

NATURAL GAS SERVICES GROUP INC
Form 10-K
March 10, 2011

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2010

or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF

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
(State or other jurisdiction of incorporation
or
organization)

75-2811855
(I.R.S. Employer Identification No.)

508 W. Wall St, Suite 550 Midland, Texas
(Address of principal executive offices)

79701
(Zip Code)

Registrant's telephone number, including
area code:

(432) 262-2700

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

Title of each class	Name of each exchange on which registered
Common Stock, \$.01 par value	New York 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.

Edgar Filing: NATURAL GAS SERVICES GROUP INC - Form 10-K

Yes No

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

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

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 Smaller Reporting Company

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

Yes No

The aggregate market value of voting and non-voting common equity held by non-affiliates of the Registrant as of June 30, 2010 was approximately \$175,117,253, based on the closing price of the common stock on that date on the New York Stock Exchange.

At March 8, 2011, there were 12,186,053 shares of common stock outstanding.

Documents Incorporated by Reference

Certain information called for in Items 10, 11, 12, 13 and 14 of Part III are incorporated by reference from the registrant's definitive proxy statement for the annual meeting of shareholders to be held on June 15, 2011.

FORM 10-K

NATURAL GAS SERVICES GROUP, INC.

TABLE OF CONTENTS

Item No.		Page
PART I		
Item 1.	Business	1
Item 1A.	Risk Factors	7
Item 1B.	Unresolved Staff Comments	16
Item 2.	Properties	16
Item 3.	Legal Proceedings	16
Item 4.	(Removed and Reserved)	17
PART II		
Item 5.	Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities	17
Item 6.	Selected Financial Data	20
Item 7.	Management’s Discussion and Analysis of Financial Condition and Results of Operations	22
Item 7A.	Quantitative and Qualitative Disclosures About Market Risk	31
Item 8.	Financial Statements and Supplementary Data	32
Item 9.	Changes in and Disagreements with Accountants on Accounting and Financial Disclosure	32
Item 9A.	Controls and Procedures	32
Item 9B.	Other Information	34
PART III		
Item 10.	Directors, Executive Officers and Corporate Governance	34
Item 11.	Executive Compensation	34

Item 12.	Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters	34
Item 13.	Certain Relationships, and Related Transactions, and Director Independence	34
Item 14.	Principal Accounting Fees and Services	34
PART IV		
Item 15.	Exhibits, Financial Statement Schedules	35

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-K contains certain forward-looking statements, within the meaning of Section 27A of the Securities Act of 1933, as amended, and information pertaining to us, our industry and the oil and natural gas industry that is based on the beliefs of our management, as well as assumptions made by and information currently available to our management. All statements, other than statements of historical facts contained in this Annual Report on Form 10-K, including statements regarding our future financial position, growth strategy, budgets, projected costs, plans and objectives of management for future operations, are forward-looking statements. We use the words “may,” “will,” “expect,” “anticipate,” “estimate,” “believe,” “continue,” “intend,” “plan,” “budget” and other similar words forward-looking statements. You should read statements that contain these words carefully and should not place undue reliance on these statements because they discuss future expectations, contain projections of results of operations or of our financial condition and/or state other “forward-looking” information. We do not undertake any obligation to update or revise publicly any forward-looking statements. Although we believe our expectations reflected in these forward-looking statements are based on reasonable assumptions, no assurance can be given that these expectations or assumptions will prove to have been correct. Important factors that could cause actual results to differ materially from the expectations reflected in the forward-looking statements include, but are not limited to, the following factors and the other factors described in this Annual Report on Form 10-K under the caption “Risk Factors”:

- conditions in the oil and natural gas industry, including the demand for natural gas and wide fluctuations in the prices of oil and natural gas;
 - regulation or prohibition of new well completion techniques;
 - competition among the various providers of compression services and products;
 - changes in safety, health and environmental regulations;
 - changes in economic or political conditions in the markets in which we operate;
 - failure of our customers to continue to rent equipment after expiration of the primary rental term;
- the inherent risks associated with our operations, such as equipment defects, malfunctions and natural disasters;
- our inability to comply with covenants in our debt agreements and the decreased financial flexibility associated with our debt;
 - future capital requirements and availability of financing;
 - fabrication and manufacturing costs;
 - general economic conditions;
 - events similar to September 11, 2001; and
 - fluctuations in interest rates.

We believe that it is important to communicate our expectations of future performance to our investors. However, events may occur in the future that we are unable to accurately predict or that we are unable to control. When

considering our forward-looking statements, you should keep in mind the risk factors and other cautionary statements in this Annual Report on Form 10-K.

PART I

ITEM 1. BUSINESS

Unless the context otherwise requires, references in this Annual Report on Form 10-K to “Natural Gas Services Group,” the “Company”, “we,” “us,” “our” or “ours” refer to Natural Gas Services Group, Inc. Certain specialized terms used describing our natural gas compressor business are defined in "Glossary of Industry Terms" on page 7.

The Company

We are a leading provider of small to medium horsepower compression equipment to the natural gas industry. We focus primarily on the non-conventional natural gas production business in the United States (such as coal bed methane, gas shale and tight gas), which, according to data from the Energy Information Administration, is the single largest and fastest growing segment of U.S. gas production. We manufacture, fabricate and rent natural gas compressors that enhance the production of natural gas wells and provide maintenance services for those compressors. In addition, we sell 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.

The vast majority of our rental operations are in non-conventional natural gas regions, which typically have lower initial reservoir pressures and faster well decline rates. These areas usually require compression to be installed sooner and with greater frequency.

Natural gas compressors are used in a number of applications for the production and enhancement of gas wells and in gas transportation lines and processing plants. Compression equipment is often required to boost a well's production to economically viable levels and enable gas to continue to flow in the pipeline to its destination.

We increased our revenue to \$53.9 million in 2010 from \$10.3 million in 2002, the year we completed our initial public offering. During the same period, income from operations increased to \$11.4 million from \$1.8 million. Our compressor rental fleet has grown from 302 compressors at the end of 2002 to 1,909 compressors at December 31, 2010.

Our revenue decreased from \$67.8 million to \$53.9 million for the year ended December 31, 2010, compared to the same year ended December 31, 2009.

Net income for the year ended December 31, 2010 decreased 36.2% to \$7.0 million (\$0.58 per diluted share), as compared to \$11.0 million (\$0.91 per diluted share) for the year ended December 31, 2009.

At December 31, 2010, current assets were \$48.3 million, which included \$19.1 million of cash and cash equivalents. Current liabilities were \$7.9 million, and the current portion of our line of credit was \$2.0 million. Our stockholders' equity as of December 31, 2010 was \$150.6 million.

We were incorporated in Colorado on December 17, 1998 and maintain our principal offices at 508 W. Wall St., Suite 550, Midland, Texas 79701 and our telephone number is (432) 262-2700. Our website is located at <http://www.ngsgi.com>. The information on or that can be accessed through our website is not part of this Annual Report on Form 10-K.

Overview and Outlook

The market for compression equipment and services is substantially dependent on the condition of the natural gas industry and, to a lesser extent, the oil industry. In particular, the willingness of natural gas and oil companies to make capital expenditures on exploration, drilling and production of natural gas and oil in the U.S. The level of activity and capital expenditures has generally been dependent upon the prevailing view of future gas and oil prices, which are influenced by numerous factors, including the level of supply or demand for natural gas and the impact on price of natural gas, worldwide economic activity, interest rates and the cost of capital, environmental regulation, seasonal fluctuations and weather patterns. Natural gas and oil prices and the level of production activity have historically been characterized by significant volatility. Increasing oil and natural gas prices from 2005 through mid-2008 resulted in natural gas and oil operators increasing capital spending for exploration, development and production programs. However, in mid-2008, natural gas and oil prices began to decline. This decline resulted in reduced production and capital spending by some natural gas and oil companies and may result in additional reductions in capital spending.

The reduction in capital expenditures and production in the natural gas and oil industry, combined with continuing problems in the global economy, led to a downturn in the demand for our products and services in 2009 which continued in 2010, including reductions in the utilization rate on our rental fleet and in our sales backlog. See “Item 1 -- Business – Our Operating Units” and “Business – Backlog” for more information.

According to the U.S. Energy Information Administration (“EIA”), total consumption of natural gas in the United States increased 5.7% for the twelve months ended November 2010 compared to the same period 2009. EIA expects total natural gas consumption to be flat in 2011 and increase 1.0 percent in 2012. While we anticipate long-term increased demand for natural gas, we expect our business to remain flat for 2011.

Long-Term Industry Trends

Natural gas prices historically have been volatile, and this volatility is expected to continue. Uncertainty continues to exist as to the direction of future United States and worldwide natural gas and crude oil price trends. Over the last several years gas prices have not shown the resiliency that crude oil prices have. We believe that natural gas is a more environmentally friendly source of energy which is likely to result in increases in demand. Being primarily a provider of services and equipment to natural gas producers, we are more significantly impacted by changes in natural gas prices than by changes in crude oil and condensate prices. Longer term natural gas prices will be determined by the supply and demand for natural gas as well as the prices of competing fuels, such as oil and coal.

We believe part of the growth of the rental compression capacity in the U.S. market has been driven by the trend toward outsourcing by energy producers and processors. Renting does not require the purchaser to make large capital expenditures for new equipment or to obtain financing through a lending institution. This allows the customer’s capital to be used for additional exploration and production of natural gas and oil.

Notwithstanding the current downturn in natural gas prices, we believe that there will continue to be a growing demand for natural gas. We expect long-term demand for our products and services will rise as a result of:

- the increasing demand for and limited supply of energy, both domestically and abroad;
 - continued non-conventional gas exploration and production;
- environmental considerations which provide strong incentives to use natural gas in place of other carbon fuels;
 - the cost savings of using natural gas rather than electricity for heat generation;
 - implementation of international environmental and conservation laws;
 - the aging of producing natural gas reserves worldwide; and
- the extensive supply of undeveloped non-conventional natural gas reserves.

Our Operating Units

We identify our segments based upon major revenue sources as Gas Compressor Rental, Engineered Equipment Sales, Service and Maintenance and Corporate. Please refer to Note 10 on page F-17 of the Notes to Financial Statements.

Gas Compressor Rental. Our rental business is primarily focused on non-conventional gas production. We provide rental of small to medium horsepower compression equipment to customers under contracts typically having minimum initial terms of six to 24 months. Historically, in our experience, most customers retain the equipment beyond the expiration of the initial term. By outsourcing their compression needs, we believe our customers are able to increase their revenues by producing a higher volume of natural gas due to greater equipment run-time. Outsourcing also allows our customers to reduce their compressor downtime, operating and maintenance

costs and capital investments and more efficiently meet their changing compression needs.

The size, type and geographic diversity of our rental fleet enables us to provide our customers with a range of compression units that can serve a wide variety of applications, and to select the correct equipment for the job, rather than the customer trying to fit the job to its own equipment. We base our gas compressor rental rates on several factors, including the cost and size of the equipment, the type and complexity of service desired by the customer, the length of contract and the inclusion of any other services desired, such as rental, installation, transportation and daily operation.

As of December 31, 2010, we had 1,909 natural gas compressors in our rental fleet totaling approximately 248,648 horsepower, as compared to 1,776 natural gas compressors totaling approximately 223,694 horsepower at December 31, 2009. As of December 31, 2010, we had 1,297 natural gas compressors totaling approximately 174,515 horsepower rented to 97 third parties, compared to 1,159 natural gas compressors totaling approximately 146,512 horsepower rented to 91 third parties at December 31, 2009. As of December 31, 2010, the utilization rate of our rental fleet was 67.9% compared to 65.3% as of December 31, 2009.

Engineered Equipment Sales. This segment includes the following components:

- Compressor fabrication. Fabrication involves the assembly of compressor components manufactured by us or other third parties into compressor units that are ready for rental or sale. In addition to fabricating compressors for our rental fleet, we engineer and fabricate natural gas compressors for sale to customers to meet their specifications based on well pressure, production characteristics and the particular applications for which compression is sought.
 - Compressor manufacturing. We design and manufacture our own proprietary line of reciprocating compressor frames, cylinders and parts known as our “CiP”, or Cylinder-in-Plane, product line. We use the finished components to fabricate compressor units for our rental fleet or for sale to third parties. We also sell finished components to other fabricators.
- Flare fabrication. We design, fabricate, sell, install and service flare stacks and related ignition and control devices for the onshore and offshore incineration of gas compounds such as hydrogen sulfide, carbon dioxide, natural gas and liquefied petroleum gases. Applications for this equipment are often environmentally and regulatory driven, and we believe we are a leading supplier to this market.
- Parts sales and compressor rebuilds. 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 part of our business.

Service and Maintenance. We service and maintain compressors owned by our customers on an “as needed” basis. Natural gas compressors require routine maintenance and periodic refurbishing to prolong their useful life. Routine maintenance includes physical and visual inspections and other parametric checks that indicate a change in the condition of the compressors. We perform wear-particle analysis on all packages and perform overhauls on a condition-based interval or a time-based schedule. Based on our past experience, these maintenance procedures maximize component life and unit availability and minimize downtime.

Business Strategy

During the downturn in the economy, our strategy was to reduce expenses in line with the lower anticipated business activity, and fabricate compressor equipment only in direct response to market requirements. As we see the economy recover, we will continue with this strategy to ensure that growth is balanced with appropriate business risk. See “Item 7 – Management’s Discussion and Analysis of Financial Condition and Results of Operations – Our Performance Trends and Outlook for more information. Our long-term intentions to grow our revenue and profitability are based on the following business strategies:

- Expand rental fleet. We intend to increase the size of our rental fleet by fabricating compressor units in numbers that correspond to the growth of the market and in relation to market share gains we may experience. We believe our growth will continue to be primarily driven through our placement of small to medium horsepower wellhead natural gas compressors for non-conventional natural gas production, which is the single largest and fastest growing segment of U.S. gas production according to data from the Energy Information Administration.
- Geographic expansion. We will continue to consolidate our operations in existing areas, as well as pursue focused expansion into new geographic regions as opportunities are identified. We presently provide our products and services to a customer base of oil and natural gas exploration and production companies operating in New Mexico, Texas, Michigan, Colorado, Wyoming, Utah, Oklahoma, Pennsylvania, West Virginia and Kansas.

- Expand our 'secondary' product lines. In addition to our primary rental and engineered product business lines, we will emphasize the growth of our other products, e.g., flares, CiP compressor products and general compressor maintenance and repair services.
- Selectively pursue acquisitions. We will continue to evaluate potential acquisitions that would provide us with access to new markets or enhance our current market position.

Competitive Strengths

We believe our competitive strengths include:

- Superior customer service. Our emphasis on the small to medium horsepower markets has enabled us to effectively meet the evolving needs of our customers. We believe these markets have been under-served by our larger competitors which, coupled with our personalized services and in-depth knowledge of our customers' operating needs and growth plans, have allowed us to enhance our relationships with existing customers as well as attract new customers. The size, type and geographic diversity of our rental fleet enable us to provide customers with a range of compression units that can serve a wide variety of applications. We are able to select the correct equipment for the job, rather than the customer trying to fit its application to our equipment.
- Diversified product line. Our compressors are available as high and low pressure rotary screw and reciprocating packages. They are designed to meet a number of applications, including wellhead production, natural gas gathering, natural gas transmission, vapor recovery and gas and plunger lift. In addition, our compressors can be built to handle a variety of gas mixtures, including air, nitrogen, carbon dioxide, hydrogen sulfide and hydrocarbon gases. A diversified product line helps us compete by being able to satisfy widely varying pressure, volume and production conditions that customers encounter.
- Purpose built rental compressors. Our rental compressor packages have been designed and built to address the primary requirements of our customers in the producing regions in which we operate. Our units are compact in design and are easy, quick and inexpensive to move, install and start-up. Our control systems are technically advanced and allow the operator to start and stop our units remotely and/or in accordance with well conditions. We believe our rental fleet is also one of the newest.
- Experienced management team. On average, our executive and operating management team has over 30 years of oilfield services industry experience. We believe our management team has successfully demonstrated its ability to grow our business both organically and through selective acquisitions.
- Broad geographic presence. We presently provide our products and services to a customer base of oil and natural gas exploration and production companies operating in New Mexico, Texas, Michigan, Colorado, Wyoming, Utah, Oklahoma, Pennsylvania, West Virginia and Kansas. Our footprint allows us to service many of the natural gas producing regions in the United States. We believe that operating in diverse geographic regions allows us better utilization of our compressors, minimal incremental expenses, operating synergies, volume-based purchasing, leveraged inventories and cross-trained personnel.
- Long-standing customer relationships. We have developed long-standing relationships providing compression equipment to many major and independent oil and natural gas companies. Our customers generally continue to rent our compressors after the expiration of the initial terms of our rental agreements, which we believe reflects their satisfaction with the reliability and performance of our services and products.

Major Customers

Sales and rental income to Devon Energy Production Inc. in the year ended December 31, 2010 amounted to 19% of revenue. Sales and rental income to XTO Energy, Inc. and Devon Energy, Inc. in the year ended December 31, 2009 amounted to 21% and 21% of revenue, respectively. Sales and rental income to XTO Energy, Inc. and Devon Energy, Inc. in the year ended December 31, 2008 amounted to 26% and 14% of revenue, respectively. No other single

customer accounted for more than 10% of our revenues in 2010, 2009 or 2008. BP and Devon Energy Production Inc. amounted to 19% and 10% of our accounts receivable as of December 31, 2010, respectively. XTO Energy, Inc. and Devon Energy Production amounted to 33% and 11%, respectively, of our accounts receivable as of December 31, 2009. No other customers amounted to more than 10% of our accounts receivable as of December 31, 2009 and 2010. The loss of either of the above customers could have a material adverse effect on our business, financial condition, results of operations and cash flows, depending upon the demand for our compressors at the time of such loss and our ability to attract new customers.

Sales and Marketing

Our sales force pursues the rental and sales market for compressors and flare equipment and other services in their respective territories. Additionally, our personnel coordinate with each other to develop relationships with customers who operate in multiple regions. Our sales and marketing strategy is focused on communication with current customers and potential customers through frequent direct contact, technical assistance, print literature, direct mail and referrals. Our sales and marketing personnel coordinate with our operations personnel in order to promptly respond to and address customer needs. Our overall sales and marketing efforts concentrate on demonstrating our commitment to enhancing the customer's cash flow through enhanced product design, fabrication, manufacturing, installation, customer service and support.

Competition

We have a number of competitors in the natural gas compression segment, some of which have greater financial resources. We believe that we compete effectively on the basis of price, customer service, including the ability to place personnel in remote locations, flexibility in meeting customer needs, and quality and reliability of our compressors and related services.

Compressor industry participants can achieve significant advantages through increased size and geographic breadth. As the number of rental compressors in our rental fleet increases, the number of sales, support, and maintenance personnel required and the minimum level of inventory do not increase proportionately.

Backlog

As of December 31, 2010, we had a sales backlog of approximately \$1.9 million compared to \$211,000 as of December 31, 2009. We expect to fulfill the backlog in 2011. Sales backlog consists of firm customer orders for which a purchase or work order has been received, satisfactory credit or a financing arrangement exists, and delivery is scheduled. In addition, the major components of our compressors are acquired from suppliers through periodic purchase orders that in many instances require three or four months of lead time prior to delivery of the order.

Employees

As of December 31, 2010, we had 234 total employees. No employees are represented by a labor union and we believe we have good relations with our employees.

Liability and Other Insurance Coverage

Our equipment and services are provided to customers who are subject to hazards inherent in the oil and gas industry, such as blowouts, explosions, caterings, fires, and oil spills. We maintain liability insurance that we believe is customary in the industry and which includes environmental cleanup, but excludes product warranty insurance because the majority of components on our compressor unit are covered by the manufacturers. We also maintain insurance with respect to our facilities. Based on our historical experience, we believe that our insurance coverage is adequate. However, there is a risk that our insurance may not be sufficient to cover any particular loss or that insurance may not cover all losses. In addition, insurance rates have in the past been subject to wide fluctuation, and changes in coverage could result in less coverage, increases in cost or higher deductibles and retentions.

Government Regulation

All of our operations and facilities are subject to numerous federal, state, foreign and local laws, rules and regulations related to various aspects of our business, including containment and disposal of hazardous materials, oilfield waste, other waste materials and acids.

To date, we have not been required to expend significant resources in order to satisfy applicable environmental laws and regulations. We do not anticipate any material capital expenditures for environmental control facilities or extraordinary expenditures to comply with environmental rules and regulations in the foreseeable future. However, compliance costs under existing laws or under any new requirements could become material and we could incur liabilities for noncompliance.

Our business is generally affected by political developments and by federal, state, foreign and local laws and regulations, which relate to the oil and natural gas industry. The adoption of laws and regulations affecting the oil and natural gas industry for economic, environmental and other policy reasons could increase our costs and could have an adverse effect on our operations. The state and federal environmental laws and regulations that currently apply to our operations could become more stringent in the future.

We have utilized operating and disposal practices that were or are currently standard in the industry. However, materials such as solvents, thinner, waste paint, waste oil, wash down waters and sandblast material may have been disposed of or released in or under properties currently or formerly owned or operated by us or our predecessors. In addition, some of these properties have been operated by third parties over whom we have no control either as to such entities' treatment of materials or the manner in which such materials may have been disposed of or released.

The federal Comprehensive Environmental Response Compensation and Liability Act of 1980, commonly known as CERCLA, and comparable state statutes impose strict liability on:

- owners and operators of sites, and
- persons who disposed of or arranged for the disposal of "hazardous substances" found at sites.

The federal Resource Conservation and Recovery Act and comparable state statutes govern the disposal of "hazardous wastes." Although CERCLA currently excludes certain materials from the definition of "hazardous substances," and the Resource Conservation and Recovery Act also excludes certain materials from regulation, such exemptions by Congress under both CERCLA and the Resource Conservation and Recovery Act may be deleted, limited or modified in the future. We could become subject to requirements to remove and remediate previously disposed of materials (including materials disposed of or released by prior owners or operators) from properties.

The federal Water Pollution Control Act and the Oil Pollution Act of 1990 and implementing regulations govern:

- the prevention of discharges, including oil and produced water spills, and
- liability for drainage into waters.

Our operations are also subject to federal, state, and local regulations for the control of air emissions. The federal Clean Air Act and various state and local laws impose on us certain air quality requirements. Amendments to the Clean Air Act revised the definition of "major source" such that emissions from both wellhead and associated equipment involved in oil and natural gas production may be added to determine if a source is a "major source." As a consequence, more facilities may become major sources and thus may require us to make increased compliance expenditures.

We believe that our existing environmental control procedures are adequate and that we are in substantial compliance with environmental laws and regulations, and the phasing in of emission controls and other known regulatory requirements should not have a material adverse affect on our financial condition or operational results. However, it is possible that future developments, such as new or increasingly strict requirements and environmental laws and enforcement policies there under, could lead to material costs of environmental compliance by us. While we may be able to pass on the additional cost of complying with such laws to our customers, there can be no assurance that attempts to do so will be successful. Some risk of environmental liability and other costs are inherent in the nature of our business, however, and there can be no assurance that environmental costs will not rise.

In recent years, increased concern has been raised over the protection of the environment. Legislation to regulate emissions of greenhouse gases has been introduced in Congress, and there has been a wide-ranging policy debate, both nationally and internationally, regarding the impact of these gases and possible means for their regulation. In addition, efforts have been made and continue to be made in the international community toward the adoption of international treaties or protocols that would address global climate change issues, such as the United Nations Climate Change Conference in Copenhagen in 2009. Also, the EPA has undertaken new efforts to collect information regarding greenhouse gas emissions and their effects. Recently, the EPA declared that certain greenhouse gases represent a danger to human health and proposed to expand its regulations relating to those emissions. To the extent that new laws or other governmental actions restrict the energy industry or impose additional environmental protection requirements that result in increased costs to the oil and gas industry, we could be adversely affected. We cannot determine to what extent our future operations and earnings may be affected by new legislation, new regulations or changes in existing regulations.

Patents, Trademarks and Other Intellectual Property

We believe that the success of our business depends more on the technical competence, creativity and marketing abilities of our employees than on any individual patent, trademark, or copyright. Nevertheless, as part of our ongoing research, development and manufacturing activities, we may seek patents when appropriate on inventions concerning

new products and product improvements. We currently own one United States patent covering certain flare system technologies; however, it expired in January 2010. We do not own any foreign patents. Although we continue to use the patented technology and consider it useful in certain applications, we do not consider the expired patent to be material to our business as a whole.

Suppliers and Raw Materials

Fabrication of our rental compressors involves the purchase by us of engines, compressors, coolers and other components, and the assembly of 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 typically 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 sale prices proportionate to any such component price increases.

Available Information

We use our website as a channel of distribution for company information. We make available free of charge on the Investor Relations section of our website (www.ngsgi.com) our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, and Current Reports on Form 8-K. We also make available through our website other reports filed with or furnished to the SEC under the Securities Exchange Act of 1934, as amended, including our proxy statements and reports filed by officers and directors under Section 16(a) of the Exchange Act, as well as our Code of Business Ethics and the charters to our various Committees of our Board of Directors. Paper copies of our filings are also available, without charge upon written request, at Natural Gas Services Group, Inc., 508 West Wall Street, Suite 550, Midland, Texas 79701. We do not intend for information contained in our website to be part of this report.

Glossary of Industry Terms

"coal bed methane" – A natural gas generated during coal formation and provided from coal seams or adjacent sandstones.

"gas shale" – Fine grained rocks where the predominant gas storage mechanism is absorption and gas is stored in volumes that are potentially economic.

"reciprocating compressors" – A reciprocating compressor is a type of compressor which compresses vapor by using a piston in a cylinder and a back-and-forth motion.

"screw compressors" – A type of compressor used in vapor compression where two intermesh rotors create pockets of continuously decreasing volume, in which the vapor is compressed and its pressure is increased.

"tight gas" – A gas bearing sandstone or carbonate matrix (which may or may not contain natural fractures) which exhibits a low-permeability (tight) reservoir.

ITEM 1A. RISK FACTORS

You should carefully consider the following risks associated with owning our common stock. Although the risks described below are the risks that we believe are material, they are not the only risks relating to our industry, our business and our common stock. Additional risks and uncertainties, including those that we have not yet identified or that we currently believe are immaterial, may also adversely affect our business, financial condition or results of operations.

Risks Associated With Our Industry

Adverse macroeconomic and business conditions may significantly and negatively affect our results of operations.

Continued weak economic conditions in the United States and abroad have, and will likely continue to, substantially affect our revenue and profitability. The domestic and global financial crisis, continued fluctuating natural gas prices, and the unprecedented levels of disruption and continuing illiquidity in the credit markets have had an adverse effect on our operating results and financial condition, and if sustained or worsened, such adverse effects could continue or worsen. Uncertainty and turmoil in the credit markets may negatively impact the ability of our customers to finance purchases of our products and services and could result in a decrease in, or cancellation of, orders included in our backlog or adversely affect the collectability of our receivables. If the availability of credit to our customers is

reduced, they may reduce their drilling and production expenditures, thereby decreasing demand for our products and services, which could have a negative impact on our financial condition.

7

Decreased oil and natural gas prices and oil and gas industry expenditure levels could adversely affect our revenue.

Our revenue is derived primarily from expenditures in the oil and natural gas industry, which, in turn, are based on budgets to explore for, develop and produce oil and natural gas. When these expenditures decline, our revenue will suffer. The industry's willingness to explore for, develop and produce oil and natural gas depends largely upon the prevailing view of future oil and natural gas prices. Prices for oil and natural gas historically have been, and are likely to continue to be, highly volatile. Many factors affect the supply and demand for oil and natural gas and, therefore, influence oil and natural gas prices, including:

- the level of oil and natural gas production;
 - the level of oil and natural gas inventories;
 - domestic and worldwide demand for oil and natural gas;
 - the expected cost of developing new reserves;
 - the cost of producing oil and natural gas;
 - the level of drilling and completions activity;
 - inclement weather;
- domestic and worldwide economic activity;
- regulatory and other federal and state requirements in the United States;
- the ability of the Organization of Petroleum Exporting Countries and other large producers to set and maintain production levels and prices for oil;
- political conditions in or affecting oil and natural gas producing countries;
- terrorist activities in the United States and elsewhere;
- the cost of developing alternate energy sources;
- environmental regulation; and
- tax policies.

Depending on the market prices of oil and natural gas, companies exploring for oil and natural gas may cancel or curtail their drilling programs, thereby reducing demand for our equipment and services. Our rental contracts are generally short-term, and oil and natural gas companies tend to respond quickly to upward or downward changes in prices. Any reduction in drilling and production activities may materially erode both pricing and utilization rates for our equipment and services and adversely affects our financial results. As a result, we may suffer losses, be unable to make necessary capital expenditures and be unable to meet our financial obligations.

The intense competition in our industry could result in reduced profitability and loss of market share for us.

In our business segments, we compete with the oil and natural gas industry's largest equipment and service providers who have greater name recognition than we do. These companies also have substantially greater financial resources, larger operations and greater budgets for marketing, research and development than we do. They may be better able to compete because of their broader geographic dispersion and ability to take advantage of international opportunities, the greater number of compressors in their fleet or their product and service diversity. As a result, we could lose customers and market share to those competitors. These companies may also be better positioned than us to successfully endure downturns in the oil and natural gas industry.

Our operations may be adversely affected if our current competitors or new market entrants introduce new products or services with better prices, features, performance or other competitive characteristics than our products and services. Competitive pressures or other factors also may result in significant price competition that could harm our revenue and our business. Additionally, we may face competition in our efforts to acquire other businesses.

Our industry is highly cyclical, and our results of operations may be volatile.

Our industry is highly cyclical, with periods of high demand and high pricing followed by periods of low demand and low pricing. Periods of low demand intensify the competition in the industry and often result in rental equipment being idle for long periods of time. We may be required to enter into lower rate rental contracts in response to market conditions, and our sales may decrease as a result of such conditions. Due to the short-term nature of most of our rental contracts, changes in market conditions can quickly affect our business. As a result of the cyclicity of our industry, our results of operations may be volatile in the future.

Increased regulation or ban of current Fracturing techniques could reduce demand for our compressors

Fracturing (frac) is a process that results in the creation of fractures in geological formations in order to stimulate production from oil and gas wells. Fracturing is also done to increase the rate and ultimate recovery of oil and natural gas. Hydraulic frac is the technique that has allowed domestic oil and natural gas exploration and production companies to produce massive shale deposits often referred to as unconventional plays. Concerns have been raised over possible environmental damages related to fluids used in the frac process. In June, the FRAC (Fracturing Responsibility and Awareness of Chemicals) Act was introduced in Congress via companion bills in the House and Senate. The FRAC Act seeks to amend the Safe Drinking Water Act so that hydraulic fracturing would be regulated on a federal level.

The ban of hydraulic fracing would likely halt some projects including unconventional projects, at least temporarily. Expanded regulations are likely to introduce a period of uncertainty as companies determine ways to proceed. Any curtailment could result in a reduction of demand for our compressors, potentially effecting both sales and rentals of our units.

We are subject to extensive environmental laws and regulations that could require us to take costly compliance actions that could harm our financial condition.

Our fabrication and maintenance operations are significantly affected by stringent and complex federal, state and local laws and regulations governing the discharge of substances into the environment or otherwise relating to environmental protection. In these operations, we generate and manage hazardous wastes such as solvents, thinner, waste paint, waste oil, wash down wastes, and sandblast material. We attempt to use generally accepted operating and disposal practices and, with respect to acquisitions, will attempt to identify and assess whether there is any environmental risk before completing an acquisition. Based on the nature of the industry, however, hydrocarbons or other wastes may have been disposed of or released on or under properties owned or leased by us or on or under other locations where such wastes have been taken for disposal. The waste on these properties may be subject to federal or state environmental laws that could require us to remove the wastes or remediate sites where they have been released. We could be exposed to liability for cleanup costs, natural resource and other damages as a result of our conduct or the conduct of, or conditions caused by, prior owners, lessees or other third parties. Environmental laws and

regulations have changed in the past, and they are likely to change in the future. If current existing regulatory requirements or enforcement policies change, we may be required to make significant unanticipated capital and operating expenditures.

Any failure by us to comply with applicable environmental laws and regulations may result in governmental authorities taking actions against our business that could harm our operations and financial condition, including the:

- issuance of administrative, civil and criminal penalties;
- denial or revocation of permits or other authorizations;
 - reduction or cessation in operations; and
- performance of site investigatory, remedial or other corrective actions.

Risks Associated With Our Company

As of December 31, 2010, a significant majority of our compressor rentals were for terms of six months or less which, if terminated or not renewed, would adversely impact our revenue and our ability to recover our initial equipment costs.

The length of our compressor rental agreements with our customers varies based on customer needs, equipment configurations and geographic area. In most cases, under currently prevailing rental rates, the initial rental periods are not long enough to enable us to fully recoup the average cost of acquiring or fabricating the equipment. We cannot be sure that a substantial number of our customers will continue to renew their rental agreements or that we will be able to re-rent the equipment to new customers or that any renewals or re-rentals will be at comparable rental rates. The inability to timely renew or re-rent a substantial portion of our compressor rental fleet would have a material adverse effect upon our business, financial condition, results of operations and cash flows.

We could be subject to substantial liability claims that could harm our financial condition.

Our products are used in hazardous drilling and production applications where an accident or a failure of a product can cause personal injury, loss of life, damage to property, equipment or the environment, or suspension of operations.

While we maintain insurance coverage, we face the following risks under our insurance coverage:

- we may not be able to continue to obtain insurance on commercially reasonable terms;
- we may be faced with types of liabilities that will not be covered by our insurance, such as damages from significant product liabilities and from environmental contamination;
 - the dollar amount of any liabilities may exceed our policy limits; and
 - we do not maintain coverage against the risk of interruption of our business.

Any claims made under our policies will likely cause our premiums to increase. Any future damages caused by our products or services that are not covered by insurance, are in excess of policy limits or are subject to substantial deductibles, would reduce our earnings and our cash available for operations.

We might be unable to employ qualified technical personnel, which could hamper our present operations or increase our costs.

Many of the compressors that we sell or rent are mechanically complex and often must perform in harsh conditions. We believe that our success depends upon our ability to employ and retain a sufficient number of technical personnel who have the ability to design, utilize, enhance and maintain these compressors. Our ability to expand our operations depends in part on our ability to increase our skilled labor force. The demand for skilled workers is high and supply is limited. A significant increase in the wages paid by competing employers could result in a reduction of our skilled labor force or cause an increase in the wage rates that we must pay or both. If either of these events were to occur, our cost structure could increase and our operations and growth potential could be impaired.

We will require a substantial amount of capital to expand our compressor rental fleet and grow our business.

During 2011, the amount we will spend on capital expenditures related to rental compression equipment will be determined primarily by the activity of our customers, and we do not anticipate that demand exceeding what we can fund with internally generated funds and additional bank borrowing with our current bank line. The amount and timing of any of these capital expenditures may vary depending on a variety of factors, including the level of activity in the oil and natural gas exploration and production industry and the presence of alternative uses for our capital, including any acquisitions that we may pursue.

Historically, we have funded our capital expenditures through internally generated funds, borrowings under bank credit facilities and the proceeds of equity financings. Although we believe that cash flows from our operations will provide us with sufficient cash to fund our planned capital expenditures for 2011, we cannot assure you that these sources will be sufficient. We may require additional capital to fund any unanticipated capital expenditures, including any acquisitions, and to fund our growth beyond 2011, and necessary capital may not be available to us when we need it or on acceptable terms. Our ability to raise additional capital will depend on the results of our operations and the status of various capital and industry markets at the time we seek such capital. Failure to generate sufficient cash flow, together with the absence of alternative sources of capital, could have a material adverse effect on our business, financial condition, results of operations or cash flow.

Disruptions in the credit and financial markets have adversely affected financial institutions, inhibited lending and limited access to capital and credit for many companies. Several large financial institutions have either recently failed or been dependent on the assistance of the U.S. federal government to continue to operate as a going concern. Of our \$20 million line of credit, we owe \$2.0 million as of December 31, 2010. All outstanding principal and unpaid interest is due on December 31, 2011. Although we believe that we will be able to renew our existing line of credit, or obtain a new line of credit with another lender, we can provide no assurance that we will be successful in renewing our line of credit or obtaining a new line. In addition, any renewal of our existing line of credit or creation of a new line of credit may be on terms less favorable than our existing line. For instance, changes in the terms of a new line of credit may include, but not be limited to: a reduction in the borrowing amount, an increase in interest rate to be paid on borrowings under the line, or restrictive covenants that are more onerous than those on our existing line of credit.

We believe that the lender participating in our current credit facility has adequate capital and resources; however, we can provide no assurance that these lenders will continue to operate as a going concern in the future. If our current lender were to fail, it is possible that the borrowing capacity under our credit facility would be reduced or eliminated. In the event that the availability under our credit facility was reduced significantly, we could be required to obtain capital from alternate sources in order to finance our capital needs. Our options for addressing such capital constraints would include, but not be limited to (1) obtaining commitments from other banks to fund increased amounts under the terms of our credit facility, (2) accessing the public capital markets, or (3) delaying certain projects. If it became necessary to access additional capital, any alternatives at the time may be on terms less favorable than under our existing credit facility terms, which could have a material effect on our consolidated financial position, results of operations and cash flows. If future financing is not available to us when required, as a result of limited access to the credit markets or otherwise, or is not available to us on acceptable terms, we may be unable to take advantage of business opportunities or respond to competitive pressures, either of which could have a material adverse effect on our consolidated financial position, results of operations and cash flows.

Our current debt level may negatively impact our current and future financial stability.

As of December 31, 2010, we had an aggregate of approximately \$2 million of outstanding indebtedness, and accounts payable and accrued expenses of approximately \$5.5 million. As a result of our indebtedness, we might not have the ability to incur any substantial additional indebtedness. The level of our indebtedness could have several important effects on our future operations, including:

- our ability to obtain additional financing for working capital, acquisitions, capital expenditures and other purposes may be limited;
- a significant portion of our cash flow from operations may be dedicated to the payment of principal and interest on our debt, thereby reducing funds available for other purposes; and
 - our significant leverage could make us more vulnerable to economic downturns.

We believe that our current cash position and the amount available under the current revolver are sufficient to meet our capital needs through 2011. If we are unable to service our debt, we will likely be forced to take remedial steps that are contrary to our business plan.

As of December 31, 2010, we had \$2.0 million due as a current liability under our Line of Credit facility which allows us to borrow up to \$20.0 million provided we maintain certain collateral and borrowing base requirements. It is possible that our business will not generate sufficient cash flow from operations to meet our debt service requirements and the payment of principal when due depending on the amount of borrowings on the facility at any given time. If

this were to occur, we may be forced to:

- sell assets at disadvantageous prices;
- obtain additional financing; or
- refinance all or a portion of our indebtedness on terms that may be less favorable to us.

Our current bank loan agreement contains covenants that limit our operating and financial flexibility and, if breached, could expose us to severe remedial provisions.

Under the terms of our loan agreement, we must:

- comply with a minimum leverage ratio;
- comply with a commitment coverage ratio; and
 - not exceed specified levels of debt;
 - comply with limits on asset sales

Our ability to meet the financial ratios and tests under our bank loan agreement can be affected by events beyond our control, and we may not be able to satisfy those ratios and tests. A breach of any one of these covenants could permit the bank to accelerate the debt so that it is immediately due and payable. If a breach occurred, no further borrowings would be available under our loan agreement. If we were unable to repay the debt, the bank could proceed against and foreclose on our assets, substantially all of which have been pledged as collateral to secure payment of our indebtedness.

If we fail to acquire or successfully integrate additional businesses, our growth may be limited and our results of operations may suffer.

As part of our business strategy, we intend to evaluate potential acquisitions of other businesses or assets. However, there can be no assurance that we will be successful in consummating any such acquisitions. Successful acquisition of businesses or assets will depend on various factors, including, but not limited to, our ability to obtain financing and the competitive environment for acquisitions. In addition, we may not be able to successfully integrate any businesses or assets that we acquire in the future. The integration of acquired businesses is likely to be complex and time consuming and place a significant strain on management and may disrupt our business. We also may be adversely impacted by any unknown liabilities of acquired businesses, including environmental liabilities. We may encounter substantial difficulties, costs and delays involved in integrating common accounting, information and communication systems, operating procedures, internal controls and human resources practices, including incompatibility of business cultures and the loss of key employees and customers. These difficulties may reduce our ability to gain customers or retain existing customers, and may increase operating expenses, resulting in reduced revenues and income and a failure to realize the anticipated benefits of acquisitions.

The loss of one or more of our current customers could adversely affect our results of operations.

Our business is dependent not only on securing new customers but also on maintaining current customers. We had one customer that accounted for approximately 19% of our revenue for the year ended December 31, 2010, and two customers of approximately 21% each of our revenue for the year ended December 31, 2009. Unless we are able to retain our existing customers, or secure new customers if we lose one or more of our significant customers, our revenue and results of operations would be adversely affected.

Loss of key members of our management could adversely affect our business.

We depend on the continued employment and performance of key members of our executive and senior management team. If any of our key managers resign or become unable to continue in his present role and is not adequately

replaced, our business operations could be materially adversely affected. We do not carry any key-man insurance on any of our officers or directors.

Failure to effectively manage our growth and expansion could adversely affect our business and operating results and our internal controls.

We have rapidly and significantly expanded our operations in recent years and anticipate that our growth will continue if we are able to execute our strategy. Our rapid growth has placed significant strain on our management and other resources which, given our expected future growth rate, is likely to continue. To manage our future growth, we must be able to, among other things:

- accurately assess the number of additional officers and employees we will require and the areas in which they will be required;
 - attract, hire and retain additional highly skilled and motivated officers and employees;
 - train and manage our work force in a timely and effective manner;
- upgrade and expand our office infrastructure so that it is appropriate for our level of activity; and
 - improve our financial and management controls, reporting systems and procedures.

Liability to customers under warranties and indemnification provisions may materially and adversely affect our earnings.

We provide warranties as to the proper operation and conformance to specifications of the equipment we manufacture. Our equipment is complex and often deployed in harsh environments. Failure of this equipment to operate properly or to meet specifications may increase our costs by requiring additional engineering resources and services, replacement of parts and equipment or monetary reimbursement to a customer. We have in the past received warranty claims and we expect to continue to receive them in the future. To the extent that we incur substantial warranty claims in any period, our reputation, our ability to obtain future business and our earnings could be materially and adversely affected.

Our rental and sales contracts provide for varying of indemnification from our customers and in most cases may require us to indemnify our customers. Under some of our rental and sales contracts, liability with respect to personnel and property is customarily assigned on a “knock-for-knock” basis, which means that we and our customers assume liability for our respective personnel and property. However, in certain rental and sales contracts we assume liability for damage to our customer’s property and other third-party on the site resulting from our negligence. Since our products are used in hazardous drilling and production applications in the natural energy industry, expenses and liabilities in connection with accidents involving our products and services could be extensive and may exceed our insurance coverages.

Failure to maintain effective internal controls could have a material adverse effect on our operations.

Section 404 of the Sarbanes-Oxley Act requires annual management assessments of the effectiveness of our internal control over financial reporting. If we fail to maintain effective internal controls, we may not be able to ensure that we can conclude on an ongoing basis that we have effective internal controls over financial reporting in accordance with Section 404 of the Sarbanes-Oxley Act. Moreover, effective internal controls are necessary for us to produce reliable financial reports and to help prevent financial fraud. If, as a result of deficiencies in our internal controls, we cannot provide reliable financial reports or prevent fraud, our business decision process may be adversely affected, our business and operating results could be harmed, investors could lose confidence in our reported financial information,

and the price of our stock could decrease as a result.

We must evaluate our intangible assets annually for impairment.

Our intangible assets are recorded at cost less accumulated amortization and consist of goodwill and patent costs and other identifiable intangibles.

We did not identify any impairment based on internal evaluations of our goodwill for the year ended December 31, 2010. Future impairment tests could result in impairments of our 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 goodwill and intangible assets were recorded on our balance sheet at approximately \$12.8 million and \$12.5 million as of December 31, 2009 and 2010, respectively. Our identifiable intangibles are currently amortized at a rate of \$260,000 per year. Any impairment in future periods of those assets, or a reduction in their consumptive lives, could materially and adversely affect our statements of income and financial position.

A reduction in demand primarily for natural gas or prices for this commodity and credit markets could adversely affect our business.

Our results of operations depend upon the level of activity in the energy market, including natural gas development, production, processing and transportation. Oil and natural gas prices and the level of drilling and exploration activity can be volatile. For example, oil and natural gas exploration and development activity and the number of well completions typically decline when there is a significant reduction in oil and natural gas prices or significant instability in energy markets. As a result, the demand for our natural gas compression services could be adversely affected. A reduction in demand could also force us to reduce our pricing substantially. Additionally, our customers' production from unconventional natural gas sources such as tight sands, shale and coal beds constitute the majority percentage of our business. Such unconventional sources are generally less economically feasible to produce in lower natural gas price environments. These factors could in turn negatively impact the demand for our products and services. A decline in demand for oil and natural gas or prices for those commodities and credit markets generally have a material adverse effect on our business, financial condition, results of operations.

The erosion of the financial condition of our customers could adversely affect our business.

Many of our customers finance their exploration and development activities through cash flow from operations, the incurrence of debt or the issuance of equity. During times when the oil or natural gas markets weaken, our customers are more likely to experience a downturn in their financial condition. Many of our customers' equity values substantially declined during the recent recession, and the capital markets have not fully recovered making it an unreliable source of financing for some customers. The combination of a reduction in cash flow resulting from declines in commodity prices, a reduction in borrowing bases under reserve-based credit facilities and the lack of availability of debt or equity financing will result in a reduction in our customers' spending for our products and services in 2011. For example, our customers could seek to preserve capital by canceling month-to-month contracts, canceling or delaying scheduled maintenance of their existing natural gas compression equipment or determining not to enter into any new natural gas compression service contracts or purchase new compression equipment.

Risks Associated With Our Common Stock

The price of our common stock may fluctuate which may cause our common stock to trade at a substantially lower price than the price paid for our common stock.

The trading price of our common stock and the price at which we may sell securities in the future is subject to substantial fluctuations in response to various factors, including our ability to successfully accomplish our business strategy, the trading volume of our stock, changes in governmental regulations, actual or anticipated variations in our quarterly or annual financial results, our involvement in litigation, general market conditions, the prices of oil and natural gas, announcements by us and our competitors, our liquidity, our ability to raise additional funds, and other events.

Future sales of our common stock could adversely affect our stock price.

Substantial sales of our common stock in the public market, or the perception by the market that those sales could occur, may lower our stock price or make it difficult for us to raise additional equity capital in the future. 43.9% of the outstanding shares of our common stock are owned by five institutional investors, each of which owns more than 5% of our outstanding shares as of March 8, 2011. Potential sales of large amounts of these shares in a short period of time by one or more of these significant investors could have a negative impact on our stock price. In addition, potential sales of our common stock by our directors and officers, who beneficially own approximately 4.49% of the outstanding shares of our common stock as of March 8, 2011, could also have a negative impact on our stock price.

We currently have on file with the SEC an effective “universal” shelf registration statement on Form S-3, which enables us to sell, from time to time, our common stock and other securities covered by the registration statement in one or more public offerings. The shelf registration statement allows us to enter the public markets and consummate sales of the registered securities in rapid fashion and with little or no notice. Issuances of securities under our shelf registration statement may dilute our existing shareholders. See “Management’s Discussion and Analysis of Financial Condition and Results of Operations — Liquidity and Capital Resources.”

If we issue debt or equity securities, you may lose certain rights and be diluted.

If we raise funds in the future through the issuance of debt or equity securities, the securities issued may have rights and preferences and privileges senior to those of holders of our common stock, and the terms of the securities may impose restrictions on our operations or dilute your ownership in our Company.

If securities analysts downgrade our stock or cease coverage of us, the price of our stock could decline.

The trading market for our common stock relies in part on the research and reports that industry or financial analysts publish about us or our business. We do not control these analysts. Furthermore, there are many large, well-established, publicly traded companies active in our industry and market, which may mean that it is less likely that we will receive widespread analyst coverage. If one or more of the analysts who do cover us downgrade our stock, our stock price would likely decline rapidly. If one or more of these analysts cease coverage of our company, we could lose visibility in the market, which in turn could cause our stock price to decline.

We do not intend to pay, and have restrictions upon our ability to pay, dividends on our common stock.

We have not paid cash dividends in the past and do not intend to pay dividends on our common stock in the foreseeable future. Net income from our operations, if any, will be used for the development of our business, including capital expenditures, and to retire debt. In addition, our bank loan agreement contains restrictions on our ability to pay cash dividends on our common stock.

We have a comparatively low number of shares of common stock outstanding and, therefore, our common stock may suffer from limited liquidity and its prices will likely be volatile and its value may be adversely affected.

Because of our relatively low number of outstanding shares of common stock, the trading price of our common stock will likely be subject to significant price fluctuations and limited liquidity. This may adversely affect the value of your investment. In addition, our common stock price could be subject to fluctuations in response to variations in quarterly operating results, changes in management, future announcements concerning us, general trends in the industry and other events or factors as well as those described above.

Provisions contained in our governing documents could hinder a change in control of us.

Our articles of incorporation and bylaws contain provisions that may discourage acquisition bids and may limit the price investors are willing to pay for our common stock. Our articles of incorporation and bylaws provide that:

- directors are elected for three-year terms, with approximately one-third of the board of directors standing for election each year;
- cumulative voting is not allowed, which limits the ability of minority shareholders to elect any directors;

- the unanimous vote of the board of directors or the affirmative vote of the holders of not less than 80% of the votes entitled to be cast by the holders of all shares entitled to vote in the election of directors is required to change the size of the board of directors; and
- directors may be removed only for cause and only by the holders of not less than 80% of the votes entitled to be cast on the matter.

Our Board of Directors has the authority to issue up to five million shares of preferred stock. The Board of Directors can fix the terms of the preferred stock without any action on the part of our stockholders. The issuance of shares of preferred stock may delay or prevent a change in control transaction. In addition, preferred stock could be used in connection with the Board of Directors' adoption of a shareholders' rights plan (also known as a poison pill), which would make it much more difficult to effect a change in control of our company through acquiring or controlling blocks of stock. Also, our directors and officers as a group will continue to beneficially own stock and although this is not a majority of our stock, it confers substantial voting power in the election of directors and management of our company. This would make it difficult for other minority stockholders to effect a change in control or otherwise extend any significant control over our management.. This may adversely affect the market price and interfere with the voting and other rights of our common stock.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

The table below describes the material facilities owned or leased by Natural Gas Services Group as of December 31, 2010:

Location	Status	Square Feet	Uses
Tulsa, Oklahoma	Owned and Leased	91,780	Compressor fabrication, rental and services
Midland, Texas	Owned	58,000	Compressor fabrication, rental and services
Midland, Texas (1)	Owned	24,600	Compressor fabrication, rental and services
Lewiston, Michigan	Owned	15,360	Compressor fabrication, rental and services
Midland, Texas	Leased	13,135	Corporate offices
Bloomfield, New Mexico	Leased	7,000	Office and parts and services
Bridgeport, Texas	Leased	4,500	Office and parts and services
Midland, Texas	Owned	4,100	Parts and services
Godley, Texas	Leased	5,000	Parts and services

Colleyville, Texas	Leased	512	Sales
		223,987	

- (1) This facility was sold on January 27, 2011.
- (2) See Note 9 to the financial statements for information concerning our leased properties.

We believe that our properties are generally well maintained and in good condition and adequate for our purposes.

ITEM 3. LEGAL PROCEEDINGS

From time to time, we are a party to various legal proceedings in the ordinary course of our business. While management is unable to predict the ultimate outcome of these actions, it believes that any ultimate liability arising from these actions will not have a material effect on our financial position, results of operations or cash flow. We are not currently a party to any bankruptcy, receivership, reorganization, adjustment or similar proceeding, and we are not aware of any other threatened litigation.

ITEM 4. [REMOVED AND RESERVED]

PART II

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

Our common stock currently trades on the New York Stock Exchange under the symbol "NGS". The following table sets forth for the periods indicated the high and low sales prices for our common stock as reported for 2009 and 2010.

2009	Low	High
First Quarter	\$ 6.72	\$ 12.60
Second Quarter	9.02	15.91
Third Quarter	10.97	18.01
Fourth Quarter	16.32	19.18
2010		
First Quarter	\$ 14.26	\$ 20.45
Second Quarter	14.95	18.56
Third Quarter	13.93	16.97
Fourth Quarter	14.64	19.72

As of December 31, 2010 as reflected by our transfer agent records, we had 20 record holders of our common stock. This number does not include any beneficial owners for whom shares of common stock may be held in “nominee” or “street” name. On March 8, 2011, the last reported sale price of our common stock as reported by the New York Stock Exchange was \$17.75 per share.

The following graph shows a five year comparison of the cumulative total stockholder return on Natural Gas Services Group common stock as compared to the cumulative total return of two other indexes: a custom composite index of the Oilfield Service Index (the “OSX”) and the Standard & Poor’s 500 Composite Stock Price Index. These comparisons assume an initial investment of \$100 and the reinvestment of dividends.

The performance graph shall not be deemed incorporated by reference by any general statement incorporating by reference the Annual Report on Form 10-K into any filing under the Securities Act of 1933 or the Securities Exchange Act of 1934, except to the extent that we specifically incorporate this information by reference, and shall not otherwise be deemed filed under those Acts.

Dividends

To date, we have not declared or paid any dividends on our common stock. We currently do not anticipate paying any cash dividends in the foreseeable future on our common stock. Although we intend to retain our earnings, if any, to finance the growth of our business, our Board of Directors will have the discretion to declare and pay dividends in the future. Payment of dividends in the future will depend upon our earnings, capital requirements, and other factors, which our Board of Directors may deem relevant. Our loan agreements also contain restrictions on paying dividends.

Equity Compensation Plans

The following table summarizes certain information regarding our equity compensation plans as of December 31, 2010:

Plan Category	(a) Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights	(b) Weighted-average Exercise Price of Outstanding Options, Warrants and Rights	(c) Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column (a))
Equity compensation plans approved by security holders:			
1998 Stock Option Plan	423,206 (1)	14.76	293,357
2009 Restricted Stock / Unit Plan	13,276		286,724
Equity compensation plans not approved by security holders	45,000 (2) \$	9.22	

(1) Total number of shares to be issued upon exercise of options granted to employees, officers, and directors under our 1998 stock option plan.

(2) Total number of shares to be issued upon exercise of options granted outside of our 1998 stock option plan to Stephen C. Taylor, our Chief Executive Officer, under the terms of his employment agreement.

Repurchase of Equity Securities

No repurchases of our securities were made by us or on our behalf by any “affiliated purchaser” during the fiscal year ended December 31, 2010.

Sale of Unregistered Securities

We made no sales of unregistered securities during the year ended December 31, 2010.

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 financial statements for each of the years in the five-year period ended December 31, 2010. This information is only a summary and it is important that you read this information along with our audited 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,				
	2006	2007	2008	2009	2010
	(in thousands, except per share amounts)				
STATEMENTS OF INCOME AND OTHER INFORMATION:					
Revenues	\$62,729	\$72,489	\$85,336	\$67,796	\$53,908
Costs of revenue, exclusive of depreciation shown separately below	39,308	41,106	44,994	32,157	24,750
Gross margin(1)	23,421	31,383	40,342	35,639	29,158
Depreciation and amortization	6,020	7,470	9,925	11,686	11,927
Other operating expenses	5,270	5,324	5,842	6,190	5,867
Operating income	12,131	18,589	24,575	17,763	11,364
Total other income (expense)	(256)	144	(355)	(536)	(64)
Income before income taxes	11,875	18,733	24,220	17,227	11,300
Income tax expense	4,287	6,455	8,627	6,212	4,272
Net income available to common stockholders	\$7,588	\$12,278	\$15,593	\$11,015	\$7,028
Net income per common share:					
Basic	\$0.67	\$1.02	\$1.29	\$0.91	\$0.58
Diluted	\$0.66	\$1.01	\$1.28	\$0.91	\$0.58
Weighted average shares of common stock outstanding:					
Basic	11,405	12,071	12,090	12,096	12,108
Diluted	11,472	12,114	12,143	12,118	12,210
EBITDA(2)	\$19,541	\$27,358	\$34,887	\$29,519	\$23,421
			As of December 31,		
	2006	2007	2008	2009	2010
BALANCE SHEET INFORMATION:					
	(in thousands)				
Current assets	\$55,170	\$55,222	\$47,032	\$56,203	\$48,338
Total assets	135,552	153,233	181,050	186,871	188,769

Long-term debt (including current portion)	18,392	13,950	16,572	13,195	2,000
Stockholders' equity	101,201	114,380	130,450	142,098	150,591

(1) Gross margin is defined, reconciled to net income and discussed immediately below under "-- Non-GAAP Financial Measures".

(2) EBITDA is defined, reconciled to net income and discussed immediately below under "-- Non-GAAP Financial Measures".

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.

EBITDA has limitations as an analytical tool, and you should not consider it in isolation, or as a substitute for analysis of our results as reported under generally accepted accounting principles. Some of these limitations are:

- EBITDA does not reflect our cash expenditures, or future requirements for capital expenditures or contractual commitments;
 - EBITDA does not reflect changes in, or cash requirements for, our working capital needs;
- EBITDA does not reflect the cash requirements necessary to service interest or principal payments on our debts; and
- although depreciation and amortization are non-cash charges, the assets being depreciated and amortized will often have to be replaced in the future, and EBITDA does not reflect any cash requirements for such replacements.

There are other 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. Please read the table below under “Reconciliation” to see how EBITDA reconciles to our net income, the most directly comparable GAAP financial measure.

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, in that gross profit 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 property and equipment 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 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 EBITDA and gross margin to our net income, the most directly comparable GAAP financial measure:

	Year Ending December 31,				
	2006	2007	2008	2009	2010
	(in thousands)				
Net Income	\$ 7,588	\$ 12,278	\$ 15,593	\$ 11,015	\$ 7,028
Interest expense, net	1,646	1,155	742	606	194
Income taxes	4,287	6,455	8,627	6,212	4,272
Depreciation & amortization	6,020	7,470	9,925	11,686	11,927
EBITDA	\$ 19,541	\$ 27,358	\$ 34,887	\$ 29,519	\$ 23,421
Other operating expenses	5,270	5,324	5,842	6,190	5,867
Other expenses (income)	(1,390)	(1,299)	(387)	(70)	(130)
Gross Margin	\$ 23,421	\$ 31,383	\$ 40,342	\$ 35,639	\$ 29,158

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 of the years ended December 31, 2008, 2009, and 2010. You should read the following discussion and analysis in conjunction with our audited 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, 2010, we had 1,909 natural gas compressors totaling approximately 248,648 horsepower rented to 97 third parties, compared to 1,776 natural gas compressors totaling approximately 223,694 horsepower rented to 91 third parties at December 31, 2009. Of the 1,909 compressors rented at December 31, 2010 1,297 were rented on a month-to-month basis.

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,		
	2008	2009	2010
	(in thousands)		
Sales	\$ 41,380	\$ 21,657	\$ 12,370
Rental	42,864	45,146	40,670
Service and maintenance	1,092	993	868
Total	\$ 85,336	\$ 67,796	\$ 53,908

Our strategy for growth is focused on our compressor rental business. Margins for our rental business historically run in the high 50% to low 60% range, while margins for the compressor sales business tend to be in the mid 20% range. If our rental business grows and contributes a larger percentage of our total revenues, we expect our overall company-wide margins to improve over time.

The oil and natural 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 natural 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 service 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 coal bed methane, gas shale and tight gas, which typically requires more compression than production from conventional natural gas reservoirs.

Demand for our products and services was strong throughout most of 2008, but in 2009 the demand declined due to lower natural gas prices, decreased demand for natural gas and the economic recession. During the latter part of 2010 the economy began to recover and demand for our products began to strengthen.

For fiscal year 2011, our forecasted capital expenditures will be directly dependent upon our customers' compression requirements and are not anticipated to exceed our internally generated cash flows. Any required capital will be for additions to our compressor rental fleet and/or addition or replacement of service vehicles. We believe that cash flows from operations will be sufficient to satisfy our capital and liquidity requirements through 2011. We may require additional capital to fund any unanticipated expenditures, including any acquisitions of other businesses, although that capital may not be available to us when we need it or on acceptable terms.

Notwithstanding the current weak economy, we believe the long-term trend in our market is favorable.

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 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 receivable;
- 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 when title passes to the customer, the customer assumes risks and rewards of ownership, collectability is reasonably assured and delivery occurs as directed by our customer. 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. 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, 2010, two customers accounted for approximately 19% and 10%, respectively, of our accounts receivable, and at December 31, 2009, two customers accounted for approximately 33% and 11% of our accounts receivable, respectively. A significant change in the liquidity or financial position of these customers could have a material adverse impact on the collectability of our accounts receivables and our future operating results.

Accounting for Income Taxes

As part of the process of preparing our 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 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 annually or 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 did not identify any impairment based on internal evaluations of our goodwill for the year ended December 31, 2010. Future impairment tests 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 goodwill and intangible assets were recorded on our balance sheet at approximately \$12.5 million and \$12.8 million as of December 31, 2010 and 2009, respectively. Our identifiable intangibles are currently amortized at a rate of \$260,000 per year. Any impairment in future periods of those assets, or a reduction in their consumptive lives, could materially and adversely affect our 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.

Our Performance Trends and Outlook

Given the current economic environment in North America and anticipated impact of continued low natural gas prices and potentially cautious capital spending by customers, we expect that the overall activity levels in 2011 to only modestly outpace 2010. Currently, we believe that the strengthening commodity prices will be slow to develop for natural gas. In addition, the recovery of credit and capital market conditions resulting from the recent financial crisis will continue to impact the level of capital spending by our customers in the near term. We believe that the recovery from the recent recession will be slow. The result will likely be lagging capital spending by our customers and therefore slow growth in demand for our products and services. We anticipate industry capital spending will be flat to a moderate increase in 2011 compared 2010 levels, and we believe our fabrication business will likely remain at a similar production level though 2011. We believe our rental operations business will increase assuming the nation recovers from the recession in 2011 and 2012, although we can give no assurances that this will occur.

Results of Operations

Year Ended December 31, 2010 Compared to the Year Ended December 31, 2009

The table below shows our revenues, percentage of total revenues, gross margin, exclusive of depreciation and amortization, and gross margin percentage of each of our segments for the years ended December 31, 2010 and December 31, 2009. Gross margin is the difference between revenue and cost of sales, exclusive of depreciation.

	Revenue				Gross Margin, Exclusive of Depreciation(1)			
	Year Ended December 31, 2009		2010		Year Ended December 31, 2009		2010	
	(dollars in thousands)							
	(unaudited)							
Sales	\$21,657	31.9%	\$12,370	23.0%	\$6,777	31.3%	\$4,360	35.3%
Rental	45,146	66.6%	40,670	75.4%	28,546	63.2%	24,465	60.2%
Service & Maintenance	993	1.5%	868	1.6%	316	31.8%	333	38.4%
Total	\$67,796		\$53,908		\$35,639	52.6%	\$29,158	54.1%

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

Total revenue decreased from \$67.8 million to \$53.9 million, or 20.5%, for the twelve months ended December 31, 2010, compared to the same period ended December 31, 2009. This was mainly the result of a 42.9% decrease in sales revenue and a 12.6% decrease in service and maintenance revenue and a 9.9% decrease in rental revenue.

Sales revenue decreased from \$21.7 million to \$12.4 million, or 42.9%, for the twelve months ended December 31, 2010, compared to the same period ended December 31, 2009. This decrease is the result of lower demand for our products which resulted in fewer compressor units sold to third parties primarily from our Tulsa operations. The downturn in demand is due to the overall slowdown in the economy and specific energy industry factors, especially with respect to prices for natural gas (Henry Hub Spot prices), which have been very volatile and declined from a high of \$13.31/MMBtu in July 2008 to a low of \$2.42/MMBtu in August 2009. The price of natural gas on December 31, 2010 was \$4.19/MMBtu, but has begun to decline since then. Because of the significant decline in natural gas prices, along with economic uncertainty and tightened credit, the energy industry encountered reduced capital spending, particularly for goods and services with respect to natural gas activities. In addition, capital project funding was shifted from gas projects to oil projects as the price of oil was not as volatile as gas, and oil prices have rebounded from its lows compared to natural gas prices. Since our compressors are primarily used in the production of natural gas, our compressor sales have been significantly impacted due to the factors described above. We also had a customer curtail its purchasing activity during the transition period following its acquisition by an industry major. We anticipate that our sales revenue should resume its growth in 2011, although it is estimated that it will be at a slower rate than our rental business. Our strategy over time has been to accelerate our rental revenues so that they are a larger component of our top line, but we intend to maintain our ability to build and sell custom fabricated equipment. In support of this, we have begun cultivating new sales-oriented customers and entertaining requests for bids on larger reciprocating compressors instead of being solely focused on screw-type equipment. Sales included: (1) compressor

unit sales, (2) flare sales, (3) parts sales and (4) compressor rebuilds.

Rental revenue decreased from \$45.2 million to \$40.7 million, or 10.0%, for the twelve months ended December 31, 2010, compared to the same period ended December 31, 2009. This decrease was the result of rental price concessions to our customers and returned rental units. As of December 31, 2010, we had 1,909 natural gas compressors in our rental fleet totaling approximately 248,648 horsepower, as compared to 1,776 natural gas compressors totaling approximately 223,694 horsepower at December 31, 2009. As of December 31, 2010, we had 1,297 natural gas compressors totaling approximately 174,515 horsepower rented to 97 third parties, compared to 1,159 natural gas compressors totaling approximately 146,512 horsepower rented to 91 third parties at December 31, 2009. The rental fleet had a utilization of 67.9% as of December 31, 2010.

The overall gross margin percentage increased to 54.1% for the twelve months ended December 31, 2010, from 52.6% for the same period ended December 31, 2009. This increase is result of two factors: (1) rentals, which have a higher margin than our other sources of revenue (rental revenue increased to 75.4% from 66.6% of our total revenue for the year ended December 31, 2010 compared to the same period ended December 31, 2009); and (2) sales margins also increased from 31.3% to 35.3% for the year ended December 31, 2010 compared to the same period in 2009 (3) our service and maintenance margin increased to 38.4% from 31.8% for the year ended December 31, 2010 compared to the same period ended December 31, 2009. This margin increase is also the result of greater efficiencies in our field service operations.

Selling, general, and administrative expense decreased from \$6.2 million, to \$5.9 million, or 4.8%, for the twelve months ended December 31, 2010, as compared to the same period ended December 31, 2009. This decrease is mainly due to a reduction in legal fees, internal controls compliance consulting and audit fees.

Depreciation and amortization expense increased from \$11.7 million, to \$11.9 million, or 1.7%, for the twelve months ended December 31, 2010, compared to the same period ended December 31, 2009. This increase was the result of 133 new gas compressor rental units being added to the rental fleet from December 31, 2009 to December 31, 2010, thus increasing the depreciable base.

Interest expense decreased 67.8% for the twelve months ended December 31, 2010, compared to the same period ended December 31, 2009, mainly due to the pay down of our term bank loan facility.

Provision for income tax decreased from \$6.2 million to \$4.3 million, or 30.7%, and is the result of the decrease in taxable income. 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. Our effective tax rate for 2010 is 38% as compared to 36% in 2009.

Year Ended December 31, 2009 Compared to the Year Ended December 31, 2008

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, 2009 and December 31, 2008. Gross margin is the difference between revenue and cost of sales, exclusive of depreciation.

	Revenue				Gross Margin, Exclusive of Depreciation(1)			
	Year Ended December 31, 2008		Year Ended December 31, 2009		Year Ended December 31, 2008		Year Ended December 31, 2009	
	(dollars in thousands)							
	(unaudited)							
Sales	\$41,380	48.5%	\$21,657	31.9%	\$13,328	32.2%	\$6,777	31.3%
Rental	42,864	50.2%	45,146	66.6%	26,671	62.2%	28,546	63.2%
Service & Maintenance	1,092	1.3%	993	1.5%	343	31.4%	316	31.8%
Total	\$85,336		\$67,796		\$40,342	47.3%	\$35,639	52.6%

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

Total revenue decreased from \$85.3 million to \$67.8 million, or 20.6%, for the twelve months ended December 31, 2009, compared to the same period ended December 31, 2008. This was mainly the result of a 47.7% decrease in sales revenue and a 9.1% decrease in service and maintenance revenue offset by a 5.3% increase in rental revenue.

Sales revenue decreased from \$41.4 million to \$21.7 million, or 47.7%, for the twelve months ended December 31, 2009, compared to the same period ended December 31, 2008. This decrease is the result of lower demand for our

products due to an industry slowdown which resulted in fewer compressor units sold to third parties from our Tulsa and Michigan operations. Sales included: (1) compressor unit sales, (2) flare sales, (3) parts sales and (4) compressor rebuilds.

Rental revenue increased from \$42.9 million to \$45.2 million, or 5.3%, for the twelve months ended December 31, 2009, compared to the same period ended December 31, 2008. This increase was the result of a revenue increase during the first six months but was offset by price concessions and returned rental units during the third and fourth quarters of 2009. As of December 31, 2009, we had 1,776 natural gas compressors in our rental fleet totaling approximately 223,694 horsepower, as compared to 1,730 natural gas compressors totaling approximately 217,085 horsepower at December 31, 2008. As of December 31, 2009, we had 1,159 natural gas compressors totaling approximately 146,512 horsepower rented to 91 third parties, compared to 1,469 natural gas compressors totaling approximately 184,831 horsepower rented to 112 third parties at December 31, 2008. The rental fleet had a utilization of 65.3% as of December 31, 2009.

The overall gross margin percentage increased to 52.6% for the twelve months ended December 31, 2009, from 47.3% for the same period ended December 31, 2008. This increase is result of two factors: (1) rentals, which have a higher margin than our other sources of revenue (rental revenue increased to 66.6% from 50.2% of our total revenue for the year ended December 31, 2009 compared to the same period ended December 31, 2008); and (2) our rental margin increased to 63.2% from 62.2% for the year ended December 31, 2009 compared to the same period ended December 31, 2008. This margin increase is also the result of greater efficiencies in our field service operations.

Selling, general, and administrative expense increased from \$5.8 million, to \$6.2 million, or 6.0%, for the twelve months ended December 31, 2009, as compared to the same period ended December 31, 2008. This increase is mainly due to an increase in stock compensation expenses.

Depreciation and amortization expense increased from \$9.9 million, to \$11.7 million, or 17.7%, for the twelve months ended December 31, 2009, compared to the same period ended December 31, 2008. This increase was the result of 46 new gas compressor rental units being added to the rental fleet from December 31, 2008 to December 31, 2009, thus increasing the depreciable base along with a full year of depreciation related to the 377 rental units added in 2008.

Other income net of other expense decreased \$317,000 for the twelve months ended December 31, 2009, compared to the same period ended December 31, 2008. This decrease is mainly the result of redemption of our short-term investments creating a decrease in interest income. Interest expense decreased 18.3% for the twelve months ended December 31, 2009, compared to the same period ended December 31, 2008, mainly due to the pay down of our term bank loan facility.

Provision for income tax decreased from \$8.6 million to \$6.2 million, or 28.0%, and is the result of the decrease in taxable income.

Liquidity and Capital Resources

Our working capital positions as of December 31, 2009 and 2010 are set forth below.

	2009	2010
	(in thousands)	
Current Assets:		
Cash and cash equivalents	\$ 23,017	\$ 19,137
Trade accounts receivable, net	7,314	5,279
Inventory, net	24,037	21,489
Prepaid income taxes	1,556	2,103
Prepaid expenses and other	279	330
Total current assets	56,203	48,338
Current Liabilities:		
Current portion of long-term debt	3,378	
Line of credit	7,000	2,000
Accounts payable	2,239	3,364
Accrued liabilities	1,485	2,151
Current portion of tax liability	1,708	
Deferred income	90	389
Total current liabilities	15,900	7,904
Total working capital	\$ 40,303	\$ 40,434

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, 2010, we invested approximately \$21.9 million in equipment for our rental fleet and service vehicles. We financed this activity with funds from operations. We also repaid approximately \$13.2 million of our debt during 2010.

Cash flows

At December 31, 2010, we had cash and cash equivalents of \$19.1 million, working capital of \$40.4 million and total debt of \$2.0 million on our line of credit, all of which was classified as current. We had positive net cash flow from operating activities of approximately \$28.8 million during 2010. This was primarily from net income of \$7.0 million, plus depreciation and amortization of \$11.9 million, an increase in deferred taxes of \$4.2 million, and a decrease in trade accounts receivable and inventory of \$4.8 million.

At December 31, 2009, we had cash and cash equivalents of approximately \$23.0 million, working capital of \$40.3 million and total debt of \$13.2 million, of which approximately \$10.4 million was classified as current. We had positive net cash flow from operating activities of approximately \$32.2 million during 2009. This was primarily from net income of \$11.0 million, plus depreciation and amortization of \$11.7 million, an increase in deferred taxes of \$4.5 million, and a decrease in trade accounts receivable and inventory of \$13.0 million offset by a decrease in accounts payable and accrued liabilities of \$8.7 million.

Trade accounts receivable decreased \$2 million from December 31, 2009 to December 31, 2010. This decrease mainly resulted from the slowdown in our Tulsa compressor sales business.

Inventory and work in progress decreased to \$21.5 million as of the end of 2010, as compared to \$24.0 million as of the end of 2009. This decrease is mainly a reflection of increased fabrication activity in our rental compression equipment lines.

Debt decreased \$11.2 million to \$2.0 million at December 31, 2010, compared to \$13.2 million at December 31, 2009. This decrease was mainly the result of principal repayment of debt and termination of our term loan and previous line of credit.

Contractual Obligations and Commitments

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

Cash Contractual Obligations	2011	2012	2013	2014	Thereafter	Total
Line of credit (secured)	2,000					2,000
Interest on line of credit	58					58
Purchase obligations	956	956	956	956	436	4,260
Other long term liabilities				528		528
Facilities and office leases	309	244	167	17		737
Total	\$ 3,323	\$ 1,200	\$ 1,123	\$ 1,501	\$ 436	\$ 7,583

As of December 31, 2010, we had a long-term liability of \$275,000 to Midland Development Corporation. This amount is to be recognized as income contingent upon certain staffing requirements in the future. In addition, we entered into a purchase agreement with a vendor on July 30, 2008 pursuant to which we agreed to purchase up to \$4.8 million of our paint and coating requirements exclusively from the vendor. In connection with the execution of the agreement, the vendor paid us a \$300,000 fee which is considered to be a discount toward future purchases from the vendor. Based on our historical and anticipated paint and coating requirements, we estimate meeting the \$4.8 million purchase obligation within five years. The \$300,000 payment we received is recorded as a long-term liability and will decrease as the purchase commitment is fulfilled. The long-term liability remaining as of December 31, 2010 was \$253,000.

Senior Bank Borrowings

On December 10, 2010, we paid off our existing term loan at Western National Bank (“WNB”) and established a new \$20 million senior secured revolving credit facility (subject to a right, on an uncommitted basis, to increase the commitments there under to up to \$40 million) with JPMorgan Chase Bank, N.A. (the “Credit Agreement”).

The Credit Agreement provides us with an aggregate initial commitment amount of \$20 million, subject to collateral availability. The terms of the Credit Agreement also include:

Borrowing Base. At any time before the maturity of the facility, we may draw, repay and re-borrow amounts available under the borrowing base up to the maximum aggregate availability discussed above. Generally, the borrowing base equals the sum of (a) 80% of our eligible accounts receivable plus (b) 50% of the book value of our eligible general inventory (not to exceed 50% of the commitment amount at the time) plus (c) 75% of the book value of our eligible equipment inventory. JPMorgan Chase Bank (the “Lender”) may adjust the borrowing base components if material deviations in the collateral are discovered in future audits of the collateral.

Interest and Fees. Under the terms of the Credit Agreement, we have the option of selecting the applicable variable rate for each revolving loan, or portion thereof, of either (a) LIBOR multiplied by the Statutory Reserve Rate (as defined in the Credit Agreement) to which the Lender is subject, with respect to this rate, for Eurocurrency funding, plus the Applicable Margin (“LIBOR-based”), or (b) CB Floating Rate, which is the Lender’s Prime Rate less the Applicable Margin; provided, however, that no more than three LIBOR-based borrowings under the facility may be outstanding at any one time. The “Applicable Margin” is based on our leverage ratio (debt-to-EBITDA). For purposes of the LIBOR-based interest rate, the Applicable Margin ranges from 2.25% if our leverage ratio exceeds 2.00x to 1.75% if our leverage ratio is less than 1.00x. For purposes of the CB Floating Rate, the Applicable Margin ranges from 0.50% if our leverage ratio exceeds 2.00x to 1.00% if our leverage ratio is less than 1.00x.

Accrued interest is payable monthly on outstanding principal amounts, provided that accrued interest on LIBOR-based loans is payable at the end of each interest period, but in no event less frequently than quarterly. In addition, fees and expenses are payable in connection with our requests for letters of credit (generally equal to the Applicable Margin for LIBOR-related borrowings multiplied by the face amount of the requested letter of credit) and administrative and legal costs.

Maturity. The maturity date of the secured revolving credit facility under the Credit Agreement is December 31, 2011, at which time all amounts borrowed under the facility will be due and outstanding letters of credit must be cash collateralized. The facility may be terminated early upon our request or the occurrence of an event of default.

Security. The obligations under the Credit Agreement are secured by a first priority lien equal to approximately two times the loan commitment as represented by our rental fleet equipment.

Covenants. The Credit Agreement contains customary representations and warranties, as well as covenants which, among other things, limit our ability to incur additional indebtedness and liens; enter into transactions with affiliates; make acquisitions in excess of certain amounts; pay dividends; redeem or repurchase capital stock or senior notes; make investments or loans; make negative pledges; consolidate, merge or effect asset sales; or change the nature of our business.

Events of Default and Acceleration. The secured revolving credit facility contains customary events of default for credit facilities of this size and type, and includes, without limitation, payment defaults; defaults in performance of covenants or other agreements contained in the transaction documents; inaccuracies in representations and warranties; certain defaults, termination events or similar events; certain defaults with respect to any other Company indebtedness in excess of \$50,000; certain bankruptcy or insolvency events; the rendering of certain judgments in excess of \$150,000; certain ERISA events; certain change in control events and the defectiveness of any liens under the secured revolving credit facility. Obligations under the secured revolving credit facility may be accelerated upon the occurrence of an event of default.

In connection with establishing the credit facility, we paid \$2,816,106 to WNB which represented payment in full of the principal and interest owed under our term loan with WNB. In making this payment, we drew \$2,000,000 on the line of credit under the Credit Agreement described above.

As of December 31, 2009 and 2010, we were in compliance with all covenants in our respective loan agreements. 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.

Shelf Registration Statement

We have an effective \$150 million “universal” shelf registration statement on Form S-3 on file with the Securities and Exchange Commission which we filed in 2009. This shelf registration statement enables us to sell, from time to time, the securities covered by the registration statement in one or more public offerings. The securities covered by the registration statement include common stock, preferred stock, depositary shares, debt securities, rights to purchase common stock, units consisting of two or more of any of the registered securities and warrants to purchase any of the registered securities. We may offer any of these securities independently or together in any combination with other securities. The shelf registration statement allows us to enter the public markets and consummate sales of the registered securities in rapid fashion and with little or no notice. We have no immediate plans to issue securities under the shelf registration statement, but our management believes that it may facilitate access to additional liquidity in the future. However, there is no assurance that equity or debt capital would be available to us in the public markets

should we determine to issue securities under the shelf registration statement.

Components of Our Principal Capital Expenditures

The table below shows the components of our principal capital expenditures for the three years ended December 31, 2010:

Expenditure Category	2008	2009	2010
	(in thousands)		
Rental equipment, vehicles and shop equipment	\$ 46,271	\$ 9,542	\$ 21,908

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 our operating cash flow and additional bank borrowing may be required to fully fund our net capital expenditures requirements for 2011. 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, 2010, the off-balance sheet arrangements and transactions that we have entered into include operating lease agreements and purchase agreements. We do not believe that these arrangements are reasonably likely to materially affect our liquidity or availability of, or requirements for, capital resources.

We entered into a purchase agreement with a vendor on July 30, 2008 pursuant to which we agreed to purchase up to \$4.8 million of our paint and coating requirements exclusively from the vendor. In connection with the execution of the agreement, the vendor paid us a \$300,000 fee which is considered to be a discount toward future purchases from the vendor. Based on our historical and anticipated paint and coating requirements, we estimate meeting the \$4.8 million purchase obligation within five years. As of December 31, 2010 we had met \$268,000 of this obligation. The \$300,000 payment we received is recorded as a long-term liability and will decrease as the purchase commitment is fulfilled. The long-term liability remaining as of December 31, 2010 was \$253,000.

Recently Issued Accounting Pronouncements

As of December 31, 2010, there were no new accounting standards applicable to us that have not yet been adopted.

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 cleanup 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.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

Commodity Risk

Our commodity risk exposure is the pricing applicable primarily to natural gas production and to lesser extent oil production. Realized commodity prices received for such production are primarily driven by the prevailing worldwide price for crude oil and spot prices applicable to natural gas. Depending on the market prices of oil and natural gas, companies exploring for such resources may cancel or curtail their drilling programs, thereby reducing demand for our equipment and services.

Financial Instruments and Debt Maturities

Our financial instruments consist of cash and cash equivalents, trade receivable, accounts payable and line of credit. The carrying amounts of cash and cash equivalents, trade receivable, and accounts payable approximate fair value because of the short-term nature of the instruments. The fair value of our bank borrowings approximate the carrying amounts as of December 31, 2010 and 2009, and were determined based upon interest rates currently available to us.

Customer Credit Risk

We are exposed to the risk of financial non-performance by our customers. Our ability to collect on rentals and sales to our customers is dependent on the liquidity of our customer base. To manage customer credit risk, we monitor credit ratings of our customers. Unless we are able to retain our existing customers, or secure new customers if we lose one or more of our significant customers, our revenue and results of operations would be adversely affected. See “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations – Critical Accounting Policies and Procedures – Allowance for Doubtful Accounts Receivable” on page 24.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Our audited financial statements and supplementary financial data are included in this Annual Report on Form 10-K beginning on page F-1.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

An evaluation was carried out under the supervision and with the participation of our management, including our President and Chief Executive Officer and our Principal Accounting Officer And Treasurer, of the effectiveness of the design of our “disclosure controls and procedures” (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended or, the “Exchange Act”) as of December 31, 2010, pursuant to Exchange Act Rule 13a-15. Based upon that evaluation, the President and Chief Executive Officer and our Principal Accounting Officer And Treasurer have concluded that our disclosure controls and procedures as of December 31, 2010, are effective to ensure that information required to be disclosed by us in the reports filed or submitted by us under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the SEC’s rules and forms and include controls and procedures designed to ensure that information required to be disclosed by us in such reports is accumulated and communicated to our management, including our principal executive and financial officers as appropriate to allow timely decisions regarding required disclosures. Due to the inherent limitations of control systems, not all misstatements may be detected. Those inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple errors or mistakes. Additionally, controls could be circumvented by the individual acts of some persons or by collusion of two or more people. Our controls and procedures can only provide reasonable, not absolute, assurance that the above objectives have been met.

Changes in Internal Control Over Financial Reporting

There were no changes in our internal control over financial reporting identified in connection with the evaluation required by paragraph (d) of Exchange Act Rules 13a-15 or 15d-15 that occurred during our last quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Management’s Report on Internal Control Over Financial Reporting

Our management, including the President and Chief Executive Officer and our Principal Accounting Officer and Treasurer, is responsible for establishing and maintaining adequate internal control over financial reporting, as defined in Rule 13a-15(f) and 15d-15(f) under the Exchange Act. Our internal control system is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Our internal control over financial reporting includes those policies and procedures that:

- pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of our assets;

- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America, and that our receipt and expenditures are being made only in accordance with authorizations of management and our Board of Directors; and
- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on the financial statements.

All internal control systems, no matter how well designed, have inherent limitations. A system of internal control may become inadequate over time because of changes in conditions or deterioration in the degree of compliance with the policies or procedures. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

Our management assessed the effectiveness of our internal control over financial reporting as December 31, 2010 using the criteria set forth by the Commission of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control-Integrated Framework. Based on this assessment, our management concluded that, as of December 31, 2010, our internal control over financial reporting was effective.

Pursuant to the Section 404 of the Sarbanes-Oxley Act of 2002, we have included a report of management's assessment of the design and effectiveness of our internal controls as part of this annual report on Form 10-K for the fiscal year ended December 31, 2010. BDO USA, LLP, our registered independent public accounting firm, attested to and issued an attestation report on the effectiveness of internal control over financial reporting.

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders
Natural Gas Services Group, Inc.
Midland, Texas

We have audited Natural Gas Services Group, Inc.'s (the "Company") internal control over financial reporting as of December 31, 2010, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Natural Gas Services Group, Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying "Item 9A, Management's Report on Internal Control Over Financial Reporting." Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

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

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

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

In our opinion, Natural Gas Services Group, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2010, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the balance sheet of Natural Gas Services Group, Inc. as of December 31, 2010, and the related statements of income, stockholders' equity and cash flows for the year then ended and our report dated March 10, 2011 expressed an unqualified opinion thereon.

/s/ BDO USA, LLP

Houston, Texas
March 10, 2011

33

ITEM 9B. OTHER INFORMATION

None.

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information required by this item is incorporated herein by reference to the sections "Election of Directors," "Executive Officers," "Corporate Governance" and "The Board of Directors and its Committees" in our definitive proxy statement which will be filed with the Securities and Exchange Commission within 120 days after December 31, 2010.

ITEM 11. EXECUTIVE COMPENSATION

The information required by this item is incorporated herein by reference to the section "Executive Compensation" in our definitive proxy statement which will be filed with the Securities and Exchange Commission within 120 days after December 31, 2010.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information required by this item is incorporated herein by reference to the section "Principal Shareholders and Security Ownership of Management" in our definitive proxy statement which will be filed with the Securities and Exchange Commission within 120 days after December 31, 2010.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information required by this item is incorporated herein by reference to the sections "Related Person Transactions" and "Corporate Governance" in our definitive proxy statement which will be filed with the Securities and Exchange Commission within 120 days after December 31, 2010.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by this item is incorporated herein by reference to the section "Principal Accountant Fees and Services" in our definitive proxy statement which will be filed with the Securities and Exchange Commission within 120 days after December 31, 2010.

PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES

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

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

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

(a)(3) Exhibits

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

Exhibit No.	Description
3.1	Articles of Incorporation, as amended (Incorporated by reference to Exhibit 3.1 of the 10-QSB 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	Non-Statutory Stock Option Agreement (Incorporated by reference to Exhibit 10.2 to Form 8-K filed with the SEC on August 30, 2005)
4.2	Form of Senior Indenture (Incorporated by reference to Exhibit 4.1 of the Registrant's Registration Statement on Form S-3 (No. 333-161346) and filed on August 14, 2009)
4.3	Form of Senior Note (Incorporated by reference to Exhibit 4.2 of the Registrant's Registration Statement on Form S-3 (No. 333-161346) and filed on August 14, 2009)
4.4	Form of Subordinated Indenture (Incorporated by reference to Exhibit 4.3 of the Registrant's Registration Statement on Form S-3 (No. 333-161346) and filed on August 14, 2009)
4.4	Form of Subordinated Note (Incorporated by reference to Exhibit 4.4 of the Registrant's Registration Statement on Form S-3 (No. 333-161346) and filed on August 14, 2009)
4.6	Form of Deposit Agreement, including Form of Depositary Share (Incorporated by reference to Exhibit 4.5 of the Registrant's Registration Statement on Form S-3 (No. 333-161346) and filed on August 14, 2009)
4.7	Form of Warrant Agreement, including Form of Warrant Certificate (Incorporated by reference to Exhibit 4.6 of the Registrant's Registration Statement on Form S-3 (No. 333-161346) and filed on August 14, 2009)
4.8	

Edgar Filing: NATURAL GAS SERVICES GROUP INC - Form 10-K

Form of Unit Agreement (Incorporated by reference to Exhibit 4.7 of the Registrant's Registration Statement on Form S-3 (No. 333-161346) and filed on August 14, 2009)

- 4.9 Form of Preferred Stock Certificate (Incorporated by reference to Exhibit 4.8 of the Registrant's Registration Statement on Form S-3 (No. 333-161346) and filed on August 14, 2009)
- 4.10 Form of Certificate of Designation with respect to Preferred Stock (Incorporated by reference to Exhibit 4.9 of the Registrant's Registration Statement on Form S-3 (No. 333-161346) and filed on August 14, 2009)
- 4.11 Form of Rights Agreement, including Form of Rights Certificate (Incorporated by reference to Exhibit 4.10 of the Registrant's Registration Statement on Form S-3 (No. 333-161346) and filed on August 14, 2009)

- 10.1 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 March 31, 2004)
- 10.2 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)
- 10.3 Eighth Amended and Restated Loan Agreement between Natural Gas Services Group, Inc. and Western National bank. (Incorporated by reference to Exhibit 10.14 of the registrants Quarterly Report on Form 10-Q for the fiscal quarter ended June 30, 2008 and filed with the Securities Exchange Commission on August 7, 2008.)
- 10.4 Revolving Line of Credit Promissory Note issued to Western National Bank. (Incorporated by reference to Exhibit 10.15 of the registrants Quarterly Report on Form 10-Q for the fiscal quarter ended June 30, 2008 and filed with the Securities Exchange Commission on August 7, 2008.)
- 10.5 Employment Agreement between Natural Gas Services Group, Inc. and Stephen C. Taylor dated October 25, 2008 (Incorporated by reference to Exhibit 10.1 of the Registrant's Current Report on Form 8-K filed with the Securities and Exchange Commission on October 30, 2008)
- 10.6 Lease Agreement, dated March 26, 2008, between WNB Tower, LTD and Natural Gas Services Group, Inc. (Incorporated by reference to Exhibit 10.15 of the Registrant's Form 10-K for the fiscal year ended December 31, 2008 and filed with the Securities and Exchange Commission on March 9, 2009)
- 10.7 2009 Restricted Stock/Unit Plan (Incorporated by reference to Exhibit 10.1 of the Registrant's Current Report on Form 8-K dated September 18, 2009 and filed with the Securities and Exchange Commission on September 18, 2009.)
- 10.8 1998 Stock Option Plan, as amended (Incorporated by reference to Exhibit 10.2 of the Registrant's Current Report on Form 8-K dated September 18, 2009 and filed with the Securities and Exchange Commission on September 18, 2009.)
- 10.9 Lease Agreement, dated December 11, 2008, between Klement-Wes Partnership, LTD and Natural Gas Services Group, Inc. and commencing on January 1, 2009
- 10.10 Credit Agreement between Natural Gas Services Group, Inc. and JPMorgan Chase Bank, N.A., dated December 10, 2010 (Incorporated by reference to Exhibit 10.1 of the Registrant's Current Report on Form 8-K filed with the Securities and Exchange Commission on December 16, 2011.)
- 10.11 Security Agreement between Natural Gas Services Group, Inc. and JPMorgan Chase Bank, N.A., dated December 10, 2010 (Incorporated by reference to Exhibit 10.2 of the Registrant's Current Report on Form 8-K filed with the Securities and Exchange

Commission on December 16, 2011.)

- 10.12 Promissory Note in the aggregate amount of \$20,000,000 issued to JPMorgan Chase Bank, N.A., dated December 10, 2010, in connection with the revolving credit line under the Credit Agreement with JPMorgan Chase Bank, N.A. (Incorporated by reference to Exhibit 10.3 of the Registrant's Current Report on Form 8-K filed with the Securities and Exchange Commission on December 16, 2011.)
- 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)
- *23.1 Consent of BDO USA, LLP
- *23.2 Consent of Hein & Associates LLP
- *31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- *31.2 Certification of Principal Accounting Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- *32.1 Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- *32.2 Certification of Principal Accounting Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

* Filed herewith.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

NATURAL GAS SERVICES GROUP, INC.

Date: March 10, 2011

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

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities 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)	March 10, 2011
/s/ G. Larry Lawrence G. Larry Lawrence	Manager of Accounting (Principal Accounting Officer)	March 10, 2011
/s/ Charles G. Curtis Charles G. Curtis	Director	March 10, 2011
/s/ William F. Hughes, Jr. William F. Hughes, Jr.	Director	March 10, 2011
/s/ Richard L. Yadon Richard L. Yadon	Director	March 10, 2011
/s/ Gene A. Strasheim Gene A. Strasheim	Director	March 10, 2011
/s/ John W. Chisolm John W. Chisholm	Director	March 10, 2011

INDEX TO FINANCIAL STATEMENTS

	Page
Reports of Independent Registered Public Accounting Firms	F-1
Balance Sheets as of December 31, 2009 and 2010	F-3
Statements of Income for the Years Ended December 31, 2008, 2009 and 2010	F-4
Statements of Stockholders' Equity for the Years Ended December 31, 2008, 2009, and 2010	F-5
Statements of Cash Flows for the Years Ended December 31, 2008, 2009 and 2010	F-6
Notes to Financial Statements	F-7

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders
Natural Gas Services Group, Inc.
Midland, Texas

We have audited the accompanying balance sheet of Natural Gas Services Group, Inc. as of December 31, 2010, and the related statements of income, stockholders' equity and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether 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, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Natural Gas Services Group, Inc. as of December 31, 2010, and the results of its operations and its cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Natural Gas Services Group, Inc.'s, internal control over financial reporting as of December 31, 2010, 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 10, 2011 expressed an unqualified opinion thereon.

/s/ BDO USA, LLP

Houston, Texas
March 10, 2011

F-1

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders
Natural Gas Services Group, Inc.
Midland, Texas

We have audited the accompanying balance sheet of Natural Gas Services Group, Inc. (the "Company") as of December 31, 2009, and the related statements of income, stockholders' equity and cash flows for each of the two years in the period ended December 31, 2009. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2009, and the results of their operations and their cash flows for each of the two years in the period ended December 31, 2009, in conformity with U.S. generally accepted accounting principles.

/s/ HEIN & ASSOCIATES LLP

Dallas, Texas
March 4, 2010

NATURAL GAS SERVICES GROUP, INC.
BALANCE SHEETS
(in thousands except per share data)

	December 31,	
	2009	2010
ASSETS		
Current Assets:		
Cash and cash equivalents	\$ 23,017	\$ 19,137
Trade accounts receivable, net of doubtful accounts of \$363 and \$171, respectively	7,314	5,279
Inventory, net of allowance for obsolescence of \$345 and \$250, respectively	24,037	21,489
Prepaid income taxes	1,556	2,103
Prepaid expenses and other	279	330
Total current assets	56,203	48,338
Rental equipment, net of accumulated depreciation of \$34,008 and \$44,245, respectively	110,263	120,755
Property and equipment, net of accumulated depreciation of \$7,210 and \$7,899, respectively	7,626	7,149
Goodwill, net of accumulated amortization of \$325, both periods	10,039	10,039
Intangibles, net of accumulated amortization of \$1,497 and \$1,757 respectively	2,721	2,461
Other assets	19	27
Total assets	\$ 186,871	\$ 188,769
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Current portion of long-term debt	\$ 3,378	\$ —
Line of credit	7,000	2,000
Accounts payable	2,239	3,364
Accrued liabilities	1,485	2,151
Current income tax liability	1,708	—
Deferred income	90	389
Total current liabilities	15,900	7,904
Long term debt, less current portion	2,817	—
Deferred income tax payable	25,498	29,746
Other long term liabilities	558	528
Total liabilities	44,773	38,178
Commitments and contingencies (Notes 4, 5, 9 and 12)		
Stockholders' Equity:		
Preferred stock, 5,000 shares authorized, no shares issued or outstanding	—	—
Common stock, 30,000 shares authorized, par value \$0.01; 12,101 and 12,148 shares issued and outstanding, respectively	121	122

Edgar Filing: NATURAL GAS SERVICES GROUP INC - Form 10-K

Additional paid-in capital	84,570	86,034
Retained earnings	57,407	64,435
Total stockholders' equity	142,098	150,591
Total liabilities and stockholders' equity	\$ 186,871	\$ 188,769

See accompanying notes to these financial statements.

F-3

NATURAL GAS SERVICES GROUP, INC.
STATEMENTS OF INCOME
(in thousands, except per share)

	For the Years Ended December 31,		
	2008	2009	2010
Revenue:			
Sales, net	\$ 41,380	\$ 21,657	\$ 12,370
Rental income	42,864	45,146	40,670
Service and maintenance income	1,092	993	868
Total revenue	85,336	67,796	53,908
Operating costs and expenses:			
Cost of sales, exclusive of depreciation stated separately below	28,052	14,880	8,010
Cost of rentals, exclusive of depreciation stated separately below	16,193	16,600	16,205
Cost of service and maintenance, exclusive of depreciation stated separately below	749	677	535
Selling, general and administrative expense	5,842	6,190	5,867
Depreciation and amortization	9,925	11,686	11,927
Total operating costs and expenses	60,761	50,033	42,544
Operating income	24,575	17,763	11,364
Other income (expense):			
Interest expense	(742)	(606)	(194)
Other income	387	70	130
Total other income (expense)	(355)	(536)	(64)
Income before provision for income taxes	24,220	17,227	11,300
Provision for income taxes:			
Current	220	1,756	24
Deferred	8,407	4,456	4,248
Total income tax expense	8,627	6,212	4,272
Net income	\$ 15,593	\$ 11,015	\$ 7,028
Earnings per common share:			
Basic	\$ 1.29	\$ 0.91	\$ 0.58
Diluted	\$ 1.28	\$ 0.91	\$ 0.58
Weighted average common shares outstanding:			
Basic	12,090	12,096	12,108
Diluted	12,143	12,118	12,210

See accompanying notes to these financial statements.

F-4

NATURAL GAS SERVICES GROUP, INC.
STATEMENTS OF STOCKHOLDERS' EQUITY
(in thousands)

	Preferred Stock		Common Stock		Additional Paid-In Capital	Retained Earnings	Total Stockholders' Equity
	Shares	Amount	Shares	Amount			
BALANCES, January 1, 2007	—	\$ —	12,085	\$ 121	\$ 83,460	\$ 30,799	\$ 114,380
Exercise of common stock options and warrants	—	—	9	—	54	—	54
Compensation expense on issuance of common stock options	—	—	—	—	423	—	423
Net income	—	—	—	—	—	15,593	15,593
BALANCES, December 31, 2008	—	\$ —	12,094	\$ 121	\$ 83,937	\$ 46,392	\$ 130,450
Exercise of common stock options and warrants	—	—	7	—	49	—	49
Compensation expense on issuance of common stock options	—	—	—	—	584	—	584
Net income	—	—	—	—	—	11,015	11,015
BALANCES, December 31, 2009	—	\$ —	12,101	\$ 121	\$ 84,570	\$ 57,407	\$ 142,098
Exercise of common stock options	—	—	46	1	406	—	407
Compensation expense on issuance of common stock options	—	—	—	—	804	—	804
Issuance of restricted stock	—	—	1	—	—	—	—
Compensation expense on issuance of restricted common stock	—	—	—	—	254	—	254
Net income	—	—	—	—	—	7,028	7,028
BALANCES, December 31, 2010	—	\$ —	12,148	\$ 122	\$ 86,034	\$ 64,435	\$ 150,591

See accompanying notes to these financial statements.

F-5

NATURAL GAS SERVICES GROUP, INC.
STATEMENTS OF CASH FLOWS
(in thousands of dollars)

	For the Years Ended December 31,		
	2008	2009	2010
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income	\$ 15,593	\$ 11,015	\$ 7,028
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	9,925	11,686	11,927
Deferred taxes	8,407	4,456	4,248
Employee stock options expense	423	584	1,058
Loss (gain) on disposal of assets	7	(51)	(46)
Changes in current assets:			
Trade accounts receivables, net	1	4,007	2,035
Inventory, net	(11,162)	9,008	2,773
Prepaid expenses and other	3,894	(1,504)	(598)
Changes in current liabilities:			
Accounts payable and accrued liabilities	4,335	(8,673)	1,791
Current income tax liability	(3,415)	1,598	(1,708)
Deferred income	(43)	52	299
Other	285	—	(9)
NET CASH PROVIDED BY OPERATING ACTIVITIES	28,250	32,178	28,798
CASH FLOWS FROM INVESTING ACTIVITIES:			
Purchase of property and equipment	(46,271)	(9,542)	(21,908)
Purchase of short-term investments	(2,620)	—	—
Redemption of short-term investments	18,981	2,300	—
Proceeds from sale of property and equipment	47	143	47
NET CASH USED IN INVESTING ACTIVITIES	(29,863)	(7,099)	(21,861)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Proceeds from line of credit	7,500	500	2,000
Proceeds from other long term liabilities, net	441	118	(30)
Repayments of long-term debt	(4,378)	(3,378)	(6,194)
Repayment of line of credit	(1,100)	(500)	(7,000)
Proceeds from exercise of stock options	54	49	407
NET CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES	2,517	(3,211)	(10,817)
NET CHANGE IN CASH	904	21,868	(3,880)
CASH AT BEGINNING OF PERIOD	245	1,149	23,017
CASH AT END OF PERIOD	\$ 1,149	\$ 23,017	\$ 19,137
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:			
Interest paid	\$ 802	\$ 613	\$ 238
Income taxes paid	\$ 294	\$ 1,477	\$ 2,204

NON-CASH TRANSACTIONS

Rental equipment transferred to inventory	\$	301	\$	1,114	\$	225
---	----	-----	----	-------	----	-----

See accompanying notes to these financial statements.

F-6

NATURAL GAS SERVICES GROUP, INC.

NOTES TO FINANCIAL STATEMENTS

1. Summary of Significant Accounting Policies

Organization and Principles of Consolidation

These notes apply to the financial statements of Natural Gas Services Group, Inc. (the "Company", "NGSG", "Natural Gas Services Group", "we" or "our") (a Colorado corporation). Natural Gas Services Group, Inc. was formed on December 17, 1998 for the purposes of combining the operations of certain manufacturing, service and leasing entities.

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

Nature of Operations

Natural Gas Services Group, Inc. is a leading provider of small to medium horsepower compression equipment to the natural gas industry. We focus primarily on the non-conventional natural gas production business in the United States (such as coal bed methane, gas shale and tight gas). We manufacture, fabricate and rent natural gas compressors that enhance the production of natural gas wells. NGSG provides maintenance services for its natural gas compressors. In addition, we sell 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 natural gas plant and production facilities.

Use of Estimates

The preparation of our financial statements in conformity with generally accepted accounting principles in the United States of America requires our management to make estimates and assumptions that affect the amounts reported in these 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 allowance for inventory obsolescence. 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, we consider all short-term investments with an original maturity of three months or less to be cash equivalents.

Accounts Receivable

Our 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 our natural gas compressors. The receivables are not collateralized except as provided for under lease agreements. However, we require deposits of as much as 50% for large custom contracts. We extend 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 \$363,000 and \$171,000 at December 31, 2009 and 2010, respectively, is

adequate.

Revenue Recognition

Revenue from the sales of custom and fabricated compressors, and flare systems is recognized when title passes to the customer, the customer assumes risks and rewards of ownership, collectability is reasonably assured and delivery occurs as directed by our customer. 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.

F-7

Description of Rental Arrangements

Our rental operations principally consist of the rental of natural gas compressor packages and flare stacks. These arrangements are classified as operating leases. See Note 2.

Major Customers and Concentration of Credit Risk

Sales and rental income to Devon Energy Production Inc. for the year ended December 31, 2010 amounted to a total of 19% of revenue. Sales and rental income to XTO Energy, Inc. and Devon Energy, Inc. for the year ended December 31, 2009 amounted to 21% and 21% of revenue, respectively. Sales and rental income to XTO Energy, Inc. and Devon Energy, Inc. in the year ended December 31, 2008 amounted to 26% and 14% of revenue, respectively. No other single customer accounted for more than 10% of our revenues in 2010, 2009 or 2008. BP and Devon Energy Production Inc. amounted to 19% and 10% of our accounts receivable as of December 31, 2010, respectively. XTO Energy, Inc. and Devon Energy Production Inc. amounted to 33% and 11%, respectively, of our accounts receivable as of December 31, 2009. No other customers amounted to more than 10% of our accounts receivable as of December 31, 2009 and 2010. We generally do not obtain collateral, but require deposits of as much as 50% on large custom contracts. We extend 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 \$345,000 and \$250,000 at December 31, 2009 and 2010, respectively. Finished goods at December 31, 2009 consists of 12 completed compressor units, there were no new completed compressor units at December 31, 2010 available for sale or for use in our rental fleet. At December 31, 2009 and 2010, respectively, inventory consisted of the following (in thousands):

	2009	2010
Raw materials	\$ 21,633	\$ 17,770
Finished goods	1,584	—
Work in process	820	3,719
	\$ 24,037	\$ 21,489

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 and intangibles are tested for impairment annually or whenever events indicate impairment may have occurred. The annual goodwill impairment test is performed internally in the fourth quarter of each year. The test includes an evaluation of the consumptive life, or longevity, of our intangible assets with finite lives with adjustments

made to their amortization periods accordingly. As a result of the test most recently completed, no impairment was indicated. We expect to continue to amortize our intangible assets with finite lives over the same time periods as previously used.

F-8

Intangibles

At December 31, 2010, NGSG 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, 2009 and 2010 was \$2.7 million and \$2.5 million respectively. 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 fourteen years as of December 31, 2010. Amortization expense recognized in each of the years ending December 31, 2008, 2009, and 2010 was \$299,000, 299,000 and \$260,000 respectively. In addition, NGSG has an intangible asset with a gross carrying value of \$654,000 at December 31, 2010 related to the trade name of SCS which was acquired in our acquisition of Screw Compression Systems in January 2005. 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).

2011	\$	179
2012		125
2013		125
2014		125
2015		125
Thereafter		1,128
	\$	1,807

Our policy is to periodically review the net realizable value of intangibles, 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 our most recent analysis, we believe no impairment of intangible assets exists as of December 31, 2010.

Patents

We have a patent covering flare tip technology. The cost of the patent was being amortized on a straight-line basis over nine years, which was the remaining life of the patents when acquired. The patent is fully amortized.

Warranty

We accrue amounts for estimated warranty claims based upon current and historical product warranty costs and any other related information known. The warranty reserve was \$166,000 and \$158,000 at December 31, 2009 and 2010, respectively.

Financial Instruments and Concentrations of Credit Risk

Management believes that, generally, the fair value of our cash and cash equivalents, trade receivables, accounts payable and line of credit at December 31, 2009 and 2010 approximate their carrying values due to the short-term nature of the instruments or the use of prevailing market interest rates. We invest our cash primarily in deposits and money market funds with commercial banks. At times, cash balances at banks and financial institutions may exceed federally insured amounts.

Advertising Costs

Advertising costs are expensed as incurred. Total advertising expense was \$31,000, \$13,000 and \$7,000 in 2008, 2009 and 2010, respectively.

Other Income

Other income in 2008, 2009, and 2010 primarily consisted of interest income from our short-term investments.

F-9

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 an anti-dilutive effect for 2008, 2009 or 2010.

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

	Year Ended December 31,		
	2008	2009	2010
Numerator:			
Net income	\$ 15,593	\$ 11,015	\$ 7,028
Denominator for basic net income per common share:			
Weighted average common shares outstanding	12,090	12,096	12,108
Denominator for diluted net income per share:			
Weighted average common shares outstanding	12,090	12,096	12,108
Dilutive effect of stock options and restricted shares	53	22	102
Diluted weighted average shares	12,143	12,118	12,210
Earnings per common share:			
Basic	\$ 1.29	\$ 0.91	\$ 0.58
Diluted	\$ 1.28	\$ 0.91	\$ 0.58

Income Taxes

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.

Fair Value Measurement

The financial assets of the company measured at fair value on a recurring basis are cash equivalents and short-term investments. Our short-term investments are generally classified within level 1 or level 2 of the fair value hierarchy because they are valued using quoted market prices, broker or dealer quotations, or alternative pricing sources with reasonable levels of price transparency.

The types of instruments valued based on quoted market prices in active markets include most U.S. government and agency securities and most money market securities. Such instruments are generally classified within level 1 of the fair value hierarchy.

The type of instruments valued based on quoted prices in markets that are not active, broker or dealer quotations, or alternative pricing sources with reasonable levels of price transparency include most investment-grade corporate bonds, and state, municipal and provincial obligations. Such instruments are generally classified within level 2 of the fair value hierarchy.

As of December 31, 2009 and 2010, our cash equivalents are classified within level 1 of the fair value hierarchy.

F-10

Recently Issued Accounting Pronouncements

As of December 31, 2010, there were no new accounting standards applicable to us that have not yet been adopted.

2. Rental Activity

We rent natural gas compressor packages to entities in the petroleum industry. 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, 2010 are as follows :

Years Ending December 31, (in thousands)		
2011	\$	5,601
2012		376
Total	\$	5,977

3. Property and Equipment

Property and equipment consists of the following at December 31, 2009 and 2010 (in thousands):

	2009	2010
Land and building	\$ 5,036	\$ 5,036
Leasehold improvements	753	758
Office equipment and furniture	1,187	1,229
Software	538	550
Machinery and equipment	2,188	2,241
Vehicles	5,134	5,234
Less accumulated depreciation	(7,210)	(7,899)
Total	\$ 7,626	\$ 7,149

Depreciation expense for property and equipment and the compressors described in Note 2 was \$9.6 million, \$11.4 million and \$11.7 million for the years ended December 31, 2008, 2009 and 2010, respectively.

4. Credit Facility

On May 16, 2008, we entered into an Eighth Amended and Restated Loan Agreement with Western National Bank (“WNB”), Midland, Texas effective April 1, 2008. This Loan Agreement (1) decreased the interest rate on existing term loan facilities, and (2) extended and renewed our revolving line of credit facility. Our revolving line of credit and multiple advance term loan facilities are described below.

Line of Credit

Our prior revolving line of credit facility with WNB allowed us to borrow, repay and re-borrow funds drawn under this facility, as amended. The total amount that we could borrow and have outstanding at any one time was the lesser of \$40.0 million or the amount available for advances under a “borrowing base” calculation established by the bank. The amount of the borrowing base was based primarily upon our receivables, equipment and inventory. The borrowing base was re-determined by the bank on a monthly basis. Interest only on borrowings under the revolving

line of credit facility was payable monthly on the first day of each month. As of December 31, 2009, we had borrowed \$7.0 million under the line of credit. The outstanding principal balance was paid in full on July 1, 2010 and the line expired on that date.

Term Loan Facility

This multiple advance term loan facility represented the consolidation of our previously existing advancing line of credit and term loan facilities. Principal under this term loan facility was due and payable in 59 monthly installments of \$282,000 each, which commenced November 1, 2006. 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 October 1, 2011. As of December 31, 2009 and 2010, this term loan facility had a principal balance of \$6.2 million and zero, respectively. This facility was paid off in full and terminated in December 2010.

Our obligations under the Loan Agreement were secured by substantially all of our properties and assets, including our equipment, trade accounts receivable and other personal property and by the real estate and related plant facilities. 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.

Chase Line of Credit

On December 10, 2010, we paid off our existing term loan and line of credit at WNB and established a new \$20 million senior secured revolving credit facility (subject to a right, on an uncommitted basis, to increase the commitments there under to up to \$40 million) with JPMorgan Chase Bank, N.A. (the "Credit Agreement").

The Credit Agreement provides us with an aggregate initial commitment amount of \$20 million, subject to collateral availability. The terms of the Credit Agreement also include:

Borrowing Base. At any time before the maturity of the facility, we may draw, repay and re-borrow amounts available under the borrowing base up to the maximum aggregate availability discussed above. Generally, the borrowing base equals the sum of (a) 80% of our eligible accounts receivable plus (b) 50% of the book value of our eligible general inventory (not to exceed 50% of the commitment amount at the time) plus (c) 75% of the book value of our eligible equipment inventory. JPMorgan Chase Bank (the "Lender") may adjust the borrowing base components if material deviations in the collateral are discovered in future audits of the collateral. The borrowing base was \$20 million at December 31, 2010.

Interest and Fees. Under the terms of the Credit Agreement, we have the option of selecting the applicable variable rate for each revolving loan, or portion thereof, of either (a) LIBOR multiplied by the Statutory Reserve Rate (as defined in the Credit Agreement) to which the Lender is subject, with respect to this rate, for Eurocurrency funding, plus the Applicable Margin ("LIBOR-based"), or (b) CB Floating Rate, which is the Lender's Prime Rate less the Applicable Margin; provided, however, that no more than three LIBOR-based borrowings under the facility may be outstanding at any one time. The "Applicable Margin" is based on our leverage ratio (debt-to-EBITDA). For purposes of the LIBOR-based interest rate, the Applicable Margin ranges from 2.25% if our leverage ratio exceeds 2.00x to 1.75% if our leverage ratio is less than 1.00x. For purposes of the CB Floating Rate, the Applicable Margin ranges from 0.50% if our leverage ratio exceeds 2.00x to 1.00% if our leverage ratio is less than 1.00x. The interest rate was 2.019% at December 31, 2010.

Accrued interest is payable monthly on outstanding principal amounts, provided that accrued interest on LIBOR-based loans is payable at the end of each interest period, but in no event less frequently than quarterly. In addition, fees and expenses are payable in connection with our requests for letters of credit (generally equal to the Applicable Margin for LIBOR-related borrowings multiplied by the face amount of the requested letter of credit) and administrative and legal costs.

Maturity. The maturity date of the secured revolving credit facility under the Credit Agreement is December 31, 2011, at which time all amounts borrowed under the facility will be due and outstanding letters of credit must be cash collateralized. The facility may be terminated early upon our request or the occurrence of an event of default.

Security. The obligations under the Credit Agreement are secured by a first priority lien equal to approximately two times the loan commitment as represented by our rental fleet equipment.

Covenants. The Credit Agreement contains customary representations and warranties, as well as covenants which, among other things, limit our ability to incur additional indebtedness and liens; enter into transactions with affiliates; make acquisitions in excess of certain amounts; pay dividends; redeem or repurchase capital stock or senior notes; make investments or loans; make negative pledges; consolidate, merge or effect asset sales; or change the nature of our business.

Events of Default and Acceleration. The secured revolving credit facility contains customary events of default for credit facilities of this size and type, and includes, without limitation, payment defaults; defaults in performance of covenants or other agreements contained in the transaction documents; inaccuracies in representations and warranties; certain defaults, termination events or similar events; certain defaults with respect to any other Company indebtedness in excess of \$50,000; certain bankruptcy or insolvency events; the rendering of certain judgments in excess of \$150,000; certain ERISA events; certain change in control events and the defectiveness of any liens under the secured revolving credit facility. Obligations under the secured revolving credit facility may be accelerated upon the occurrence of an event of default.

In connection with establishing the credit facility, we paid \$2,816,106 to WNB which represented payment in full of the principal and interest owed under our term loan with WNB. In making this payment, we drew \$2,000,000 on the line of credit under the Credit Agreement described above.

As of December 31, 2009 and 2010, we were in compliance with all covenants in our respective loan agreements. 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 likely limit our ability to access credit and would have a material adverse effect on our liquidity, financial position and operations.

5. Other Long-term Liabilities

As of December 31, 2009 and 2010, we had a long-term liability of \$275,000 to Midland Development Corporation. This amount is to be recognized as income contingent upon certain staffing requirements in the future.

In addition, we entered into a purchase agreement with a vendor on July 30, 2008 pursuant to which we agreed to purchase up to \$4.8 million of our paint and coating requirements exclusively from the vendor. In connection with the execution of the agreement, the vendor paid us a \$300,000 fee which is considered to be a discount toward future purchases from the vendor. Based on our historical and anticipated paint and coating requirements, we estimate meeting the \$4.8 million purchase obligation within five years. The \$300,000 payment we received is recorded as a long-term liability and will decrease as the purchase commitment is fulfilled. The long-term liability remaining for the purchase commitment was \$283,000 and \$253,000 as of December 31, 2009 and 2010, respectively.

6. Income Taxes

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

	2008	2009	2010
Current provision:			
Federal	\$ —	\$ 1,522	\$ —
State	220	234	24
	220	1,756	24
Deferred provision:			
Federal	8,347	4,179	4,009
State	60	277	239
	8,407	4,456	4,248
	\$ 8,627	\$ 6,212	\$ 4,272

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):

	2008	2009	2010
Deferred income tax assets:			
Net operating loss carryover	\$ 2,331	\$ —	\$ 2,523
Other	650	614	685
Total deferred income tax assets	\$ 2,981	\$ 614	\$ 3,208
Deferred income tax liabilities:			
Property and equipment	(22,723)	(24,898)	(31,811)
Goodwill and other intangible assets	(1,299)	(1,214)	(1,143)
Other	(1)	—	—
Total deferred income tax liabilities	(24,023)	(26,112)	(32,954)
Net deferred income tax liabilities	\$ (21,042)	\$ (25,498)	\$ (29,746)

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

	2008	2009	2010
Statutory rate	34%	34%	34%

Edgar Filing: NATURAL GAS SERVICES GROUP INC - Form 10-K

State and local taxes	2%	2%	2%
Other	—	—	2%
Effective rate	36%	36%	38%

F-13

Our policy regarding income tax interest and penalties is to expense those items as general and administrative expense but to identify them for tax purposes. During the years ended December 31, 2009 and 2010, there were no income tax interest or penalty items in the income statement or as a liability on the balance sheet. Prepaid income taxes are estimated payments paid for the current year estimated tax liability.

We had a regular income tax net operating loss carry forward of \$7.1 million for federal income taxes for the year ended December 31, 2010. This net operating loss will expire in 2031. We file income tax returns in the U.S. federal jurisdiction and various state jurisdictions. With few exceptions, we are no longer subject to U.S. federal or state income tax examination by tax authorities for years before 2005. We are currently involved in a Michigan Single Business Tax audit for the tax years 2005-2007. The audit is not at a stage where an outcome could be determined, however, we believe it will not result in a material tax liability.

7. Stockholders' Equity

Preferred Stock

We have a total of 5.0 million authorized preferred shares with rights and preferences as designated by the Board of Directors. As of December 31, 2009 and 2010, there were no outstanding preferred shares.

Securities offering

On August 14, 2009 we filed a universal shelf registration statement on Form S-3 with the Securities and Exchange Commission (SEC) to register up to \$150,000,000 of securities, including debt securities, common stock, preferred stock, depository shares, rights to purchase common stock and warrants to purchase any of the foregoing securities. The SEC has declared the statement effective, and we may issue any of the registered securities from time to time in one or more offerings depending on market conditions and our financing needs.

Restricted Securities

On June 16, 2009, at our annual meeting of shareholders, our shareholders adopted the 2009 Restricted Stock/Unit Plan. A total of 300,000 shares of Company common stock are reserved for issuance under the restricted stock plan. During January 2010, we awarded 13,276 restricted shares of stock under the 2009 Restricted Stock Plan for payment of the executive bonus plan of 2009. The restricted shares vest over a one-year period, beginning on the date of grant. On December 31, 2010, the vesting of 1,227 restricted shares were accelerated due to negotiated terms with a retiring member of management. Compensation expense related to the restricted shares was approximately \$254,000, for the year ended December 31, 2010. As of December 31, 2010, there was a total of approximately \$4,000 of unrecognized compensation expense related to the non vested portion of these restricted shares. This expense is expected to be recognized in January 2011.

8. Stock-Based Compensation

Stock Option Plan

Our 1998 Stock Option Plan (the Plan), which is stockholder approved, permits the grant of stock options to its employees for up to 550,000 shares of common stock. On June 16, 2009, at our annual meeting of shareholders, our shareholders approved a proposed amendment to our 1998 Stock Option Plan (the "Plan") to add an additional 200,000 shares of common stock to the Plan, thereby authorizing the issuance of up to 750,000 shares of common stock under the Plan. We believe that such awards better align the interests of our employees with our stockholders. Option awards are generally granted with an exercise price equal to the market price of our 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). The last date that grants can be made under the Plan is March 1, 2016. As of December 31, 2010, 293,357 shares were still available for issue under the 1998 Stock Option Plan.

F-14

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 based on the vesting period and historical exercise and post vesting employment termination behavior for similar grants. We use historical 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.

Weighted average Black –Scholes fair value assumption	2008	2009	2010
Risk free rate	3.90%	1.82%	1.22%
Expected life	5 yrs	5 yrs	2 yrs
Expected volatility	48.0%	66.75%	64.32%
Expected dividend yield	0.0%	0.0%	0.0%

A summary of all option activity as of December 31, 2010 and changes during the year then ended is presented below.

	Number of Stock Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (years)	Aggregate Intrinsic Value (in thousands)
Outstanding at December 31, 2009	437,877	\$ 13.88	8.02	\$ 2,260
Granted	60,000	\$ 18.32		
Exercised	(45,504)	\$ 8.92		
Forfeited or expired	(29,167)	\$ 17.94		
Outstanding at December 31, 2010	423,206	\$ 14.76	7.33	\$ 1,858
Exercisable at December 31, 2010	306,873	\$ 13.84	6.91	\$ 1,614

We granted 30,000 options to an officer on January 18, 2010 at an exercise price of \$19.90 with a three year vesting period. We granted 30,000 options to the board of directors on March 23, 2010 at an exercise price of \$16.74 vesting within one year of the grant date.

The weighted average grant date fair value of options granted during the years 2008, 2009 and 2010 was \$8.46, \$6.68, and \$7.30 respectively. 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 years ended December 31, 2008, 2009 and 2010 was approximately \$149,000, \$65,000 and \$400,000 respectively. Cash received from stock options exercised during

Edgar Filing: NATURAL GAS SERVICES GROUP INC - Form 10-K

the years ended December 31, 2008, 2009 and 2010 was \$53,000, \$49,000 and \$407,000, respectively.

The following table summarizes information about the options outstanding at December 31, 2010:

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	7,500	2.67	\$ 4.99	7,500	\$ 4.99
5.59 – 9.43	105,623	6.22	8.54	105,623	8.54
9.44 – 15.60	70,000	6.91	12.47	50,000	13.48
15.61 – 20.48	240,083	8.09	18.48	143,750	18.32
\$ 0.00 - 20.48	423,206	7.33	\$ 14.76	306,873	\$ 13.84

The summary of the status of our unvested stock options as of December 31, 2010 and changes during the year then ended is presented below:

	Unvested Stock Options	Weighted Average Grant Date Fair Value
Unvested at December 31, 2009	230,210	\$ 7.40
Granted	60,000	7.30
Vested	(151,293)	6.72
Forfeited	(22,584)	7.67
Unvested at December 31, 2010	116,333	\$ 8.18

We recognized stock compensation expense from stock options vesting of \$423,000, \$584,000 and \$804,000, respectively, for the years ended December 31, 2008, 2009 and 2010. The total income tax benefit recognized in the income statement for stock based compensation was \$50,000, \$23,000 and \$137,000, respectively, for the years ended December 31, 2008, 2009 and 2010. As of December 31, 2010, there was approximately \$623,000 of total unamortized compensation cost related to unvested stock options. We expect to recognize such cost over a weighted-average period of 1.7 years. There was no income tax benefit realized for the tax deductions from stock options exercised for the years ending 2008, 2009 and 2010.

9. Commitments

401(k) Plan

We offer a 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. We contributed \$234,000, \$211,000, and \$185,000 to the 401(k) Plan in 2008, 2009 and 2010, respectively.

Rented Facilities

We lease certain of our facilities under operating leases with terms generally ranging from month to month to five years. Most facility leases contain renewal options. Remaining future minimum rental payments due under these leases for the years ended December 31 are as follows (in thousands):

2011	\$ 309
2012	244
2013	167
2014	17
Total	\$ 737

Rent expense under such leases was \$363,000, \$466,000, and \$526,000 for the years ended December 31, 2008, 2009, and 2010, respectively.

F-16

10. Segment Information

Accounting Standards Codification (“ASC”) 280-10, 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 about which separate financial information is available that is evaluated regularly by chief operating decision makers in the allocation of resources and the assessment of performance. Our management identifies segments based upon major revenue sources as shown in the tables below. However, management does not track assets by segment. All sales and assets are currently located in continental United States.

For the Year Ended December 31, 2008

	Sales	Rental	Service & Maintenance	Corporate	Total
	(in thousands of dollars)				
Revenue	\$ 41,380	\$ 42,864	\$ 1,092	\$ —	\$ 85,336
Operating costs and expenses	28,052	16,193	749	15,767	60,761
Other income/(expense)	—	—	—	(355)	(355)
Income before provision for income taxes	\$ 13,328	\$ 26,671	\$ 343	\$ (16,122)	\$ 24,220

For the Year Ended December 31, 2009

	Sales	Rental	Service & Maintenance	Corporate	Total
	(in thousands of dollars)				
Revenue	\$ 21,657	\$ 45,146	\$ 993	\$ —	\$ 67,796
Operating costs and expenses	14,880	16,600	677	17,876	50,033
Other income/(expense)	—	—	—	(536)	(536)
Income before provision for income taxes	\$ 6,777	\$ 28,546	\$ 316	\$ (18,412)	\$ 17,227

For the Year Ended December 31, 2010

	Sales	Rental	Service & Maintenance	Corporate	Total
	(in thousands of dollars)				
Revenue	\$ 12,370	\$ 40,670	\$ 868	\$ —	\$ 53,908
Operating costs and expenses	8,010	16,205	535	17,794	42,544
Other income/(expense)	—	—	—	(64)	(64)
Income before provision for income taxes	\$ 4,360	\$ 24,465	\$ 333	\$ 17,858	\$ 11,300

11. Quarterly Financial Data (in thousands, except per share data) – Unaudited

2008	Q1	Q2	Q3	Q4	Total
Total revenue	\$ 18,933	\$ 19,478	\$ 24,946	\$ 21,979	\$ 85,336
Operating income	5,453	5,145	7,448	6,529	24,575
Net income applicable to common shares	3,517	3,333	4,811	3,932	15,593
Net income per share - Basic	0.29	0.28	0.40	0.33	1.29
Net income per share - Diluted	0.29	0.27	0.40	0.33	1.28

2009	Q1	Q2	Q3	Q4	Total
Total revenue	\$ 20,025	\$ 16,757	\$ 16,380	\$ 14,634	\$ 67,796
Operating income	6,057	4,631	4,211	2,864	17,763
Net income applicable to common shares	3,797	2,872	2,643	1,703	11,015
Net income per share - Basic	0.31	0.24	0.22	0.14	0.91
Net income per share - Diluted	0.31	0.24	0.22	0.14	0.91

2010	Q1	Q2	Q3	Q4	Total
Total revenue	\$ 11,549	\$ 11,901	\$ 14,245	\$ 16,213	\$ 53,908
Operating income	2,228	2,394	3,363	3,379	11,364
Net income applicable to common shares	1,364	1,544	2,153	1,967	7,028
Net income per share - Basic	0.11	0.13	0.18	0.16	0.58
Net income per share - Diluted	0.11	0.13	0.18	0.16	0.58

12. Legal Proceedings

From time to time, we are a party to various legal proceedings in the ordinary course of our business. While management is unable to predict the ultimate outcome of these actions, it believes that any ultimate liability arising from these actions will not have a material effect on our financial position, results of operations or cash flow. We are not currently a party to any bankruptcy, receivership, reorganization, adjustment or similar proceeding, and we are not aware of any other threatened litigation.

INDEX TO EXHIBITS

Exhibit No.	Description
3.1	Articles of Incorporation, as amended (Incorporated by reference to Exhibit 3.1 of the 10-QSB 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	Non-Statutory Stock Option Agreement (Incorporated by reference to Exhibit 10.2 to Form 8-K filed with the SEC on August 30, 2005)
4.2	Form of Senior Indenture (Incorporated by reference to Exhibit 4.1 of the Registrant's Registration Statement on Form S-3 (No. 333-161346) and filed on August 14, 2009)
4.3	Form of Senior Note (Incorporated by reference to Exhibit 4.2 of the Registrant's Registration Statement on Form S-3 (No. 333-161346) and filed on August 14, 2009)
4.4	Form of Subordinated Indenture (Incorporated by reference to Exhibit 4.3 of the Registrant's Registration Statement on Form S-3 (No. 333-161346) and filed on August 14, 2009)
4.5	Form of Subordinated Note (Incorporated by reference to Exhibit 4.4 of the Registrant's Registration Statement on Form S-3 (No. 333-161346) and filed on August 14, 2009)
4.6	Form of Deposit Agreement, including Form of Depositary Share (Incorporated by reference to Exhibit 4.5 of the Registrant's Registration Statement on Form S-3 (No. 333-161346) and filed on August 14, 2009)
4.7	Form of Warrant Agreement, including Form of Warrant Certificate (Incorporated by reference to Exhibit 4.6 of the Registrant's Registration Statement on Form S-3 (No. 333-161346) and filed on August 14, 2009)
4.8	Form of Unit Agreement (Incorporated by reference to Exhibit 4.7 of the Registrant's Registration Statement on Form S-3 (No. 333-161346) and filed on August 14, 2009)
4.9	Form of Preferred Stock Certificate (Incorporated by reference to Exhibit 4.8 of the Registrant's Registration Statement on Form S-3 (No. 333-161346) and filed on August 14, 2009)
4.10	Form of Certificate of Designation with respect to Preferred Stock (Incorporated by reference to Exhibit 4.9 of the Registrant's Registration Statement on Form S-3 (No. 333-161346) and filed on August 14, 2009)
4.11	

Form of Rights Agreement, including Form of Rights Certificate (Incorporated by reference to Exhibit 4.10 of the Registrant's Registration Statement on Form S-3 (No. 333-161346) and filed on August 14, 2009)

- 10.1 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 March 31, 2004)
- 10.2 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)
- 10.3 Eighth Amended and Restated Loan Agreement between Natural Gas Services Group, Inc. and Western National bank. (Incorporated by reference to Exhibit 10.14 of the registrants Quarterly Report on Form 10-Q for the fiscal quarter ended June 30, 2008 and filed with the Securities Exchange Commission on August 7, 2008.)
- 10.4 Revolving Line of Credit Promissory Note issued to Western National Bank. (Incorporated by reference to Exhibit 10.15 of the registrants Quarterly Report on Form 10-Q for the fiscal quarter ended June 30, 2008 and filed with the Securities Exchange Commission on August 7, 2008.)
- 10.5 Employment Agreement between Natural Gas Services Group, Inc. and Stephen C. Taylor dated October 25, 2008 (Incorporated by reference to Exhibit 10.1 of the Registrant's Current Report on Form 8-K filed with the Securities and Exchange Commission on October 30, 2008)
- 10.6 Lease Agreement, dated March 26, 2008, between WNB Tower, LTD and Natural Gas Services Group, Inc. (Incorporated by reference to Exhibit 10.15 of the Registrant's Form 10-K for the fiscal year ended December 31, 2008 and filed with the Securities and Exchange Commission on March 9, 2009)
- 10.7 2009 Restricted Stock/Unit Plan (Incorporated by reference to Exhibit 10.1 of the Registrant's Current Report on Form 8-K dated September 18, 2009 and filed with the Securities and Exchange Commission on September 18, 2009.)
- 10.8 1998 Stock Option Plan, as amended (Incorporated by reference to Exhibit 10.2 of the Registrant's Current Report on Form 8-K dated September 18, 2009 and filed with the Securities and Exchange Commission on September 18, 2009.)
- 10.9 Lease Agreement, dated December 11, 2008, between Klement-Wes Partnership, LTD and Natural Gas Services Group, Inc. and commencing on January 1, 2009
- 10.10 Credit Agreement between Natural Gas Services Group, Inc. and JPMorgan Chase Bank, N.A., dated December 10, 2010 (Incorporated by reference to Exhibit 10.1 of the Registrant's Current Report on Form 8-K filed with the Securities and Exchange Commission on December 16, 2011.)
- 10.11 Security Agreement between Natural Gas Services Group, Inc. and JPMorgan Chase Bank, N.A., dated December 10, 2010 (Incorporated by reference to Exhibit 10.2 of the Registrant's Current Report on Form 8-K filed with the Securities and Exchange Commission on December 16, 2011.)

- 10.12 Promissory Note in the aggregate amount of \$20,000,000 issued to JPMorgan Chase Bank, N.A., dated December 10, 2010, in connection with the revolving credit line under the Credit Agreement with JPMorgan Chase Bank, N.A. (Incorporated by reference to Exhibit 10.3 of the Registrant's Current Report on Form 8-K filed with the Securities and Exchange Commission on December 16, 2011.)
- 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)
- *23.1 Consent of BDO USA, LLP
- *23.2 Consent of Hein & Associates LLP
- *31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- *31.2 Certification of Principal Accounting Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- *32.1 Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- *32.2 Certification of Principal Accounting Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

* Filed herewith.
