term debt at December 31, 2005 and 2006, respectively, consisted of the following (in thousands):

	2005	2006
Note payable to a bank, interest at bank's prime rate plus .5% but not less than 5.25% (7.75% at December 31, 2005). This was an advance line of credit note for \$10.0 million. Interest was payable monthly. Principal was due in 60 consecutive payments of \$167 thousand beginning December 15, 2004 until November 15, 2009. The note was collateralized by substantially all of the assets of the Company. See Note 5 regarding loan covenants. This note was consolidated into the last note in this table on October 15, 2006.	\$ 7,900	\$ —
Note payable to a bank, interest at the greater of (1) the prime rate plus 0.5% or (2) 6.0% (7.75% at December 31, 2005). This was an \$8.0 million term loan. Principal under this credit facility was due and payable in 84 monthly installments of \$95 thousand each, commencing February 1, 2005 and continuing through December 1, 2011. Interest on the unpaid principal balance was due and payable on the same dates as principal payments. All outstanding principal and unpaid interest was due on January 1, 2012. See Note 5 regarding loan covenants. This note was consolidated into the last note in this table on October 15, 2006.	6,952	—
Note payable to a bank, interest at the greater of (1) the prime rate plus 0.5% or (2) 5.25% (7.75% at December 31, 2005). Interest only under this credit facility was due and payable on the 15th day of each month commencing May 1, 2005 and continuing through April 30, 2006. Principal under this credit facility was due and payable in 59 monthly installments of \$167 thousand each, commencing May 1, 2006 and continuing through April 1, 2011. See Note 5 regarding loan covenants. This note was consolidated into the last note in this table on October 15, 2006.	10,000	—
Note payable to a bank, interest at a fixed rate of 7.5%. Principal and interest payment due and payable on the 1st day of each month commencing November 1, 2006 and continuing through September 1, 2011. Principal under this credit facility is due and payable in 59 monthly installments of \$281,500 each. The note is collateralized by substantially all of the assets of the Company. See Note 5 regarding loan covenants. This note consolidated the three previous notes into one obligation on October 15, 2006.	—	16,328
Other notes payable for vehicles, various terms	53	64
Total	24,905	16,392
Less current portion	(4,680)	(3,442)
Total	\$ 20,225	\$ 12,950

Maturities of long-term debt based on contractual requirements for the years ending December 31 are as follows (in thousands):

2007	\$ 3,442
2008	3,378

2009	3,378
2010	3,378
2011	2,816
Total \$	16,392

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## 7. Subordinated Notes

In 2001, the Company completed an offering of units consisting of subordinated debt and warrants. The balance of the subordinated debt, net of unamortized discount of \$90 thousand, was \$1.4 million at December 31, 2004. All amounts due on the notes were paid in full during 2005. Each unit consisted of a \$25 thousand 10% subordinated note due December 31, 2006 and a five-year warrant to purchase 10 thousand shares of the Company's common stock at \$3.25 per share. Interest only was payable annually, with all principal due at maturity. Warrants to purchase 61.6 thousand shares were also granted on the same terms to a placement agent in connection with the offering. Certain stockholders, officers and directors purchased units in the subordinated debt offering, (totaling \$259 thousand in notes and warrants representing 104 thousand shares) on the same terms and conditions as non-affiliated purchasers in the offering. As of December 31, 2006, none of the warrants remained outstanding.

On January 3, 2005, the Company issued subordinated promissory notes to Paul D. Hensley, James R. Hazlett and Tony Vohjesus, the owners of SCS, as part of the consideration for the acquisition of Screw Compression Systems, Inc. As of January 3, 2005, Screw Compression Systems, Inc. became a wholly owned subsidiary of the Company. Mr. Hensley is currently the President of Screw Compression Systems, Inc. and a Director of Natural Gas Services Group, Inc. Mr. Hazlett became Vice President-Technical Services of Natural Gas Services Group, Inc. in June 2005 and also continues to serve as a Vice President of Screw Compression Systems, Inc. Mr. Vohjesus remains employed by Screw Compression Systems, Inc. as a Vice President. The aggregate principal amount was \$3 million bearing interest at the rate of 4.00% per annum. Beginning January 1, 2006, a principal payment of \$1 million is due and payable each year until maturity on January 1, 2008, plus the current outstanding interest. The subordinated promissory notes are secured by a letter of credit in the face amount of \$2 million. As of December 31, 2006, \$2 million was outstanding on these notes.

## 8. Income Taxes

The provision for income taxes consists of the following (in thousands):

	2004	2005	2006
Current provision:			
Federal	\$ —	\$ 91	\$ 1,475
State	20	116	268
	20	207	1,743
Deferred provision:			
Federal	1,029	2,310	2,403
State	91	98	141
	1,120	2,408	2,544
	\$ 1,140	\$ 2,615	\$ 4,287

The income tax effects of temporary differences that give rise to significant portions of deferred income tax assets and (liabilities) are as follows (in thousands):

	2004	2005	2006
Deferred income tax assets:			
Net operating loss	\$ 2,669	\$ 984	\$ —
Alternative minimum tax credit	—	91	99
Other	7	60	242
Total deferred income tax assets	2,676	1,135	341
Deferred income tax liabilities:			
Property and equipment	(5,483)	(6,736)	(8,571)

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Goodwill and other intangible assets	(142)	(1,575)	(1,508)
Other	(9)	(71)	(26)
Total deferred income tax liabilities	(5,634)	(8,382)	(10,105)
Net deferred income tax liabilities	\$ (2,958)	\$ (7,247)	\$ (9,764)

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The effective tax rate differs from the statutory rate as follows:

	2004	2005	2006
Statutory rate	34%	34%	34%
State and local taxes	3%	3%	3%
Nontaxable life insurance proceeds	(12)%	—	—
Other	—	—	(1)%
Effective rate	25%	37%	36%

## 9. Stockholders' Equity

### *Initial Public Offering*

In October, 2002, the Company closed an initial public offering in which it sold 1.5 million shares of common stock and warrants to purchase 1.5 million shares of common stock for a total of \$7.9 million. Costs and commissions associated with the offering totaled \$1.3 million. The warrants were exercisable anytime through October 21, 2006 at \$6.25 per share. In connection with this offering, the underwriter received options to purchase 150 thousand shares of common stock at \$6.25 per share and warrants at \$0.3125 per share. The warrants, if purchased by the underwriter, will contain an exercise price of \$7.81 per share. The underwriter's options expire in October 2007 and include a cashless exercise provision utilizing the Company's common stock. The underwriter's warrants expire in October 2008. As of December 31, 2006, there were 9 thousand underwriter's options outstanding at \$6.25 per share and 5 thousand underwriter's warrants outstanding at \$7.81 per share.

### *Secondary Public Offering*

On March 8, 2006, we sold 2.5 million shares of our common stock pursuant to a public offering at a price of \$17.50 per share, resulting in net proceeds to us of \$40.7 million. We did not receive any proceeds from sales by certain selling stockholders. We granted the underwriter an option for a period of 30 days to purchase up to an additional 428 thousand shares to cover over-allotments, if any. On March 27, 2006, the underwriter exercised its over-allotment option and on March 30, 2006, the Company sold an additional 428 thousand shares, resulting in proceeds to the Company of \$7.1 million, in addition to the net proceeds of \$40.7 million from the sale of the 2.5 million shares of common stock on March 8, 2006. The net proceeds after offering costs to us were \$47.1 million and a portion has been used to reduce our bank debt by \$5.0 million.

### *Conversion*

On July 28, 2005, Natural Gas Services Group, Inc. announced that it would redeem its outstanding common stock purchase warrants that were issued in connection with its initial public offering in October 2002 (the "IPO Warrants"). Holders of the IPO Warrants were required to exercise the IPO Warrants by 5:00 p.m., Mountain Daylight Savings Time on Tuesday, September 6, 2005 (the "Redemption Date"). The IPO Warrants had an exercise price of \$6.25 per share and were subject to redemption at the redemption price of \$0.25 per IPO Warrant. IPO Warrants that were not properly exercised by the Redemption Date ceased to be exercisable and were redeemed for \$0.25 per IPO Warrant, without interest. A total of 1.5 million IPO Warrants were initially issued in conjunction with our initial public offering. The Company received a total of \$9.4 million in proceeds from IPO Warrants exercised in 2005. Approximately 2.4 thousand IPO Warrants were not exercised by the Redemption Date and were redeemed for the aggregate redemption amount of \$.6 thousand.

### *Warrants*

In March 2001 and April 2002, five-year warrants to purchase 68.5 thousand shares of common stock at \$2.50 per share and 16.5 thousand shares at \$3.25 per share, respectively, were issued to certain board members and

stockholders as compensation for their debt guarantees. All of these warrants have been exercised as of December 31, 2006.

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### ***Preferred Stock***

The Company has a total of 5.0 million authorized preferred shares, with rights and preferences as designated by the Board of Directors. The Company had a private placement of Series A shares in 2001 and 2002. In connection with the offering, the underwriter received warrants to purchase 38,165 shares of common stock at \$3.25 per share through December 1, 2006. The Series A shares had a cumulative annual dividend rate of 10%, when and if declared by the Board of Directors payable thirty days after the end of each quarter. Holders were entitled to one vote per share and the Series A shares were convertible into common stock initially at a price of \$3.25 per share, subject to adjustment based on the market price and various other contingencies. In addition, Series A shares automatically converted to common stock on a one-for-one basis when the Company's common stock traded on a public exchange at a price of \$6.50 per share or greater for twenty consecutive days. The Series A shares had a liquidation preference of \$3.25 per share plus accrued and unpaid dividends over common stock.

In 2003, 38 thousand Series A shares were converted to common stock. Total Series A shares outstanding at December 31, 2003 were 343.7 thousand.

In accordance with the provisions of the Convertible Series A Preferred Stock, on March 26, 2004 each share of Preferred Stock automatically converted to one share of Common Stock. The conversion occurred after the closing market price of the stock was equal to or higher than \$6.50 for 20 consecutive trading days. 343.7 thousand Preferred shares were converted at that time. Dividends payable at the conversion date were approximately \$25 thousand. As of December 31, 2005 and 2006, none of the warrants were outstanding.

### ***Other***

In 2001, the Company completed an offering of units consisting of subordinated debt and warrants. Each unit consisted of a \$25 thousand 10% subordinated note due December 31, 2006 and a five-year warrant to purchase 10 thousand shares of the Company's common stock at \$3.25 per share. On August 26, 2005, we prepaid all of the outstanding 10% subordinated notes that were due December 31, 2006. As of December 31, 2006, none of these warrants are outstanding.

On August 26, 2005, we entered into a non-statutory Stock Option Agreement with Mr. Stephen C. Taylor, our Chief Executive Officer and President. The Stock Option Agreement grants to Mr. Taylor a ten-year option to purchase 45 thousand shares of our common stock at an exercise price equal to \$9.22 (the fair market value of our common stock on January 13, 2005, the date we initially hired Mr. Taylor), with 15 thousand shares vesting on each of January 13, 2006, 2007 and 2008. The options expire ten years from the date of grant. Compensation expense of \$135 thousand was recognized related to these options in the year ended December 31, 2005.

### ***Common Stock Private Placement***

On July 20, 2004, the Company and CBarney Investments, Ltd. entered into a Securities Purchase Agreement. Under this agreement, the Company issued and sold 649.6 thousand shares of its common stock to CBarney at \$7.69736 per share. The per share price was determined by multiplying (x) \$8.747, the average closing market price of the common stock on the American Stock Exchange for the twenty consecutive trading days ended July 15, 2004, times (y) eighty-eight percent. The Company received aggregate gross proceeds of \$5.0 million and net proceeds of \$4.9 million.

## 10. Stock-Based Compensation

### *Stock Options*

Effective January 1, 2006, the Company adopted the fair value recognition provisions of Statement of Financial Accounting Standard 123(R) “*Share-Based Payment*” (“SFAS 123(R)”) using the modified prospective transition method. In addition, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 107 “*Share-Based Payment*” (“SAB 107”) in March, 2005, which provides supplemental SFAS 123(R) application guidance based on the views of the SEC. Under the modified prospective transition method, compensation cost recognized in the year ended December 31, 2006 includes: (a) compensation cost for all share-based payments granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123, and (b) compensation cost for all share-based payments granted beginning January 1, 2006, based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R). In accordance with the modified prospective transition method, results for prior periods have not been restated. The adoption of SFAS 123(R) resulted in stock compensation expense for the year ended December 31, 2006 of \$376 thousand, respectively, to income before income taxes.

The Black-Scholes option-pricing model was used to estimate the option fair values. The option-pricing model requires a number of assumptions, of which the most significant are expected stock price volatility, the expected pre-vesting forfeiture rate and the expected option term (the amount of time from the grant date until the options are exercised or expire). Expected volatility was calculated based upon actual historical stock price movements over the most recent periods ending December 31, 2006. The expected option term was calculated using the “simplified” method permitted by SAB 107. The expected forfeiture rate is based on historical experience and expectations about future forfeitures.

Prior to the adoption of SFAS 123(R), the Company accounted for stock-based awards to employees using the intrinsic value method described in Accounting Principles Board Opinion (APB) No. 25, *Accounting for Stock Issued to Employees*, and its related interpretations. Accordingly, no compensation expense has been recognized in the accompanying consolidated financial statements for stock-based awards to employees or directors when the exercise price of the award is equal to or greater than the quoted market price of the stock on the date of the grant.

### *Pro-Forma Stock Compensation Expense for the Year Ended December 31, 2005*

For the years ended December 31, 2004 and 2005, the Company applied the intrinsic value method of accounting for stock options as prescribed by APB 25. If compensation expense had been recognized based on the estimated fair value of each option granted in accordance with the provisions of SFAS 123 as amended SFAS 148, our net income and net income per share would have been reduced to the following pro-forma amounts (in thousands, except per share amounts):

	<b>Years Ended</b>	
	<b>December 31</b>	
	<b>2004</b>	<b>2005</b>
Net income, as reported	\$ 3,374	\$ 4,446
Less preferred dividends	53	—
Income available to common stockholders	3,321	4,446
Compensation expenses regained under Opinion 25	—	135
Deduct: Total stock-based employee compensation expense determined under fair value method for all awards (net of tax)	(38)	(295)
Income available to common stockholders, pro forma	\$ 3,283	\$ 4,286
Earnings per common share:		

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Basic, as reported	\$	0.59	\$	0.59
Basic, pro forma	\$	0.59	\$	0.57
Diluted, as reported	\$	0.52	\$	0.52
Diluted, pro forma	\$	0.51	\$	0.51
Weighted average fair value of options granted during the year	\$	4.75	\$	10.37

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Pro-forma compensation expense under SFAS 123, among other computational differences, does not consider potential pre-vesting forfeitures. Because of these differences, the pro-forma stock compensation expense presented above for the prior years ended December 31, 2004 and 2005 under SFAS 123 and the stock compensation expense recognized during the years ended December 31, 2006 under SFAS 123(R) are not directly comparable. In accordance with the modified prospective transition method of SFAS 123(R), the prior comparative results have not been restated.

### *Stock Option Plan*

The Company's 1998 Stock Option Plan (the Plan), which is stockholder approved, permits the grant of options to its employees for up to 550 thousand shares of common stock. The Company believes that such awards better align the interests of its employees with those of its stockholders. Option awards are generally granted with an exercise price equal to the market price of the Company's stock at the date of grant; those option awards generally vest based on three years of continuous service and have ten-year contractual terms. Certain option and share awards provide for accelerated vesting if there is a change in control of the Company (as defined in the Plan).

On June 20, 2006, the 1998 Stock Option Plan was amended and approved by the stockholders. The number of shares of common stock authorized for issuance under the 1998 Plan was increased from 150 thousand to 550 thousand. The last date that grants could be made was extended from December 17, 2008 to March 1, 2016. The exercise price of incentive stock options granted to employees who do not own more than 10% of our common stock was changed from not less than 140% of the fair market value per share of our common stock on the date of grant to not less than 100% of the fair market value of our common stock on the date of grant. The provision allowing the Compensation Committee to increase, without stockholder approval, the number of shares of stock subject to the 1998 Plan from 150 thousand shares to 400 thousand shares was eliminated. Also eliminated was a provision allowing the Compensation Committee, in its sole discretion, to provide an optionee with the right to exchange, in a cashless transaction, all or part of a stock option for shares of our common stock on terms and conditions determined by the Compensation Committee.

The fair value of each option award is estimated on the date of grant using the Black-Scholes option valuation model that uses the assumptions noted in the following table. The risk-free rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant. The expected life of options granted is derived from the output of the option valuation model and represents the period of time that options granted are expected to be outstanding. The Company uses historical stock data to estimate option exercise and employee termination within the valuation model; separate groups of employees that have similar historical exercise behavior are considered separately for valuation purposes.

<b>Weighted average Black-Scholes fair value assumptions:</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>
Risk free rate	5.25%	7.25%	8.25%
Expected life	10 yrs	10 yrs	4 yrs
Expected volatility	44.0%	47.0%	50.3%
Expected dividend yield	0.0%	0.0%	0.0%



A summary of option activity under the plan as of December 31, 2006 is presented below.

	Number of Stock Options	Weighted Average Exercise Price	Weighted Remaining Contractual Life (years)	Aggregate Intrinsic Value (in thousands)
Outstanding, January 1, 2006	146,668	\$ 7.69		
Granted	49,500	14.12		
Exercised	(8,998)	6.43		
Forfeited or expired	(13,000)	7.06		
Outstanding, December 31, 2006	174,170	\$ 9.63	8.22	\$ 744
Exercisable, December 31, 2006	88,332	\$ 7.41	7.15	\$ 574

During the year ended December 31, 2006, 49,500 options were granted. The total intrinsic value or the difference between the exercise price and the market price on the date of exercise, of options exercised during the year ended December 31, 2006, was approximately \$79 thousand. Cash received from stock options exercised during the year ended December 31, 2006 was \$58 thousand.

The following table summarizes information about the options outstanding at December 31, 2006:

Range of Exercise Prices	Shares	Options Outstanding		Options Exercisable	
		Weighted Average Remaining Contractual Life (years)	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
\$ 0.00 – 5.58	42,000	5.83	\$ 3.98	42,000	\$ 3.98
5.59 – 9.43	72,670	8.32	8.83	36,332	8.74
9.44 – 16.96	59,500	9.77	14.60	10,000	16.96
\$ 0.00 - 16.96	174,170	8.22	\$ 9.63	88,332	\$ 7.41



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The summary of the status of the Company's unvested stock options as of December 31, 2006 and changes during the year ended December 31, 2006 is presented below.

Unvested stock options:	Shares	Weighted Average Grant Date Fair Value
Unvested at January 1, 2006	75,333	\$ 10.34
Granted	49,500	4.75
Vested	27,328	9.86
Forfeited	11,667	4.25
Unvested at December 31, 2006	85,838	\$ 8.10

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As of December 31, 2006, there was approximately \$508 thousand of unrecognized compensation cost related to unvested options. Such cost is expected to be recognized over a weighted-average period of 1.79 years. Total compensation expense for stock options was \$376 thousand for the year ended December 31, 2006. An income tax benefit was recognized of approximately \$140 thousand for the year ended December 31, 2006, respectively.

## 11. Commitments

### *401(k) Plan*

The Company offers a 401(k) Plan (the "401(k) Plan") to all employees that have reached the age of eighteen and have completed six months of service. The participants may contribute up to 100% of their salary subject to IRS limitations. Employer contributions are subject to Board discretion and are subject to a vesting schedule of 20% each year after the first year and 100% after six years. The Company contributed \$78 thousand \$96 thousand and \$125 thousand to the 401(k) Plan in 2004, 2005 and 2006, respectively.

### *Rented Facilities*

The facility in Bloomfield, New Mexico is leased at a current rate of \$2.7 thousand per month pursuant to a lease that terminates in May 2008. The facility in Catoosa, Oklahoma is leased at a current rate of \$5.5 thousand per month pursuant to a lease that terminates in March 2008. Additional leases for facilities are at a current rate of \$2.5 thousand per month. Future rental payments under these leases for the years ended December 31 are as follows (in thousands):

2007	\$ 129
2008	62
2009	29
2010	29
2011	30
Thereafter	76
Total	\$ 355

## 12. Other Income

On March 15, 2004, the former President and Chief Executive Officer of the Company, Mr. Wayne L. Vinson, passed away after a battle with cancer. The Company held two life insurance policies on him, one for \$1.0 million and one for \$500 thousand, with the Company as the beneficiary. The proceeds of \$1.5 million were recorded as other income in 2004. Other income in 2006 primarily consisted of interest income from our short-term investment account.

## 13. Segment Information

FAS No. 131, *Disclosures About Segments of an Enterprise and Related Information*, establishes standards for public companies relating to the reporting of financial and descriptive information about their operating segments in financial statements. Operating segments are components of an enterprise which separate financial information is available and is evaluated regularly by chief operating decision makers in deciding how to allocate resources and in assessing performance.

The Company identifies its segments based upon major revenue sources as follows:

**For the Year Ended December 31, 2004**

	<b>Sales</b>	<b>Service &amp; Maintenance</b>	<b>Rental</b>	<b>Corporate</b>	<b>Total</b>
	<b>(in thousands of dollars)</b>				
Revenue	\$ 3,593	\$ 1,874	\$ 10,491	\$ —	\$ 15,958
Operating costs and expenses	2,556	1,357	3,038	5,096	12,047
Operating income	1,037	517	7,453	(5,096)	3,911
Other income/(expense)	—	—	—	603	603
Income before provision for income taxes	1,037	517	7,453	(4,493)	4,514
*Segment assets	\$ —	\$ —	\$ —	\$ 43,255	\$ 43,255

**For the Year Ended December 31, 2005**

	<b>Sales</b>	<b>Service &amp; Maintenance</b>	<b>Rental</b>	<b>Corporate</b>	<b>Total</b>
	<b>(in thousands of dollars)</b>				
Revenue	\$ 30,278	\$ 2,424	\$ 16,609	\$ —	\$ 49,311
Operating costs and expenses	23,331	1,479	6,528	9,114	40,452
Operating income	6,947	945	10,081	(9,114)	8,859
Other income/(expense)	—	—	—	(1,798)	(1,798)
Income before provision for income taxes	6,947	945	10,081	\$ (10,912)	7,061
*Segment assets	\$ —	\$ —	\$ —	\$ 86,369	\$ 86,369

**For the Year Ended December 31, 2006**

	<b>Sales</b>	<b>Service &amp; Maintenance</b>	<b>Rental</b>	<b>Corporate</b>	<b>Total</b>
	<b>(in thousands of dollars)</b>				
Revenue	\$ 38,214	\$ 979	\$ 23,536	\$ —	\$ 62,729
Operating costs and expenses	29,629	735	8,944	11,290	50,598
Operating income	8,585	244	14,592	(11,290)	12,131
Other income/(expense)	—	—	—	(256)	(256)
Income before provision for income taxes	8,585	244	14,592	(11,546)	11,875
*Segment assets	\$ —	\$ —	\$ —	\$ 135,552	\$ 135,552

\* Management does not track assets by segment.

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**14. Quarterly Financial Data (In thousands, except per share data) - Unaudited**

<b>2006</b>	<b>Q1 2006</b>	<b>Q2 2006</b>	<b>Q3 2006</b>	<b>Q4 2006</b>	<b>Total</b>
Net Revenue	\$ 13,578	\$ 15,458	\$ 17,130	\$ 16,563	\$ 62,729
Operating income	3,053	1,912	3,690	3,476	12,131
Net income applicable to common shares	1,696	1,208	2,364	2,320	7,588
Net income per share - Basic	0.18	0.10	0.20	0.19	0.67
Net income per share - Diluted	0.17	0.10	0.20	0.19	0.66
<b>2005</b>	<b>Q1 2005</b>	<b>Q2 2005</b>	<b>Q3 2005</b>	<b>Q4 2005</b>	<b>Total</b>
Net Revenue	\$ 11,041	\$ 12,031	\$ 12,460	\$ 13,779	\$ 49,311
Operating income	1,837	2,200	2,207	2,615	8,859
Net income applicable to common shares	898	1,070	1,091	1,387	4,446
Net income per share - Basic	0.13	0.16	0.14	0.15	0.59
Net income per share - Diluted	0.11	0.13	0.12	0.15	0.52

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INDEX TO EXHIBITS

(a) Exhibits

<u>Exhibit No.</u>	<u>Description</u>
3.1	Articles of Incorporation, as amended (Incorporated by reference to Exhibit 3.1 of the 10QSB filed and dated November 10, 2004)
3.2	Bylaws (Incorporated by reference to Exhibit 3.4 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
4.1	Form of warrant certificate (Incorporated by reference to Exhibit 4.1 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
4.2	Form of warrant agent agreement (Incorporated by reference to Exhibit 4.2 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
4.3	Form of representative's option for the purchase of common stock (Incorporated by reference to Exhibit 4.4 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
4.4	Form of representative's option for the purchase of warrants (Incorporated by reference to Exhibit 4.5 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
4.5	Stockholders Agreement, dated January 3, 2005 among Paul D. Hensley, Tony Vohjesus, Jim Hazlett and Natural Gas Services Group, Inc. (Incorporated by reference to Exhibit 4.3 of the Registrant's Form 8-K Report, dated January 3, 2005, as filed with the Securities and Exchange Commission on January 7, 2005)
	Executive Compensation Plans and Arrangements (Exhibits 10.1, 10.14, 10.15, 10.16, 10.23, 10.24, 10.26 and 10.27)
10.1	1998 Stock Option Plan, as amended (Incorporated by reference to Exhibit 10.1 of the Registrant's Form 8-K Report dated June 20, 2006 on file with the SEC June 26, 2006)
10.2	Form of Series A 10% Subordinated Notes due December 31, 2006 (Incorporated by reference to Exhibit 10.8 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
10.3	Form of Five-Year Warrants to Purchase Common Stock (Incorporated by reference to Exhibit 10.9 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
10.4	Warrants issued to Berry-Shino Securities, Inc. (Incorporated by reference to Exhibit 10.10 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
10.5	Warrants issued to Neidiger, Tucker, Bruner, Inc. (Incorporated by reference to Exhibit 10.11 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
10.6	Form of warrant issued in March 2001 for guaranteeing debt (Incorporated by reference to Exhibit 10.12 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
10.7	Form of warrant issued in April 2002 for guaranteeing debt (Incorporated by reference to Exhibit 10.13 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)

10.8 First Amended and Restated Loan Agreement between the Registrant and Western National Bank (Incorporated by reference to Exhibit 10.1 of the Registrant's Current Report on Form 8-K, dated March 27, 2003 and filed with the Securities and Exchange Commission on April 14, 2003)

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<u>Exhibit No.</u>	<u>Description</u>
10.9	Lease Agreement, dated March 1, 2004, between the Registrant and the City of Midland, Texas (Incorporated by reference to Exhibit 10.19 of the Registrant's Form 10-QSB for the fiscal quarter ended June 30, 2004)
10.10	Second Amended and Restated Loan Agreement, dated November 3, 2003, between the Registrant and Western National Bank (Incorporated by reference to Exhibit 10.20 of the Registrant's Form 10-QSB for the fiscal quarter ended June 30, 2004)
10.11	Securities Purchase Agreement, dated July 20, 2004, between the Registrant and CBarney Investments, Ltd. (Incorporated by reference to Exhibit 4.1 of the Registrant's Current Report on Form 8-K dated July 20, 2004 and filed with the Securities and Exchange Commission on July 27, 2004)
10.12	Stock Purchase Agreement, dated October 18, 2004, by and among the Registrant, Screw Compression Systems, Inc., Paul D. Hensley, Jim Hazlett and Tony Vohjesus (Incorporated by reference to Exhibit 4.1 of the Registrant's Current Report on Form 8-K dated October 18, 2004 and filed with the Securities and Exchange Commission on October 21, 2004)
10.13	Third Amended and Restated Loan Agreement, dated as of January 3, 2005, among Natural Gas Services Group, Inc., Screw Compression Systems, Inc. and Western National Bank (Incorporated by reference to Exhibit 10.1 of the Registrant's Current Report on Form 8-K, dated January 3, 2005, and filed with the Securities and Exchange Commission on January 7, 2005)
10.14	Employment Agreement between Paul D. Hensley and Natural Gas Services Group, Inc. (Incorporated by reference to Exhibit 10.1 of the Registrants Form 8-K Report, dated January 3, 2005, as filed with the Securities and Exchange Commission on January 7, 2005)
10.15	Employment Agreement between William R. Larkin and Natural Gas Services Group, Inc. (Incorporated by reference to Exhibit 10.25 of the Registrant's Form 10-KSB for the fiscal year ended December 31, 2004, and filed with the Securities and Exchange Commission on March 30, 2005)
10.16	Promissory Note, dated January 3, 2005, in the original principal amount of \$2.1 million made by Natural Gas Services Group, Inc. payable to Paul D. Hensley (Incorporated by reference to Exhibit 10.26 of the Registrant's Form 10-KSB for the fiscal year ended December 31, 2004, and filed with the Securities and Exchange Commission on March 30, 2005)
10.17	Fourth Amended and Restated Loan Agreement (Incorporated by reference to Exhibit 10.1 of the Registrant's Current Report on Form 8-K, dated March 14, 2005, and filed with the Securities and Exchange Commission on March 18, 2005)
10.18	Modification Agreement, dated as of January 3, 2005, by and between Natural Gas Services Group, Inc. and Western National Bank (Incorporated by reference to Exhibit 10.2 of the Registrant's Current Report on Form 8-K, dated January 3, 2005, and filed with the Securities and Exchange Commission on January 7, 2005)
10.19	Guaranty Agreement, dated as of January 3, 2005, made by Natural Gas Service Group, Inc., for the benefit of Western National Bank (Incorporated by reference to Exhibit 10.3 of the Registrant's Current Report on Form 8-K, dated January 3, 2005, and filed with the Securities and Exchange Commission on January 7, 2005)
10.20	Guaranty Agreement, dated as of January 3, 2005, made by Screw Compression Systems, Inc., for the benefit of Western National Bank (Incorporated by reference to Exhibit 10.4 of the Registrant's Current Report on Form



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8-K, dated January 3, 2005, and filed with the Securities and Exchange Commission on January 7, 2005)

10.21 Fifth Amended and Restated Loan Agreement (Incorporated by reference to Exhibit 10.2 of the Registrant's Form 8-K dated January 3, 2006 and filed with the Securities and Exchange Commission January 6, 2006)

10.22 First Modification to Fourth Amended and Restated Loan Agreement (Incorporated by reference Exhibit 10.1 of the Registrant's Form 8-K dated May 1, 2005 and filed with Securities and Exchange Commission May 13, 2005)

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<u>Exhibit No.</u>	<u>Description</u>
10.23	Employment Agreement between Stephen C. Taylor and Natural Gas Services Group, Inc. (Incorporated by reference to Exhibit 10.1 of the Registrant's Form 8-K Report, dated August 24, 2005, and filed with the Securities and Exchange Commission on August 30, 2005)
10.24	Employment Agreement between James R. Hazlett and Natural Gas Services Group, Inc. (Incorporated by reference to Exhibit 10.1 of the Registrant's Form 8-K Report, dated June 14, 2005, and filed with the Securities and Exchange Commission on November 14, 2005)
10.25	Stockholders Agreement, dated January 3, 2005 among Paul D. Hensley, Tony Vohjesus, Jim Hazlett and Natural Gas Services Group, Inc. (Incorporated by reference to Exhibit 4.3 of the Registrant's Form 8-K Report, dated January 3, 2005, and filed with the Securities and Exchange Commission on January 7, 2005)
10.26	Promissory Note, dated January 3, 2005, in the original principal amount of \$300 thousand made by Natural Gas Services Group, Inc. payable to Jim Hazlett (Incorporated by reference to Exhibit 10.3 of the Registrant's Form 8-K Report, dated June 14, 2005, and filed with the Securities and Exchange Commission on November 14, 2005)
10.27	Retirement Agreement, dated December 14, 2005, between Wallace C. Sparkman and Natural Gas Services Group, Inc. (Incorporated by reference to Exhibit 10.1 of the Registrant's Form 8-K Report, dated December 14, 2005, and filed with the Securities and Exchange Commission on December 15, 2005)
10.28	Sixth Amended and Restated Loan Agreement, dated as of January 3, 2006 (Incorporated by reference to Exhibit 10.3 of the Registrant's Current Report on Form 8-K, dated January 3, 2006, and filed with the Securities and Exchange Commission on January 6, 2006)
10.29	Guaranty Agreement, dated as of January 3, 2006, and made by Screw Compression Systems, Inc. for the benefit of Western National Bank (Incorporated by reference to Exhibit 10.4 of the Registrant's Current Report on Form 8-K, dated January 3, 2006, and filed with the Securities and Exchange Commission on January 6, 2006)
10.30	Seventh Amended and Restated Loan Agreement (Incorporated by reference to Exhibit 10.1 of the Registrant's Form 8-K dated October 26, 2006 and filed with the Securities and Exchange Commission on November 1, 2006)
14.0	Code of Ethics (Incorporated by reference to Exhibit 14.0 of the Registrant's Form 10-KSB for the fiscal year ended December 31, 2004, and filed with the Securities and Exchange Commission on March 30, 2005)
21.0	Subsidiaries (Incorporated by reference to Exhibit 21.0 of the Registrant's Form 10-KSB for the fiscal year ended December 31, 2004, and filed with the Securities and Exchange Commission on March 30, 2005)
*23.1	Consent of Hein & Associates LLP
*31.1	Certifications
*31.2	Certifications
*32.1	Certification required by Section 906 of the Sarbanes-Oxley Act of 2002

\*32.2

Certification required by Section 906 of the Sarbanes-Oxley Act of 2002

\* Filed herewith.