

NATURAL GAS SERVICES GROUP INC

Form 10-K

March 15, 2007

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**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, 2006**

☐ **Transition Report Pursuant to Section 13 of 15(d) of the Securities Exchange Act of 1934  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission File Number: 1-31398**

**NATURAL GAS SERVICES GROUP, INC.**

(Exact Name of Registrant as Specified in its Charter)

Colorado

75-2811855

(State or Other Jurisdiction of Incorporation or Organization)

(I.R.S. Employer Identification No.)

2911 South County Road 1260 Midland, Texas

79706

(Address of Principal Executive Offices)

(Zip Code)

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

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

American Stock Exchange

Securities Registered Pursuant to Section 12(g) of the Act: None.

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes ☐ No ☒

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

Yes ☐ No ☒

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

Yes ☒ No ☐

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

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

Yes ☐ No ☒

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

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

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**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 to identify 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 fluctuations in the prices of oil and natural gas;
- 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 substantial debt;
- future capital requirements and availability of financing;
- 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.

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**PART I**

**ITEM 1. BUSINESS**

Unless the context otherwise requires, references in this Annual Report on Form 10-K to Natural Gas Services Group, we, us, our or ours refer to Natural Gas Services Group, Inc., together with our operating subsidiary. Where context requires, we refer to these entities separately. Certain specialized terms used in 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 coalbed methane, gas shales 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.

Historically, the majority of our revenue has been derived from our compressor rental business. In January 2005, we acquired Screw Compression Systems, Inc., or SCS, which predominantly focuses on the custom fabrication sales business. By acquiring SCS, we increased our fabrication capacity by over 91 thousand square feet. We are using this capacity to expand our rental fleet while continuing SCS core business of custom fabrication.

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 \$62.7 million in 2006 from \$10.3 million in 2002, the year we completed our initial public offering. During the same period, income from operations increased to \$12.1 million from \$1.8 million. Our compressor rental fleet has grown from 302 compressors at the end of 2002 to 1,111 compressors at December 31, 2006.

Net income for the year ended December 31, 2006 increased 70.7% to \$7.6 million (\$.66 per diluted share), as compared to \$4.4 million (\$.52 per diluted share) for the year ended December 31, 2005.

At December 31, 2006, current assets were \$55.2 million, which included \$4.4 million of cash and \$25.1 million in short-term investments. Current liabilities were \$10.6 million, and long-term debt, net of current portion, was \$14.0 million. Our stockholders' equity as of December 31, 2006 was \$101.2 million.

We were incorporated in Colorado on December 17, 1998 and initially operated through wholly or partly owned subsidiaries, all of which have either been merged into us or dissolved. However, a portion of our operations are currently conducted through SCS.

We maintain our principal offices at 2911 South County Road 1260, Midland, Texas 79706 and our telephone number is (432) 563-3974. 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.

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### **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. In our opinion, overall natural gas production in the United States is declining, and the increasing recognition of natural gas as a more environmentally friendly source of energy 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.

We believe that there will continue to be a growing demand for natural gas. We expect demand for our products and services to continue to 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 natural gas reserves.

### **Our Operating Units**

The Company identifies its segments based upon major revenue sources as Gas Compressor Rental, Engineered Equipment Sales, Service and Maintenance and Corporate. Please refer to Footnote 13 on page F-21 of the Notes to Consolidated 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 via 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. As of December 31, 2006, 87.7% of our rental fleet was utilized. In 2007, we intend to increase the number of units in our rental fleet by approximately 250-300 additional units.

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.

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As of December 31, 2006, we had 1,111 natural gas compressors in our rental fleet totaling approximately 129,158 horsepower, as compared to 865 natural gas compressors totaling approximately 97,275 horsepower at December 31, 2005. As of December 31, 2006, we had 974 natural gas compressors totaling approximately 112,718 horsepower rented to 84 third parties, compared to 820 natural gas compressors totaling approximately 90,486 horsepower rented to 75 third parties at December 31, 2005.

### ***Engineered Equipment Sales.***

***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**

As in the past, our intentions to grow our revenue and profitability continue to be based on the following business strategies:

***Expand rental fleet.*** Using the additional fabrication capacity gained with the SCS acquisition, we intend to increase our market share by expanding our rental fleet by approximately 250-300 additional units by the end of 2007. 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. As of December 31, 2006, we had 974 natural gas compressors rented to third parties.

***Operational expansion.*** With the planned increase in our rental fleet, we will continue to expand our operations in existing areas, as well as pursue focused expansion into new geographic regions.

***Expand CiP (Cylinder-in-Plane) product line.*** The CiP, or Cylinder-in-Plane, is our proprietary reciprocating compressor product line. This product line has allowed us to expand our compressor rentals and sales into higher pressure gas gathering and transmission lines. We intend to establish new distributorship relationships and after-market sales and services networks.





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***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 enables 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 with an average age of less than four years old.

***Experienced management team.*** On average, our executive and operating management team has over 20 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.

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### **Major Customers**

Sales to XTO Energy, Inc. and Energen Resources Corporation during the year ended December 31, 2006 amounted to a total of approximately 39% and 12%, respectively, of consolidated revenue. No other single customer accounted for more than 10% of our consolidated revenues during the year ended December 31, 2006. During the year ended December 31, 2005, revenues from XTO Energy, Inc. amounted to approximately 36% of consolidated revenue. Sales to Dominion Exploration & Production, Inc. and Devon Energy Corporation during the year ended December 31, 2004 amounted to a total of approximately 21% and 17%, respectively, of consolidated revenue. No other single customer accounted for more than 10% of our revenues in 2004 and 2005. At December 31, 2006, XTO Energy, Inc. accounted for approximately 54% of our trade accounts receivable. No other single customer accounted for more than 10% of our trade accounts receivable at December 31, 2006. At December 31, 2005, XTO Energy, Inc. accounted for approximately 44% of our trade accounts receivable. No other single customer accounted for more than 10% of our trade accounts receivable at December 31, 2005. The loss of any one or more of the above customers could have a material adverse effect on our business, consolidated 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. Our top five customers accounted for approximately 76% of our trade accounts receivable at December 31, 2006.

### **Sales and Marketing**

Our salespeople pursue 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 does not increase commensurately.

### **Backlog**

As of February 1, 2007, we had a sales backlog of approximately \$25.0 million. We expect to fulfill substantially all of the backlog in 2007. 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. There can be no assurance, however, that the orders representing such backlog will not be cancelled.

### **Employees**

As of December 31, 2006, we had 266 total employees. No employees are represented by a labor union and we believe we have good relations with our employees.

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**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, craterings, fires, and oil spills. We maintain liability insurance that we believe is customary in the industry. 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, washdown 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,

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.

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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 thereunder, 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.

## **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, which will expire 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 these patents 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.

## **Glossary of Industry Terms**

**coalbed methane** A natural gas generated during coal formation and provided from coal seams or adjacent sandstones.

**gas shales** Fine grained rocks where the predominant gas storage mechanism is sorption 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.

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**ITEM 1A. RISK FACTORS**

You should carefully consider the following risks before you decide to buy our common stock. If any of the following risks actually occur, our business, financial condition or results of operations would likely suffer. If this occurs, the trading price of our common stock could decline, and you could lose all or part of the money you paid to buy 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 are 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**

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

Our revenue is derived 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. If 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 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 producing 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 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.

If the demand for oil and natural gas decreases, then demand for our compressors likely will decrease.



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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, 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 in the future, 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 cyclical nature of our industry, our results of operations may be volatile in the future.

### ***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, washdown 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 existing regulatory requirements or enforcement policies change, we may be required to make significant unanticipated capital and operating expenditures.



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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**

***We might be unable to employ adequate technical personnel, which could hamper our plans for expansion 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 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 will require a substantial amount of capital to expand our compressor rental fleet and grow our business.***

During 2007, we plan to spend approximately \$25.0 million to \$30.0 million in capital expenditures to expand our rental fleet. The amount and timing 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.

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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 the proceeds from the public offering we completed in March 2006, cash flows from our operations and borrowings under our existing bank credit facility will provide us with sufficient cash to fund our planned capital expenditures for 2007, 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 2007, 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, consolidated financial condition, results of operations or cash flows.

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

As of December 31, 2006, we had an aggregate of approximately \$18.4 million of outstanding indebtedness, not including outstanding letters of credit in the aggregate face amount of \$2.0 million, and accounts payable and accrued expenses of approximately \$4.9 million. As a result of our significant 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.

***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, 2006, our principal payments for our debt service requirements were approximately \$282 thousand on a monthly basis; \$845 thousand on a quarterly basis; and \$3.4 million on an annual basis. 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. 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 current ratio;

- maintain minimum levels of tangible net worth;

- not exceed specified levels of debt;

- comply with a debt service coverage ratio; and

- comply with a debt to tangible net worth ratio.

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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.

***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.

***As of December 31, 2006, 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, consolidated financial condition, results of operations and cash flows.

***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. XTO Energy, Inc. accounted for approximately 39% of our consolidated revenue for the year ended December 31, 2006, and approximately 36% of our consolidated revenue for the year ended December 31, 2005. Energen Resources Corporation accounted for approximately 12% of our consolidated revenue for the year ended December 31, 2006. 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 Stephen C. Taylor, our Chairman of the Board of Directors, President and Chief Executive Officer, and other key members of our management. If any of our key managers resigns or becomes unable to continue in his present role and is not adequately replaced, our business operations could be materially adversely affected.

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***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, 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 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.

***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 and a report by our independent auditors addressing these assessments. 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 acquired as part of the SCS acquisition. Through December 31, 2001, goodwill was amortized using the straight-line method over 15 years and patent costs were amortized over 13 to 15 years.

In June 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets. FAS 142 provides that: (1) goodwill and intangible assets with indefinite lives will no longer be amortized; (2) goodwill and intangible assets with indefinite lives must be tested for impairment at least annually; and (3) the amortization period for intangible assets with finite lives will no longer be limited to 40 years. If we determine that our intangible assets with indefinite lives have been impaired, we must record a write-down of those assets on our consolidated statements of income during the period of impairment. Our determination of impairment will be based on various factors, including any of the following factors, if they materialize:

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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;

significant negative industry or economic trends;

significant decline in our stock price for a sustained period; and

our market capitalization relative to net book value.

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

**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. These potential sales could include sales of shares of our common stock by our Directors and officers, who beneficially owned approximately 8.46% of the outstanding shares of our common stock as of March 12, 2007.

**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.

**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 Natural Gas Services Group, Inc.

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**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 will be 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 the management of our company. This may adversely affect the market price and interfere with the voting and other rights of our common stock.

**ITEM 1B. UNRESOLVED STAFF COMMENTS**

We have not received any written comments from the Staff of the Securities and Exchange Commission that remain unresolved.

**Table of Contents****ITEM 2. PROPERTIES**

The table below describes the material facilities owned or leased by Natural Gas Services Group and SCS as of December 31, 2006:

Location	Status	Square Feet	Uses
Tulsa, Oklahoma	Owned and Leased	91,780 <sup>(1)</sup>	Executive offices of SCS and compressor fabrication, manufacturing, rental and services
Midland, Texas	Owned	24,600	Compressor fabrication, rental and services
Lewiston, Michigan	Owned	15,360	Compressor fabrication, rental and services
Bridgeport, Texas	Leased	4,500	Office and parts and services
Midland, Texas	Owned	4,100	Executive offices and parts and services
Bloomfield, New Mexico	Leased	4,672	Office and parts and services
		145,012	

(1) Includes 52,780 square feet owned by SCS on which its executive offices are located and on which compressor fabrication, rental and service operations are conducted; 19,500 square feet leased by SCS for manufacturing CiP compressors; and 19,500 square feet leased by SCS for compressor fabrication.

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. We are not currently a party to any material pending legal proceedings. We have not been a party to any bankruptcy, receivership, reorganization, adjustment or similar proceeding.

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

We did not submit any matters to a vote of our stockholders during the fourth quarter of 2006.



**Table of Contents****PART II****ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES**

Our common stock trades on the American 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 by the American Stock Exchange.

	Low	High
2004		
First Quarter	\$ 5.41	\$ 7.20
Second Quarter	7.20	10.04
Third Quarter	7.12	9.45
Fourth Quarter	8.07	9.43
2005		
First Quarter	\$ 9.08	\$11.11
Second Quarter	9.51	11.85
Third Quarter	11.55	36.00
Fourth Quarter	15.67	39.99
2006		
First Quarter	\$16.57	\$22.80
Second Quarter	13.77	18.00
Third Quarter	12.01	16.69
Fourth Quarter	12.76	16.43

As of December 31, 2006, there were approximately 25 holders of record 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 12, 2007, the last reported sale price of our common stock as reported by the American Stock Exchange was \$13.00 per share.

**Dividends**

We have never declared or paid any dividends on our common stock. We currently intend to continue our policy of retaining earnings for use in our business and we do not anticipate paying cash dividends on our common stock. Our ability to pay cash dividends in the future on the common stock will be dependent upon our:

financial condition,

results of operations,

current and anticipated cash requirements,

plans for expansion, and

restrictions under our debt obligations,

as well as other factors that our Board of Directors deems relevant. The loan agreement with our bank lender contains provisions that prohibit us from paying cash dividends on our common stock.

**Table of Contents****Equity Compensation Plans**

The following is a table with information regarding our equity compensation plans as of December 31, 2006:

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	129,170	\$ 9.77	360,000
Equity compensation plans not approved by security holders	45,000	\$ 9.22	
Total	174,170	\$ 9.63	360,000

**Repurchase of Equity Securities**

No repurchases of our securities were made by or on our behalf or any affiliated purchaser during the fourth quarter of the fiscal year ended December 31, 2006.

**Sale of Unregistered Securities**

In March 2001, we issued to Richard L. Yadon, a Director, a warrant to purchase 9,365 shares of our common stock at an exercise price of \$2.50 per share, and expiring on December 31, 2006. In April 2002 we issued another warrant to Mr. Yadon to purchase 5,318 shares of our common stock at an exercise price of \$3.25 per share, and expiring on April 23, 2007. Both of these warrants were issued to Mr. Yadon as consideration for his guarantee of payment of a portion of our bank debt. On November 30, 2006, Mr. Yadon exercised all of his warrants with a cash payment to us in the aggregate amount of approximately \$41 thousand. The common stock was issued in reliance upon the exemptions from registration contained in Section 3(a)(9) and Section 4(2) of the Securities Act of 1933, as amended.

In February and May 2001, Charles G. Curtis, a Director, purchased from us in a private placement a warrant to purchase 16,000 shares of our common stock and a warrant to purchase 24,000 shares. The exercise price of both warrants was \$3.25 per share and the expiration date of the warrants was December 31, 2006. Utilizing a cashless exercise feature in the warrants, Mr. Curtis exercised the warrants on November 21, 2006 and a total of 30,857 shares of common stock were issued to him. The common stock was issued in reliance upon the exemptions from registration contained in Section 3(a)(9) and Section 4(2) of the Securities Act of 1933, as amended.

**ITEM 6. SELECTED FINANCIAL DATA**

In the table below, we provide you with selected historical financial data. We have derived this information from our audited consolidated financial statements for each of the years in the five-year period ended December 31, 2006. This information is only a summary and it is important that you read this information along with our audited

consolidated financial statements and related notes, and Management's Discussion and Analysis of Financial Condition and Results of Operations under Item 7 below, which discusses factors affecting the comparability of the information presented. The selected financial information provided is not necessarily indicative of our future results of operations or financial performance.

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	2002	Year Ended December 31,			2006
		2003	2004	2005 <sup>(1)</sup>	
		<i>(in thousands, except per share amounts)</i>			
CONSOLIDATED STATEMENTS OF INCOME AND OTHER INFORMATION:					
Revenues	\$ 10,297	\$ 12,750	\$ 15,958	\$ 49,311	\$ 62,729
Costs of revenue, exclusive of depreciation shown separately below	5,572	6,057	6,951	31,338	39,308
Gross profit	4,725	6,693	9,007	17,973	23,421
Depreciation and amortization	1,166	1,726	2,444	4,224	6,020
Other operating expenses	1,718	2,292	2,652	4,890	5,270
Operating income	1,841	2,675	3,911	8,859	12,131
Total other income (expense) <sup>(2)</sup>	(471)	(671)	603	(1,798)	(256)
Income before income taxes	1,370	2,004	4,514	7,061	11,875
Income tax expense	584	697	1,140	2,615	4,287
Net income	786	1,307	3,374	4,446	7,588
Preferred dividends	107	121	53		
Net income available to common stockholders	\$ 679	\$ 1,186	\$ 3,321	\$ 4,446	\$ 7,588
Net income per common share:					
Basic	\$ 0.19	\$ 0.24	\$ 0.59	\$ 0.59	\$ 0.67
Diluted	\$ 0.16	\$ 0.23	\$ 0.52	\$ 0.52	\$ 0.66
Weighted average shares of common stock outstanding:					
Basic	3,649	4,947	5,591	7,564	11,405
Diluted	4,305	5,253	6,383	8,481	11,472
EBITDA <sup>(3)</sup>	\$ 3,511	\$ 4,397	\$ 7,796	\$ 13,282	\$ 19,541
	2002	2003	As of December 31,		2006
			2004	2005	
			<i>(in thousands)</i>		
BALANCE SHEET INFORMATION:					
Current assets	\$ 5,084	\$ 3,654	\$ 7,295	\$ 24,642	\$ 55,170
Total assets	23,937	28,270	43,255	86,369	135,552
Long-term debt (including current portion)	8,847	10,724	15,017	28,205	18,392
Stockholders' equity	13,001	14,425	22,903	45,690	101,201

(1) The information for the periods presented may not be

comparable because of our acquisition of SCS in January 2005. For additional information regarding this acquisition, you should read the information under Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations and Item 13. Certain Relationships, Related Transactions and Director Independence Acquisition of Screw Compression Systems, Inc. in this Annual Report on Form 10-K.

(2) Total other income (expense) for the year ended December 31, 2004 includes \$1.5 million in life insurance proceeds paid to us upon the death of our former Chief Executive Officer.

(3) 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:

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it is widely used by investors in the energy industry to measure a company's operating performance without regard to items excluded from the calculation of EBITDA, which can vary substantially from company to company depending upon accounting methods and book value of assets, capital structure and the method by which assets were acquired, among other factors;

it helps investors to more meaningfully evaluate and compare the results of our operations from period to period by removing the impact of our capital structure and asset base from our operating structure; and

it is used by our management for various purposes, including as a measure of operating performance, in presentations to our Board of Directors, as a basis for strategic planning and forecasting, and as a component for setting incentive compensation.

There are material limitations to using EBITDA as a measure of performance, including the inability to analyze the impact of certain recurring items that materially affect our net income or loss, and the lack of comparability of results of operations of different companies. The following table reconciles EBITDA to our net income, the most directly comparable GAAP financial measure:

	Year Ended December 31,				
	2002	2003	2004	2005	2006
	<i>(in thousands)</i>				
EBITDA	\$ 3,511	\$ 4,397	\$ 7,796	\$ 13,282	\$ 19,541
Depreciation and amortization	1,166	1,726	2,444	4,224	6,020
Interest expense, net	975	667	838	1,997	1,646
Income taxes	584	697	1,140	2,615	4,287
Net Income	\$ 786	\$ 1,307	\$ 3,374	\$ 4,446	\$ 7,588

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

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

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

### **Overview**

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



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We also fabricate natural gas compressors for sale to our customers, designing compressors to meet unique specifications dictated by well pressures, production characteristics and particular applications for which compression is sought. Fabrication of compressors involves the purchase by us of engines, compressors, coolers and other components, and then assembling these components on skids for delivery to customer locations. These major components of our compressors are acquired through periodic purchase orders placed with third-party suppliers on an as needed basis, which presently requires a three to four month lead time with delivery dates scheduled to coincide with our estimated production schedules. Although we do not have formal continuing supply contracts with any major supplier, we believe we have adequate alternative sources available. In the past, we have not experienced any sudden and dramatic increases in the prices of the major components for our compressors. However, the occurrence of such an event could have a material adverse effect on the results of our operations and financial condition, particularly if we were unable to increase our rental rates and sales prices proportionate to any such component price increases.

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

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

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

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

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

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

The oil and gas equipment rental and services industry is cyclical in nature. The most critical factor in assessing the outlook for the industry is the worldwide supply and demand for natural gas and the corresponding changes in

commodity prices. As demand and prices increase, oil and gas producers increase their capital expenditures for drilling, development and production activities. Generally, the increased capital expenditures ultimately result in greater revenues and profits for services and equipment companies.

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In general, we expect our overall business activity and revenues to track the level of activity in the natural gas industry, with changes in domestic natural gas production and consumption levels and prices more significantly affecting our business than changes in crude oil and condensate production and consumption levels and prices. We also believe that demand for compression services and products is driven by declining reservoir pressure in maturing natural gas producing fields and, more recently, by increased focus by producers on non-conventional natural gas production, such as coalbed methane, gas shales and tight gas, which typically requires more compression than production from conventional natural gas reservoirs.

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

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

**Results of Operations*****Year Ended December 31, 2006 Compared to the Year Ended December 31, 2005***

The table below shows our revenues, percentage of total revenues, gross profit, exclusive of depreciation, and gross profit margin of each of our segments for the years ended December 31, 2006 and December 31, 2005. The gross profit margin is the ratio, expressed as a percentage, of gross profit, exclusive of depreciation, to total revenue.

	Revenue				Gross Profit, Exclusive of Depreciation			
	Year Ended December 31,		Year Ended December 31,		Year Ended December 31,		Year Ended December 31,	
	2005		2006		2005		2006	
	(dollars in thousands)							
Sales	\$ 30,278	61%	\$ 38,214	61%	\$ 6,947	23%	\$ 8,585	23%
Service and maintenance	2,424	5%	979	1%	945	39%	244	25%
Rental	16,609	34%	23,536	38%	10,081	61%	14,592	62%
Total	\$ 49,311		\$ 62,729		\$ 17,973	36%	\$ 23,421	37%

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

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

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

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

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

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

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

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

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

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

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

**Table of Contents*****Year Ended December 31, 2005 Compared to the Year Ended December 31, 2004***

The table below shows our revenues, percentage of total revenues, gross profit, exclusive of depreciation, and gross profit margin of each of our segments for the years ended December 31, 2005 and December 31, 2004. The gross profit margin is the ratio, expressed as a percentage, of gross profit, exclusive of depreciation, to total revenue.

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

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

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

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

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

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

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

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

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

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



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

**Critical Accounting Policies and Practices**

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

Our critical accounting policies are as follows:

revenue recognition;

estimating the allowance for doubtful accounts;

accounting for income taxes;

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

valuation of inventory

*Revenue Recognition*

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

*Allowance for Doubtful Accounts Receivable*

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

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### *Accounting for Income Taxes*

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

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

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

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

significant underperformance relative to expected historical or projected future operating results;

significant changes in the manner of our use of the acquired assets or the strategy for our overall business; and

significant negative industry or economic trends.

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

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

### *Inventories*

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



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### **Recently Issued Accounting Pronouncements**

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

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

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

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

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

**Table of Contents****Environmental Regulations**

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

**Liquidity and Capital Resources**

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

At December 31, 2006, we had cash and cash equivalents of approximately \$4.4 million, working capital of \$44.5 million and total debt of \$18.4 million, of which approximately \$4.4 million was classified as current. At that same date, we also had letters of credit outstanding in the aggregate face amount of \$2.0 million. We had positive net cash flow from operating activities of approximately \$11.8 million during 2006. This was primarily from net income of \$7.6 million, plus depreciation and amortization of \$6.0 million, an increase in deferred taxes of \$2.5 million, offset by an increase in trade accounts receivable of \$2.3 million, and an increase in inventory of \$2.2 million.

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

***Contractual Obligations and Commitments***

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

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Cash Contractual Obligations	2007	2008	Obligation Due in Period			Thereafter	Total
			2009	2010	2011		
			<i>(in thousands)</i>				
Credit facility (secured)	\$ 3,442	\$ 3,378	\$ 3,378	\$ 3,378	\$ 2,816	\$	\$ 16,392
Interest on credit facility.	1,160	865	591	338	211		3,165
Subordinated debt	1,000	1,000					2,000
Facilities and office leases	129	62	29	29	30	76	355
Purchase obligations							
Total	\$ 5,731	\$ 5,305	\$ 3,998	\$ 3,745	\$ 3,057	\$ 76	\$ 21,912

**Senior Bank Borrowings**

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

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

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

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

SCS has guaranteed payment of our loans.

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

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

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

at the end of each month, a consolidated current ratio (as defined in the Loan Agreement) of at least 1.4 to 1.0;

at the end of each month, consolidated tangible net worth (as defined in the Loan Agreement) of at least \$70.0 million;

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

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

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

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

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

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

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

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

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

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

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

### **Off-Balance Sheet Arrangements**

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

## **ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK**

### **Commodity Risk**

Our commodity risk exposure is the pricing applicable to oil and natural gas 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 oil and natural gas may cancel or curtail their drilling programs, thereby reducing demand for our equipment and services.

### **Interest Rate Risk**

Our Loan Agreement provides for a fixed interest rate of 7.5% for our term loan facility and our revolving line of credit facility. Consequently, our exposure to interest rates relates primarily to interest earned on short-term investments and paying above market rates if such rates are below the fixed rate on our bank borrowings. As of December 31, 2006, we were not using any derivatives to manage interest rate risk.

### **Financial Instruments and Debt Maturities**

Our financial instruments consist of cash and cash equivalents, accounts receivable, accounts payable, bank borrowings, and notes. The carrying amounts of cash and cash equivalents, accounts receivable, and accounts payable approximate fair value because of the highly liquid nature of these short-term instruments. The fair value of our bank borrowings approximate the carrying amounts as of December 31, 2006 and 2005, 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 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 25.

## **ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

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

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**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, 2006, 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 Natural Gas Services Group, Inc.'s disclosure controls and procedures as of December 31, 2006, 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 Securities Exchange Act of 1934, as amended. 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.

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Our management assessed the effectiveness of our internal control over financial reporting as December 31, 2006 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, 2006, our internal control over financial reporting was effective.

Our management's assessment of the effectiveness of our internal control over our financial reporting as of December 31, 2006 has been audited by Hein & Associates LLP, an independent registered public accounting firm, as stated in their report.

**Report of Independent Registered Public Accounting Firm**

To the Board of Directors

Natural Gas Services Group, Inc.

We have audited management's assessment, included in Management's Report on Internal Control over Financial Reporting appearing under Item 9A, that Natural Gas Services Group, Inc. maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (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. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of Natural Gas Services Group, Inc.'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, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and 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 the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that Natural Gas Services Group, Inc. maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, Natural Gas Services Group, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on the COSO criteria.

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We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Natural Gas Services Group, Inc. as of December 31, 2005 and 2006, and the related consolidated statements of income, stockholders' equity and cash flows for each of the three years in the period ended December 31, 2006 of Natural Gas Services Group, Inc. and our report dated March 12, 2007 expressed an unqualified opinion thereon.

***/s/ HEIN & ASSOCIATES LLP***

Dallas, Texas

March 12, 2007

**ITEM 9B. OTHER INFORMATION**

None.



**Table of Contents****PART III****ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE****Executive Officers and Directors**

Our executive officers and Directors at February 15, 2007 are:

Name	Age	Position
Stephen C. Taylor	53	Chairman, President and Chief Executive Officer
Earl R. Wait	63	Vice President    Accounting and Treasurer
Paul D. Hensley	54	Director, President of SCS
James R. Hazlett	51	Vice President    Technical Services
Charles G. Curtis <sup>(1)(3)(4)</sup>	73	Director
William F. Hughes, Jr. <sup>(1)(2)</sup>	54	Director
Gene A. Strasheim <sup>(1)(4)</sup>	66	Director
Richard L. Yadon <sup>(2)(3)(4)</sup>	48	Director
Alan A. Baker <sup>(2)(3)</sup>	75	Director
John W. Chisholm <sup>(2)(3)</sup>	52	Director

(1) Member of our  
audit committee

(2) Member of our  
compensation  
committee

(3) Member of our  
governance and  
personnel  
development  
committee

(4) Member of our  
nominating  
committee

Stephen C. Taylor was elected by the Board of Directors of Natural Gas Services Group to assume the position of President and Chief Executive Officer in January, 2005. Mr. Taylor was elected as a Director at the annual meeting of stockholders in June 2005. Effective January 1, 2006, Mr. Taylor was appointed Chairman of the Board of Directors. Immediately prior to joining Natural Gas Services Group, Mr. Taylor held the position of General Manager – US Operations for Trican Production Services, Inc. from 2002 through 2004. Mr. Taylor joined Halliburton Resource Management in 1976, becoming its Vice President – Operations in 1989. Beginning in 1993, he held multiple senior level management positions with Halliburton Energy Services until 2000 when he was elected Senior Vice President/Chief Operating Officer of Enventure Global Technology, LLC, a joint-venture deep water drilling technology company owned by Halliburton Company and Shell Oil Company. Mr. Taylor elected early retirement from Halliburton Company in 2002 to join Trican Production Services, Inc. Mr. Taylor holds a Bachelor of Science degree in Mechanical Engineering from Texas Tech University and a Master of Business Administration degree from the University of Texas at Austin.

Earl R. Wait became Vice President – Accounting in January 2006. He served as our Chief Financial Officer from May 2000 to January 2006. He has also served as our Treasurer since 1998. Mr. Wait was our Chief Accounting Officer from 1998 to May 2000. During the period from 1993 to 2003, he also served as an officer or director of our former subsidiaries. Mr. Wait is a certified public accountant, has a Bachelor of Business Administration degree from

Texas A&M University Kingsville and holds a Master of Business Administration degree from Texas A&M University Corpus Christi and has more than 25 years of experience in the energy industry.

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Paul D. Hensley was appointed as a Director of Natural Gas Services Group in January 2005 to fill a vacancy on the Board of Directors and was elected as a Director at the annual meeting of stockholders held in June 2005. He founded SCS in 1997 and is the president and a director of SCS. Mr. Hensley has over 30 years of industry experience.

James R. Hazlett has served as Vice President Technical Services since June 2005. Mr. Hazlett has served as vice president of sales for SCS since 1997, a position he continues to hold. Mr. Hazlett holds an Industrial Engineering degree from Texas A&M University and has over 27 years of industry experience.

Charles G. Curtis has served as a Director since April 2001. Since 2002, substantially all of Mr. Curtis' business activities have been devoted to managing personal investments. From 1992 until 2002, Mr. Curtis was the President and Chief Executive Officer of Curtis One, Inc., a manufacturer of aluminum and steel mobile stools and mobile ladders. From 1988 to 1992, Mr. Curtis was the President and Chief Executive Officer of Cramer, Inc. a manufacturer of office furniture. Mr. Curtis holds a Bachelor of Science degree from the United States Naval Academy and a Master of Science in Aeronautical Engineering degree from the University of Southern California.

William F. Hughes, Jr. has served as a Director since December 2003. Since 1983, Mr. Hughes has been co-owner of The Whole Wheatery, LLC, a natural foods store located in Lancaster, California. Mr. Hughes holds a Bachelor of Science degree in Civil Engineering from the United States Air Force Academy and a Master of Science in Engineering from the University of California at Los Angeles.

Gene A. Strasheim has served as a Director since 2003. From 2001 to 2004, Mr. Strasheim was a financial consultant to Skyline Electronics/Products, a manufacturer of circuit boards and large remotely controlled digital interstate highway signs. From 1992 to 2001, Mr. Strasheim was the Chief Financial Officer of Skyline Electronics/Products. From 1985 to 1992, Mr. Strasheim was the Vice President Finance and Treasurer of CF&I Steel Corporation. Prior to that, Mr. Strasheim was the Vice President Finance for two companies and was a partner with the public accounting firm of Deloitte Haskins & Sells. Mr. Strasheim has practiced as a certified public accountant in three states. Mr. Strasheim holds a Bachelor degree in Business from the University of Wyoming.

Richard L. Yadon has served as a Director since 2003. Mr. Yadon is one of the founders of Rotary Gas Systems, Inc., a former subsidiary of Natural Gas Services Group, and served as an advisor to the Board of Directors of Natural Gas Services Group from June 2002 to June 2003. Since 1981, Mr. Yadon has owned and operated Yadeco Pipe & Equipment. Since December 1994, he has co-owned and served as President of Midland Pipe & Equipment, Inc. Both companies are engaged in the business of providing oil and gas well drilling and completion services and equipment to oil and gas producers conducting operations in Texas, New Mexico, Louisiana and Oklahoma. Since 1981, he has owned Yadon Properties, which owns and operates real estate in Midland, Texas. Mr. Yadon has 22 years of experience in the energy service industry.

Alan A. Baker was appointed as a Director of Natural Gas Services Group on March 20, 2006 to fill a vacancy on the Board of Directors created by the retirement of our former Chairman of the Board and Chief Executive Officer, Wallace C. Sparkman, in December 2005. Mr. Baker was elected as a Director at the annual meeting of stockholders in June 2006. He has served as a consultant to Halliburton Company and previously served as President, Chairman and Chief Executive Officer of Halliburton Company's Energy Services Group, Houston, Texas, from 1991 until his retirement in 1995. Mr. Baker joined Halliburton Services in 1954 after graduating with a degree in petroleum engineering from Marietta College in Ohio. Mr. Baker has served Halliburton Services as Senior Vice President for U.S. Operations, Senior Vice President for International Operations and as President of the Vann Systems Division of Halliburton Company. Mr. Baker also served as a member of Halliburton's executive committee. Mr. Baker has served on the Boards of Noble Affiliates, Natural Gas and Oil, Crestar Energy of Canada and the Mid-Continent Oil and Gas Association. He is Trustee Emeritus of Marietta College and is a registered professional engineer.

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John W. Chisholm was appointed as a Director of Natural Gas Services Group on December 19, 2006 to fill a vacancy created by expanding the size of the Board from seven to eight Directors. Mr. Chisholm is the founder of Wellogix, an oil and gas software company that develops software aimed at expediting the exchange of enterprise data and communication of complex engineered services. Mr. Chisholm has served on the Board of Directors of Flotek Industries, Inc. since 2002 and is a member of its Compensation Committee. Prior to founding Wellogix, Mr. Chisholm co-founded and served as President of ProTechnics Company from 1985 until its sale to Core Laboratories in December of 1996. Mr. Chisholm served as Senior Vice President of Global Sales and Marketing of Core Laboratories until 1998, when he started Chisholm Energy Partners, an investment fund focused on mid-size energy service companies. Mr. Chisholm holds a Business Administration degree from Fort Lewis College in Colorado. He currently serves on the Editorial Advisory Board on Middle East Technology of the Oil & Gas Journal.

### **Section 16(a) Beneficial Ownership Reporting Compliance**

Section 16(a) of the Securities Exchange Act of 1934, as amended, requires our Directors and officers to file periodic reports of beneficial ownership with the Securities and Exchange Commission. These reports show the Directors' and officers' ownership, and the changes in ownership, of common stock and other equity securities of Natural Gas Services Group.

Based on a review of Forms 3, 4 and 5, certain of our directors and officers did not file on a timely basis reports of transactions in our equity securities required by Section 16(a) of the Securities Exchange Act of 1934. These transactions and related reports are described in the following paragraphs.

On December 29, 2006, a stock option to purchase 2,500 shares of our common stock was granted to each of our six non-employee directors, including Richard L. Yadon, Charles G. Curtis, William F. Hughes, Jr., Gene A. Strasheim, Alan A. Baker and John Chisholm. Form 4 reports for each Director reflecting these option grants were filed on January 5, 2007, or two days late.

On March 8, 2006, Mr. Hensley and Mr. Hughes sold 100,000 and 50,000 shares of common stock, respectively, in our underwritten public offering. Form 4 Reports reporting these sales were filed on March 30, 2006, or twenty days late.

On December 19, 2006, Mr. Chisholm was appointed as a Director of Natural Gas Services Group, Inc. A Form 3 report reflecting Mr. Chisholm's appointment as a Director was filed on January 3, 2007, or five days late.

### **Board of Directors**

The Board of Directors is divided into three classes with Directors serving staggered three-year terms. Mr. Hughes term expires in 2009; the terms of Messrs. Hensley and Yadon expire in 2007; and the terms of Messrs. Curtis, Strasheim and Taylor expire in 2008; and Mr. Baker's term expires in 2009. Mr. Chisholm was appointed to serve as a Director until the annual stockholders meeting to be held in June 2007, when he will stand for election.

Our Board of Directors has four standing committees, as follows:

Audit Committee,

Compensation Committee,

Governance and Personnel Development, and

Nominating Committee.

Until June 2006, our Governance and Personnel Development Committee and our Nominating Committee acted together as one committee. On June 30, 2006, we split our former Governance, Personnel Development and Nominating Committee into two separate committees which at the present time are still operating under the same charter. However, we expect to revise the existing charter and create new separate charters for each of the Governance and Personnel Development Committee and the Nominating Committee.

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***Audit Committee***

Our Audit Committee is composed of Gene A. Strasheim (Chairman), Charles G. Curtis and William F. Hughes, Jr. Under rules of the American Stock Exchange, the Audit Committee is to be comprised of three or more directors, each of whom must be independent. Our Board has determined that all of the members of the Audit Committee are independent, as defined in the listing standards of AMEX and the rules of the SEC, and that Gene A. Strasheim is qualified as an audit committee financial expert as that term is defined in the rules of the SEC.

The functions of the Audit Committee include:

assisting the Board in fulfilling its oversight responsibilities as they relate to our accounting policies, internal controls, financial reporting practices and legal and regulatory compliance;

hiring independent auditors;

monitoring the independence and performance of our independent auditors;

maintaining, through regularly scheduled meetings, a line of communication between the Board, our financial management and independent auditors; and

overseeing compliance with our policies for conducting business, including ethical business standards.

***Compensation Committee***

The Compensation Committee of the Board of Directors includes William F. Hughes, Jr. (Chairman), Alan A. Baker, John W. Chisholm and Richard L. Yadon. Our Board has determined that all of the members of the Compensation Committee are independent, as defined in the listing standards of AMEX and the rules of the SEC.

The functions of the Compensation Committee include:

assisting the Board in overseeing the management of our human resources, including compensation and benefits programs and evaluating the performance and compensation of our chief executive officer; and

overseeing the evaluation of management.

The Compensation Committee's policy is to offer the executive officers competitive compensation packages that will permit us to attract and retain individuals with superior abilities and to motivate and reward such individuals in an appropriate fashion in the long-term interests of Natural Gas Services Group and its stockholders. Currently, executive compensation is comprised of salary and cash bonuses and awards of long-term incentive opportunities in the form of stock options under our 1998 Stock Option Plan.

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***Governance and Personnel Development***

Our Governance and Personnel Development Committee is composed of Charles G. Curtis (Chairman), John W. Chisholm, Alan A. Baker and Richard L. Yadon.

The functions of this Committee include:

assisting the Board in interpreting the Board Governance Guidelines, the Board's Principles of Conduct and any other similar governance documents adopted by the Board;

overseeing the evaluation of the Board and its committees;

generally overseeing the governance of the Board; and

overseeing executive development and succession and diversity efforts.

Our Board of Directors has determined that all of the members of the Governance and Personnel Development Committee are independent, as defined in the listing standards of AMEX and the rules of the SEC.

***Nominating Committee***

Our Nominating Committee is composed of Richard L. Yadon (Chairman), Gene A. Strasheim and Charles G. Curtis.

The functions of this Committee include:

identifying individuals qualified to become board members, consistent with the criteria approved by the Board;

recommending director nominees and individuals to fill vacant positions;

Our Nominating Committee will consider director candidates recommended by stockholders. The Committee will evaluate nominees for directors recommended by stockholders in the same manner in which it evaluates other nominees for directors. Our Board of Directors has determined that all of the members of the Nominating Committee are independent, as defined in the listing standards of AMEX and the rules of the SEC.

***Code of Ethics***

Our Board of Directors has adopted a Code of Business Conduct and Ethics ( Code ), which is posted on our web site located at [www.ngsgi.com](http://www.ngsgi.com). You may also obtain a copy of our Code by requesting a copy in writing at 2911 SCR 1260, Midland, Texas 79706 or by calling us at (432) 563-3974.

Our Code provides general statements of our expectations regarding ethical standards that we expect our directors, officers and employees, including our Chief Executive Officer and Chief Financial Officer, to adhere to while acting on our behalf. Among other things, the Code provides that:

we will comply with all laws, rules and regulations;

our Directors, officers and employees are to avoid conflicts of interest and are prohibited from competing with us or personally exploiting our corporate opportunities;

our Directors, officers and employees are to protect our assets and maintain our confidentiality;

we are committed to promoting values of integrity and fair dealing; and

we are committed to accurately maintaining our accounting records under generally accepted accounting principles and timely filing our periodic reports.

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Our Code also contains procedures for our employees to report, anonymously or otherwise, violations of the Code.

**ITEM 11. EXECUTIVE COMPENSATION**

**Compensation Discussion and Analysis**

*Introduction and Overview*

The Compensation Committee or, the Committee, of the Board of Directors is responsible for determining the types and amounts of compensation we pay to our executives. The Committee operates under a written charter that you can view on our website at <http://www.ngsgi.com>. The Board of Directors has determined that each member of the Committee meets the independence requirements of the American Stock Exchange. The Board determines, in its business judgment, whether a particular Director satisfies the requirements for membership on the Committee set forth in the Committee's charter. None of the members of the Committee are current or former employees of Natural Gas Services Group or any of its subsidiaries.

The Committee is responsible for formulating and administering our overall compensation principles and plans. This includes establishing the compensation paid to our Chief Executive Officer, meeting and consulting with our Chief Executive Officer to establish the compensation paid to our other executive officers, counseling our Chief Executive Officer as to different compensation approaches, administering our stock option plan, monitoring adherence to our compensation philosophy and conducting an annual, and sometimes more frequent, review of our compensation programs and philosophy regarding executive compensation.

The Committee periodically meets in executive session without members of management or management directors present and reports to the Board of Directors on its actions and recommendations.

*Compensation Philosophy and Objectives*

Our compensation philosophy is to provide an executive compensation program that:

- rewards performance and talents necessary to advance our company objectives and further the interests of our stockholders;

- is fair and reasonable and appropriately applied to each executive officer; and

- is competitive with compensation programs offered by our competitors.

The overall objectives of our compensation philosophy are to:

- provide a competitive level of current annual income that attracts and retains qualified executives at a reasonable cost to us;

- retain and motivate executives to accomplish our company goals;

- provide long-term incentive compensation opportunities at levels appropriate for the respective responsibilities and performance of each executive;

- align compensation and benefits with our business strategies and goals;

- encourage the application of a decision making process that takes into account both short-term and long-term risks and the sometimes volatile nature of our industry; and

- align the financial interests of our executives with those of our stockholders through the potential grant of equity based rewards.

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Our Committee supports these objectives by emphasizing compensation arrangements that we believe are reasonable and will attract and retain qualified executives and reward them for their efforts to further our long-term growth and success. At the same time, we remain cognizant of and aim to balance our executive compensation arrangements with the interests and concerns of our stockholders.

We feel that our compensation philosophies and practices are more fully understood when viewed in the context of certain specific aspects of our history as a public company. Our initial public offering occurred in October 2002. Our market capitalization did not exceed \$75.0 million until mid 2006. Given our small size in our earlier years as a public company, we chose to implement a relatively simple compensation framework for our executives. This framework consisted primarily of base salaries, cash bonuses and stock options. We have currently chosen to continue a relatively simple compensation framework for our executives and believe that by doing so we are able to establish a higher degree of understanding and certainty for our executives as well as the investing public, while at the same time avoiding complex benefit packages and agreements that can be, in some ways, difficult to understand and require significant time and cost to properly administer. In the end, we believe our compensation arrangements provide the desired results: fair and reasonable pay for achievements beneficial to Natural Gas Services Group and its stockholders.

### *Assistance Provided to the Committee*

The Committee makes all compensation decisions regarding our executive officers. Stephen C. Taylor, our Chief Executive Officer, annually reviews the performance of each of our executive officers (other than the Chief Executive Officer whose performance is reviewed by the Committee) and presents recommendations to the Committee with respect to salary and cash bonus percentage adjustments and stock option grants for our executives (other than the Chief Executive Officer whose salary, cash bonus percentage adjustments and stock option grants are determined solely by the Committee). The Committee may exercise its discretion in modifying any recommendations made by our Chief Executive Officer.

The Committee also seeks the input and insight of Mr. Taylor concerning specific factors that Mr. Taylor believes to be appropriate for the Committee's consideration and which the Committee may not be aware of, such as extraordinary efforts or accomplishments of our executive officers. Mr. Taylor also advises the Committee on general topics such as the morale of our executives.

Mr. Earl R. Wait, our Vice President - Accounting, assists the Committee in the compensation process by gathering and organizing data for their review.

### *Compensation Components*

We base our decisions regarding executive compensation primarily on our assessment of company performance, and each executive officer's leadership, performance and individual contributions to our business. The accounting and tax treatment of different elements of compensation has not to date had a significant impact on our use of any particular type of compensation. In reviewing the overall compensation of our officers, we have historically considered and used a mix of the following components or elements of executive compensation:

base salary;

cash bonuses under our incentive cash bonus program;

stock option grants;

retirement and other benefits generally available to all of our employees; and

limited perquisites.



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We do not presently and have not in the past used any of the following types of executive compensation:

- stock awards;

- defined benefit pension plans;

- tax gross-ups;

- employee stock purchase/ownership plans;

- supplemental executive retirement plans/benefits; and

- deferred compensation plans.

*Compensation Evaluation Factors*

We continue, as we have in the past, to rely on the following factors in evaluating and determining the amount of compensation we pay our executives:

- our general knowledge of executive compensation levels in the natural gas compression industry;

- each executive's individual performance and the overall performance of Natural Gas Services Group; and

- specific company financial metrics and the application of specific weights to such metrics.

The applicability of these factors varies depending on the type of compensation being evaluated and determined. For instance, we do not rely on weighted company financial metrics to evaluate and determine base salary levels, but such factor is the primary means through which we evaluate and determine the amount of the cash bonuses we award to our executives. Below is a more detailed discussion of how these factors apply to the different types of compensation we utilize.

*Executive Compensation Levels of other Companies in the Natural Gas Compression and Related Businesses*

Historically, we have not focused on a specific peer group to evaluate and establish the compensation of our executive officers. We do, however, have some general knowledge of the executive compensation paid by certain of our competitors and general industry peers. These competitors include public and privately held companies in the natural gas compression business, industry partners and related businesses, such as natural gas well servicing. In order to maintain a compensation package that is competitive, we have considered, and continue to consider, the executive compensation paid by these companies in evaluating and establishing the compensation we pay our executive officers. Our competitors in the natural gas compression industry that are public companies are considerably larger than we are, and for this reason, we have not in the past and do not currently consider the specific amounts of executive compensation paid by such companies when evaluating or determining our executive compensation. We do, however, from time to time, consider the types of Executive Compensation offered by our competitors that are public companies and the annual increases or decreases on a percentage basis in such compensation

*Individual and Company Performance Base Salary and Stock Options*

We also evaluate compensation, particularly base salary levels and stock option awards, through an analysis of each executive officer's individual performance and the overall performance of Natural Gas Services Group, our goal being to strengthen the link between what we pay our executives and the performance of Natural Gas Services Group. Factors we consider in our analysis include:

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the individual performance, leadership, business knowledge and level of responsibility of our officers;

the particular skill-set and longevity of service of the officer;

the effectiveness of the officer in implementing our overall strategy;

the general level of competitive compensation packages;

cash flows from operations;

earnings per share;

our market share in the rental of natural gas compression units; and

the market value of our common stock.

*Specific Company Financial Metrics Cash Bonuses*

With respect to compensation we pay in the form of cash bonuses, the Committee sets target performance levels for three specific company financial metrics. The Committee relies on whether these targets are achieved and the individual performance of our executive officers to determine whether cash bonuses are awarded and the amounts of such bonuses. The three financial metrics the Committee considers are:

total revenues;

EBITDA; and

net income before taxes.

EBITDA is calculated from our audited consolidated financial statements by adding to net income, or loss, (1) amortization and depreciation expense, (2) interest expense and (3) provision for income tax expense.

We believe that our core executive compensation mix of base salary, cash bonuses and stock options, while fairly limited, presently provides enough diversity for us to link executive compensation to our short-term and long-term objectives. For instance, base salaries and cash bonuses are closely linked to the short-term objectives of providing reasonable and competitive levels of current annual income, while stock options are more closely linked to the long-term objectives of earnings per share and increased market value of our common stock.

*Base Salary*

We provide our executive officers and other employees with base salary to compensate them for services rendered during the fiscal year. Each year the Committee receives base salary recommendations from our Chief Executive Officer for all of our executive officers (other than our Chief Executive Officer whose base salary is evaluated by the Committee on an annual basis). The Committee reviews comparative salary data and information gathered by the Committee relative to certain of our competitors and industry peers to gain some general knowledge of what our competitors pay their executive officers. The competitors are certain privately held companies in the natural gas industry that are comparable in size to us. We do not consider the specific amounts of the compensation packages offered by our competitors that are public companies because of the considerable size difference between those companies and us, but we do from time to time consider the types of compensation offered by such competitors and the annual increases or decrease on a percentage basis in such compensation. The Committee determines base salary levels by considering the comparative salary data and information gathered by the Committee in conjunction with the factors described under the caption Individual and Company Performance Base Salary and Stock Options on page 42. We do not give specific weights to any of the factors the Committee considers in determining base salary levels or adjustments thereto. Based on our criteria for base salary level determinations, each executive officer identified below received an increase in annual base salary for 2006 as follows:



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Mr. Taylor from \$155,000 to \$175,000;

Mr. Wait from \$100,000 to \$112,500; and

Mr. Hazlett from \$105,000 to \$115,000.

The base salaries of our officers for 2006 are reflected in column (c) of the Summary Compensation Table on page 48.

*Short-Term Incentives Incentive Cash Bonus Program*

The Committee has adopted an incentive cash bonus program or, the IBP, that provides guidelines for the calculation of annual non-equity incentive based compensation in the form of cash bonuses to our executives, subject to Committee oversight and modification. The bonuses awarded under the IBP are short-term awards in recognition of the overall performance and efforts made by our executives during a particular year. Each year, the Committee approves the group of executives eligible to participate in the IBP and establishes target award opportunities for such executives, excluding our Chief Executive Officer, whose employment agreement provides for a target award opportunity of up to 50% of base salary. Target award opportunities for our executives range from 20% to 50% of base salary.

In 2006, 90% of an executive officer's IBP award was based on achievement of company financial objectives relating to:

total revenues;

EBITDA; and

net income before taxes.

Each of these three components accounts for 30% of the total company financial objective portion of the IBP. The remaining 10% of an executive officer's IBP award is based upon individual performance as evaluated by our Chief Executive Officer (except with respect to our Chief Executive Officer whose individual performance is evaluated by the Committee).

Each year, the Committee sets a target level for each component of the company financial objective portion of the IBP. The payment of awards under the IBP is based upon whether these target levels are achieved for the year. If we achieve the target levels for all components of the company financial objective portion of the IBP, an executive with a base salary of \$100,000 and a target award opportunity of 40% will receive a cash bonus of \$40,000, assuming the executive receives the full amount (10%) of the individual performance portion of the IBP. If we do not achieve the target levels for all of the components, the target award opportunity for each executive officer is decreased by 30% for each component in which there is a shortfall. For instance, if we meet all target levels except the target level for EBITDA, the executive's award opportunity is decreased by 30%. With respect to the executive described above, the award opportunity for such executive would be reduced from 40% to 28% (the target bonus of 40% multiplied by 70%) and the executive would receive a cash bonus of \$28,000, assuming the executive receives the full amount of the individual performance portion of the IBP.

In 2006, we met or exceeded all of our targets and each of our executives received the maximum bonus amount they could be awarded. The cash awards made to our executive officers under the IBP for 2006 are included in column (g) of the Summary Compensation Table on page 48.

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### *Long-Term Incentives    Stock Option Grants*

We consider stock options to be a type of long-term incentive compensation that motivates our executive officers to work toward our long-term growth and allows them to participate in the growth and profitability of Natural Gas Services Group. Stock options align the interests of our executive officers with our stockholders in that our executive officers will benefit from the options only to the extent that the value of our common stock increases. The number of options granted to an executive officer is based on an officer's individual performance and his current contributions and potential for future contributions to the overall performance of Natural Gas Services Group.

All stock options are granted under our 1998 Stock Option Plan, except one stock option was granted outside of the plan to Stephen C. Taylor, our Chief Executive Officer, under the terms of his employment agreement. We do not grant discounted options and exercise prices are not based on a formula. Options granted under our 1998 Stock Option Plan are at-the-money. In other words, the exercise price of the option equals the closing price of the underlying stock on the actual date of grant.

On November 21, 2006, the Committee granted stock options to two executive officers. Mr. Taylor was granted an option to purchase 15,000 shares of common stock, and Mr. Wait was granted an option to purchase 5,000 shares. The options have an exercise price of \$14.22 per share, the closing price of Natural Gas Services Group's common stock on the date of grant. The option granted to Mr. Taylor is exercisable in two equal annual installments commencing on November 21, 2007 and the option granted to Mr. Wait is exercisable in three equal annual installments commencing on November 21, 2007. The options expire ten years from the grant date. These option grants are reflected in column (j) of the Grants of Plan-Based Awards Table on page 49.

The Compensation Committee does not have any specific program or plan with regard to the timing or dating of option grants, except that it has been the Committee's practice to grant options within thirty days after the latest quarterly or annual earnings release by Natural Gas Services Group. The Committee's practice as to when options are granted has historically been made at the discretion of the Committee. Generally, option grants to executives and other employees have been made at the same time. We have not and do not plan to purposefully time the release of material non-public information for the purpose of affecting the value of executive compensation.

### *Other Compensation*

We maintain a 401(k) retirement plan in which our executives and employees participate. We match executive and employee contributions to our 401(k) plan, on an equal percentage basis, with cash contributions. The Company matching portion is equal to one-half of the employee's contribution up to a maximum of 3% of the employee's salary. Our matching amounts for our executive officers are included in column (i) of the Summary Compensation Table on page 48.

Other than the reductions that can occur with respect to the target award opportunities of our executives under the IBP, we do not have a written policy or formula regarding the adjustment, reduction or recovery of awards or payments if company performance measures are restated or adjusted in a manner that would reduce the award or payment. However, the Committee does consider compensation realized or potentially realizable from prior compensation awards in setting new types and amounts of compensation, the result of such consideration being varying increases in annual salaries and cash bonuses, with some increases being smaller than previous years.

### *Employment Agreements*

We currently have written employment agreements with three of our executive officers, including Stephen C. Taylor, Paul D. Hensley and James R. Hazlett. We do not have written employment agreements with any of our other executive officers. We employed Mr. Taylor in January 2005. Mr. Taylor's employment was governed by a verbal arrangement until August 2005 when we negotiated and entered into a written employment agreement with Mr. Taylor. We negotiated and entered into written employment agreements with Messrs. Hensley and Hazlett in January 2005 in connection with our acquisition of SCS.

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The employment agreements of Messrs. Taylor, Hensley and Hazlett provide for, among other things, base salary, incentive cash bonuses under the IBP, and insurance, medical and other benefits generally available to our other employees. Mr. Taylor's employment agreement also contains change of control and severance provisions, as referenced under the caption *Change of Control and Severance Arrangements* on page 52 and more particularly described under the caption *Potential Payments Upon Termination or Change of Control* on page 52. More information regarding the above-referenced employment agreements is provided under the heading *Compensation Agreements with Management* on page 56.

### *Allocation of Amounts and Types of Compensation*

Other than the stock options we grant to our executives from time to time and the determinations made by the Committee as to specific target award opportunities under our IBP, the allocation of different amounts and types of compensation has not been a consideration for us. The Committee has not adopted a specific policy or target for the allocation between either amounts or types of compensation. However, since our initial public offering in October 2002, the compensation we have paid to our executive officers has emphasized the use of cash rather than non-cash compensation. We have chosen to do this in order to maintain and continue our practice of having a simplified, but effective and competitive, compensation package.

### *Assistance of Compensation Consultants*

Although the Committee has the authority to retain, at the expense of Natural Gas Services Group, compensation consultants, the Committee has not in the past sought or relied on an outside compensation consultant to evaluate or establish the compensation we pay our executives. While the Committee believes the executive compensation we pay is fair and generally competitive within the natural gas compression industry, the Committee tends to target pay within approximately 20% of what it believes to be the industry median. This approach helps ensure that our executive compensation remains reasonable and lessens the need for an outside consultant to validate such compensation. Our Committee, nevertheless, understands the value of an outside compensation consultant, and in light of our growth over the last three years and the increased level of competition within the natural gas compression industry for attracting and retaining talented executives, is considering retaining a compensation consultant to help the Committee better evaluate our executive compensation.

### *Change of Control and Severance Arrangements*

Our 1998 Stock Option Plan contains change of control provisions. In addition, Mr. Taylor's employment agreement contains change of control and severance provisions. Information regarding these provisions is provided under the caption *Potential Payments Upon Termination or Change of Control* on page 52.

### *Stock Ownership/Retention Guidelines*

We have not in the past had written guidelines or policy statements that required our executives to maintain specified levels of stock ownership or adhere to specified holding practices with regard to our common stock.

### *Perquisites*

#### *General Perquisites*

We provide limited perquisites to our executives. The primary perquisites are allowing our executives a choice of receiving an automobile allowance or personal use of a company-provided automobile, and to a lesser extent, the reimbursement of dues for club memberships. In 2006, we reimbursed club membership dues to one of our executive officers, William L. Larkin, Vice President Sales and Marketing. Mr. Larkin ceased to be employed by Natural Gas Services Group as of October 31, 2006. Although we provide Mr. Taylor with one club membership, since his use of the club is limited solely for business entertainment, we have not considered it to be a perquisite and have not valued it as such for inclusion in column (i) of the Summary Compensation Table on page 48. We do not currently have any executive officers that are reimbursed for club membership dues.

Our executives also participate in the same medical, dental and life insurance plans as other employees. However, we pay a greater percentage of the premiums for health insurance for our executives than we do for our other employees.

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*Cash Payment to Chief Executive Officer Upon Exercise of Stock Option*

As part of the negotiations with Mr. Taylor as to his compensation under his employment agreement and as an inducement to Mr. Taylor to join our employment, we agreed to make a cash payment to Mr. Taylor upon his exercise of the stock option granted to him under his employment agreement in an amount sufficient to place Mr. Taylor in the same after-tax position he would be in if the income recognized by Mr. Taylor upon his exercise of the stock option were taxed at the then applicable Federal capital gains tax rate. Mr. Taylor is responsible for all tax due with respect to this cash payment.

*Limit on Deductibility of Certain Compensation*

Provisions of the Internal Revenue Code that restrict the deductibility of certain compensation over one million dollars per year have not been a factor in our considerations or recommendations. Section 162(m) of the Code currently imposes a \$1 million limitation on the deductibility of certain compensation paid to specified executives. Excluded from the limitation is compensation that is performance based. For compensation to be performance based, it must meet certain criteria, including being based on predetermined objective standards approved by stockholders. The Committee has not taken the requirements of Section 162(m) into account in designing executive compensation. If the compensation level of any executive officer approaches \$1.0 million for purposes of Section 162(m), the Committee will assess the implications of Section 162(m) and determine what action would be appropriate, which may be influenced by factors other than full tax deductibility.

**COMPENSATION COMMITTEE REPORT**

The Committee has reviewed and discussed the Compensation Discussion and Analysis with management.

Based on its review and discussions, the Committee recommended to the Board of Directors that the Compensation Discussion and Analysis be included in our Annual Report on Form 10-K for the year ended December 31, 2006 and in our proxy statement for the 2007 annual meeting of stockholders.

Members of the Compensation Committee

William F. Hughes, Jr. (Chairman)

Alan A. Baker

John W. Chisholm

Rick L. Yadon

**Table of Contents****Executive Compensation**

The table below sets forth the compensation earned by our Chief Executive Officer, Stephen C Taylor, and our other named executive officers for services rendered to Natural Gas Services Group, Inc. and its subsidiaries for the fiscal year ended December 31, 2006.

**Summary Compensation Table**

Name and Principal Position (a)	Year (b)	Salary (\$) (c)	Bonus (\$) (d)	Stock Awards (\$) (e)	Option Awards (\$) (f)	Non-Equity Incentive Plan Compensation (g)	Change in Pension Value and Nonqualified Deferred Compensation (h)	All Other Compensation (\$) <sup>(7)</sup> (i)	Total (\$) (j)
							Earnings (h)		
Stephen C. Taylor Chairman, President and Chief Executive Officer	2006	\$ 175,350	\$ 0		\$ 215,550 <sup>(4)</sup>	\$ 87,500		\$ 7,259	\$ 485,659
Earl R. Wait Vice President Accounting	2006	\$ 102,769	\$ 0		\$ 0	\$ 39,375		\$ 16,490	\$ 158,634
Paul D. Hensley Director, President of SCS	2006	\$ 133,110	\$ 0		\$ 0	\$ 50,680		\$ 10,941	\$ 194,731
James R. Hazlett Vice President - Technical Services	2006	\$ 107,715	\$ 0		\$ 0	\$ 40,250		\$ 5,623	\$ 153,588
S. Craig Rogers <sup>(1)</sup> Vice President- Operations	2006	\$ 93,846	\$ 0		\$ 0	N/A		\$ 8,074	\$ 101,920
William R. Larkin <sup>(2)</sup> Vice President- Sales and Marketing	2006	\$ 90,769	\$ 0		\$ 18,240 <sup>(5)</sup>	N/A		\$ 13,887	\$ 122,896

(1) Mr. Rogers ceased serving as Vice President-Operations



on November 10,  
2006.

- (2) Mr. Larkin ceased serving as Vice President-Sales and Marketing on October 31, 2006.
- (3) The amounts in column (f) reflect the dollar amounts recognized for financial statement reporting purposes for the fiscal year ended December 31, 2006, in accordance with FAS 123(R), associated with stock option grants under our 1998 Stock Option Plan and the stock option grant to Mr. Taylor under his employment agreement and thus include amounts associated with grants made in 2006 and prior to 2006. Assumptions used to calculate these amounts are included in footnote 10 to our audited consolidated financial statements for the fiscal year ended December 31, 2006, as set forth on page F-17. There were no stock options exercised or stock awards that vested during the fiscal year ended December 31, 2006 with respect to any named executive officer.

(4)

This amount reflects the dollar amount recognized for financial statement reporting purposes for the fiscal year ended December 31, 2006, in accordance with FAS 123(R), for 15,000 shares that vested on January 13, 2006 under the stock option granted to Mr. Taylor in August 2005 under his employment agreement.

- (5) This amount reflects the dollar amount recognized for financial statement reporting purposes for the fiscal year ended December 31, 2006, in accordance with FAS 123(R), for 4,000 shares that vested on August 26, 2006 under the stock option granted to Mr. Larkin under our 1998 Stock Option Plan.

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(6) The amounts in column (g) reflect the cash bonus awards to the named executive officers under our IBP, which is discussed in further detail on page 44 under the caption Short-Term Incentives Incentive Bonus Program.

(7) The amounts shown in column (i) include matching contributions made by Natural Gas Services Group to each named executive officer under our 401(k) plan and the aggregate incremental cost to Natural Gas Services Group of perquisites provided to our named executive officers as follows:

	Personal Use of Company		Additional Incremental Portion of Health Insurance Premiums
Automobile	Provided	Reimbursement	

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	Allowance	Automobiles	of Club Dues	Paid for Officers Only	401(k)	Total
Stephen C. Taylor	\$	\$ 4,566	\$	\$ 927	\$ 1,766	\$ 7,259
Earl R. Wait	9,000			4,581	2,909	16,490
Paul D. Hensley		3,464		2,895	4,582	10,941
James R. Hazlett		1,041		4,582		5,623
S. Craig Rogers		3,865		3,279	930	8,074
William R. Larkin	7,547		2,879	513	2,948	13,887
Total	\$16,547	\$ 12,936	\$ 2,879	\$ 16,777	\$13,135	\$62,274

### Grants of Plan Based Awards

The table below sets forth the estimated future payouts under non-equity incentive plan awards and stock option awards granted and the grant date fair value of the stock option awards.

#### Grants of Plan-Based Awards Table

Name	Grant Date	Estimated Future Payouts Under Non-Equity Incentive Plan Awards <sup>(1)</sup>			Estimated Future Payouts Under Equity Incentive Plan Awards			All Other Awards: Number of Shares of Stock or Underlying Securities			Grant Date Fair Value of Stock and Option Awards	
		Threshold	Target	Maximum	Threshold	Target	Maximum	Units	Option (#) <sup>(2)</sup>	Awards (\$/Sh)	Awards (\$)	Awards (\$)
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)	(k)	(l)	(l)
Stephen C. Taylor	11/21/06											
	N/A		\$ 105,000	\$ 105,000					15,000	\$ 14.22	\$ 108,150	
Earl R. Wait	11/21/06											
	N/A		\$ 39,375	\$ 39,375					5,000	\$ 14.22	\$ 36,050	
Paul D. Hensley	N/A		\$ 50,680	\$ 50,680								
James R. Hazlett	N/A		\$ 40,250	\$ 40,250								

S. Craig Rogers.	N/A
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William R. Larkin	N/A
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- (1) No amounts are shown in column (c) because there is no minimum bonus amount under our Incentive Bonus Program. The amounts shown in column (d) reflect the product of the target award opportunity for each executive under our Incentive Bonus Program, times the executive's base salary and are based on the assumption that all three components of the company financial objective portion of the IBP (total revenues, EBITDA and net income before taxes) will be met and each executive will receive the full amount of the individual performance portion of the IBP. The amounts shown in column (e) match the amounts shown in column

(d) because there are no circumstances under which any executive would be entitled to a cash bonus award under the Incentive Bonus Program that exceeds the target amount. These amounts are based on each executive's current salary and position.

- (2) All of the awards reflected in column (j) were made under our 1998 Stock Option Plan.

#### **Incentive Cash Bonus Program**

Our Incentive Cash Bonus Program or, the IBP, provides for annual non-equity incentive based compensation in the form of cash bonuses to our executive officers. Our Compensation Committee or, the Committee, administers and determines from year to year the executives that are eligible to participate in the IBP. The Committee establishes target award opportunities for the executives eligible to participate in the plan. These target award opportunities are expressed as a percentage of an executive's base salary. An executive's target award opportunity is the maximum cash bonus an executive is eligible to receive in any one year under the IBP.

The Committee establishes annual target levels for Natural Gas Services Group's total revenues, EBITDA and net income before taxes and assigns a weight of 30% to each of these components. The executive's individual performance is assigned a weight of 10%. If during the year Natural Gas Services Group achieves all of the target levels established by the Committee for total revenues, EBITDA and net income before taxes, and it is determined by the Committee that an executive is entitled to the full 10% weight assigned to individual performance, the executive is entitled to receive the maximum cash bonus amount for the executive for that year. If any one of the target levels is not met or it is determined that an executive is not entitled to the full 10% weight assigned to individual performance, the cash bonus award for the executive is reduced accordingly. More information regarding the IBP and the calculation of awards is provided under the caption Short-Term Incentives Incentive Cash Bonus Program on page 44.

#### **1998 Stock Option Plan**

Our 1998 Stock Option Plan provides for the issuance of stock options to purchase up to 550 thousand shares of our common stock. The purpose of this plan is to attract and retain the best available personnel for positions of substantial responsibility and to provide long-term incentives to employees and consultants and to promote the long-term growth and success of our business. The plan is administered by the Compensation Committee of the Board of Directors. At its discretion, the Compensation Committee may determine the persons to whom stock options may be granted and the terms upon which options will be granted. In addition, the Compensation Committee may interpret the plan and may adopt, amend and rescind rules and regulations for its administration. Option awards are granted with an exercise price equal to the closing price of our common stock at the date of grant and generally vest based on three years of continuous service and have ten-year contractual terms.

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



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At March 12, 2007, stock options to purchase a total of 158 thousand shares of our common stock were outstanding under the 1998 Stock Option Plan, which includes 15 thousand shares underlying stock options granted on December 29, 2006 to our six non-employee Directors under the compensation arrangements described under the caption Compensation of Directors on page 55. As described under the caption Compensation Agreements with Management on page 56, one additional stock option to purchase 45 thousand shares of common stock, which was not granted under the 1998 Stock Option Plan, and which was granted on August 26, 2005 without stockholder approval, was also outstanding at that same date.

A total of 360 thousand shares of common stock were available at December 31, 2006 for future grants of stock options under the 1998 Stock Option Plan.

**Outstanding Equity Awards at Fiscal Year-End**

The following table shows outstanding stock option awards classified as exercisable and unexercisable as of December 31, 2006 for our Chief Executive Officer, Stephen C. Taylor, and each other named executive officer.

**Outstanding Equity Awards at Fiscal Year-End Table**

Name (a)	Option Awards				Stock Awards			
	Number of Securities Underlying Unexercised Options (#) Exercisable (b)	Number of Securities Underlying Unexercised Options (#) Unexercisable (c)	Option Exercise Price (d)	Option Expiration Date (e)	Number of Shares that Have Not Vested (f)	Market Value of Stock that Have Not Vested (g)	Equity Incentive Plan	Equity Incentive Plan
							Awards:	Awards:
							Number of Awards: Rights that Have Not Vested (h)	Market or Payout Value of Unearned Shares or Other Rights that Have Not Vested (i)
Stephen C. Taylor	15,000	30,000 15,000	\$ 9.22 \$ 14.22	8/06/2015 11/21/2016				
Earl R. Wait	15,000	5,000	\$ 3.25 \$ 14.22	4/12/2012 11/21/2016				
Paul D. Hensley								
James R. Hazlett								
S. Craig Rogers <sup>(1)</sup>	12,000		\$ 3.25	2/08/2007				

William R. Larkin <sup>(2)</sup>	4,000	\$ 7.50	1/29/2007
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(1) Before leaving our employment, Mr. Rogers held a fully-vested stock option to purchase 12,000 shares of our common stock. The expiration date of Mr. Rogers stock option was April 12, 2012; however, under our 1998 Stock Option Plan, upon Mr. Rogers departure from our employment, the stock option became subject to an accelerated ninety-day expiration period. This accelerated expiration period was February 8, 2007 and Mr. Rogers exercised his stock option in full on January 26, 2007.

(2) Before leaving our employment, Mr. Larkin owned a stock option to purchase 8,000

shares of our common stock, 4,000 of which had vested. The expiration date of Mr. Larkin's stock option was August 26, 2014; however, under 1998 Our Stock Option Plan, the unvested portion of the stock option (4,000 shares) immediately expired and the vested portion (4,000 shares) became subject to an accelerated ninety-day expiration period. This accelerated expiration period was January 29, 2007 and Mr. Larkin exercised his stock option with respect to the vested portion on January 26, 2007.

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### **Potential Payments Upon Termination or Change of Control**

Our 1998 Stock Option Plan contains change of control provisions. These provisions are designed to provide some assurance that we will be able to rely upon each executive's services and advice as to the best interests of Natural Gas Services Group and our stockholders without concern that the executive might be distracted by the personal uncertainties and risks created by any proposed or threatened change of control and to promote continuity of our executive team.

Under our stock option plan, the Committee may adjust the stock options held by our executives upon the occurrence of a change of control. With this authority, the Committee may in its discretion elect to accelerate the vesting of any stock options that were not fully vested and allow for the exercise of such options as to all shares of stock subject thereto.

Mr. Taylor and Mr. Wait are our only executive officers that hold stock options granted under our stock option plan that have not fully vested. Mr. Taylor holds an option to purchase 15,000 shares of stock, none of which had vested as of December 31, 2006. Mr. Wait holds two stock options to purchase our common stock, one covering 15,000 shares and the other covering 5,000 shares. As of December 31, 2006, Mr. Wait's option to purchase 15,000 shares had fully vested and none of the shares underlying the option to purchase 5,000 shares had vested. The stock options held by Mr. Taylor and Mr. Wait and the exercise price for each of the options are set forth in the Outstanding Equity Awards at Fiscal Year-End table on page 51.

Mr. Taylor's option to purchase 15,000 shares of stock and Mr. Wait's option to purchase 5,000 shares, each having an exercise price of \$14.22 per share, could have become fully exercisable on December 31, 2006 assuming a change of control were to have occurred on that date. In this event, Mr. Taylor would have had to pay approximately \$213 thousand and Mr. Wait would have had to pay approximately \$71 thousand to purchase the shares. The closing price of our common stock on December 31, 2006, was \$13.90 per share. Accordingly, at December 31, 2006, the aggregate value of the shares covered by Mr. Taylor's and Mr. Wait's options were approximately \$209 thousand and \$70 thousand, respectively, and both Mr. Taylor's and Mr. Wait's options were out-of-the money. As a result, at December 31, 2006, and assuming the vesting of the options had been accelerated by the Compensation Committee, there was no potential for Mr. Taylor or Mr. Wait to realize any immediate value upon exercise of their respective options at such date.

### **Change of Control and Severance Arrangements- Stephen C. Taylor's Employment Agreement**

As described under Employment Agreements on page 45 and under Compensation Agreements With Management on page 56, we have written employment agreements with three of our executive officers: Stephen C. Taylor, our Chief Executive Officer, Paul D. Hensley, President of SCS and a Director, and James R. Hazlett, Vice-President-Technical Services. Mr. Taylor's employment agreement contains change of control and severance provisions. These provisions were included in Mr. Taylor's employment agreement as part of our negotiations with Mr. Taylor as to the terms of his employment and as an inducement for Mr. Taylor to join Natural Gas Services Group. The change of control and severance provisions are designed to promote stability and continuity with respect to Mr. Taylor's employment as our Chief Executive Officer and President. Our employment agreements with Messrs. Hensley and Hazlett do not contain change of control or severance provisions.

Mr. Taylor's employment agreement provides that he is entitled to certain severance benefits if his employment is terminated as the result of a fundamental change or for any other reason, but excluding the following:

for cause ;

the mental or physical incapacity or inability of Mr. Taylor to perform his duties for a period of 120 or more consecutive days or for multiple periods totaling 180 or more days during any twelve-month period;

the death of Mr. Taylor; or

the voluntary retirement or resignation of Mr. Taylor.

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Generally, a fundamental change is defined in Mr. Taylor's employment agreement as the occurrence of any of the following:

the dissolution, merger or consolidation of Natural Gas Services Group;

the sale of all or substantially all of the assets of Natural Gas Services Group;

the recapitalization or any other type of transaction which results in 51% or more of the common stock of Natural Gas Services Group being changed into, or exchanged for, different securities of Natural Gas Services Group, or other securities in other entities; or

any change in the duties, functions, responsibilities or authority of Mr. Taylor or any decrease in his base salary.

The severance benefits provided to Mr. Taylor upon the occurrence of a fundamental change include:

a single lump sum cash payment equal to 200% of his base salary;

immediate vesting of all unvested stock options;

continued health care and insurance benefits and premium payments for a period of 18 months from the date of termination;

bonuses or individual incentive compensation not yet paid but earned prior to the year of termination;

bonuses or individual incentive compensation earned during the fiscal year, prorated to reflect the date of termination; and

immediate vesting of 100% of all other compensation plans or bonus or incentive plans that Mr. Taylor contributed to at the date of termination, except to the extent covered by the benefits listed above.

In connection with this employment agreement, Mr. Taylor was granted a stock option to purchase 45,000 shares of our common stock at an exercise price of \$9.22 per share. Unlike his employment agreement, the stock option agreement provides that upon the occurrence of a fundamental change (without the termination of Mr. Taylor) or the termination of Mr. Taylor as a result of his incapacity or inability to perform his duties, the voluntary retirement or resignation of Mr. Taylor, or the death of Mr. Taylor, the stock option vests in full on the date immediately prior to the effective date of the occurrence of any of these events. These provisions were negotiated by Mr. Taylor and us and were included in Mr. Taylor's compensation package as an additional inducement for him to join our employment.

The table below shows the potential payments to Mr. Taylor under the change of control and severance provisions contained in his employment agreement and the stock option agreement entered into in connection with his employment agreement. The potential payments are based on Mr. Taylor's salary level and compensation package as of December 31, 2006, and the assumption that the change of control or severance event occurred on December 31, 2006.

**Table of Contents****Chief Executive Officer Potential Payments Table**

Potential Payments and other Benefits upon a Change of Control or Severance	Fundamental Change	Termination Upon Fundamental Change	Voluntary Resignation or Retirement	Death	Incapacity or Inability to Perform Duties	Termination for Cause	Termination Without Cause
Compensation:							
Salary		\$350,000					\$350,000
Short-Term Incentive Compensation-Cash Bonus Under IBP		\$ 87,500					\$ 87,500
Long-Term Incentive Stock Option Grants	\$215,550	\$215,550	\$215,550	\$215,550	\$215,550		\$215,550
Benefits:							
401(k) Plan		\$ 8,583					\$ 8,583
Medical Benefits		\$ 5,209					\$ 5,209
Life Insurance Benefits		\$ 1,135					\$ 1,135
Other							
Total	\$215,550	\$667,977	\$215,550	\$215,550	\$215,550		\$667,977

**Table of Contents****Compensation of Directors****Director Compensation Table**

The following table discloses the cash, equity awards and other compensation earned, paid or awarded, as the case may be, to each of our non-employee Directors during the fiscal year ended December 31, 2006.

Name	Fees	Stock	Option	Non-Equity	Change in	All	Total
	Or				Plan		
(a)	Paid	Awards	Awards	Compensation	Value and Nonqualified Deferred Earnings	Compensation	(h)
	(\$)	(\$)	(\$) <sup>(3)(4)</sup>	(\$)		(\$)	(\$)
Charles G. Curtis	\$ 12,500		\$ 34,750				\$ 47,250
Gene A. Strasheim <sup>(1)</sup>	\$ 17,500		\$ 34,750				\$ 52,250
William F. Hughes	\$ 12,500		\$ 34,750				\$ 47,250
Richard L. Yadon	\$ 12,500		\$ 34,750				\$ 47,250
Alan A. Baker	\$ 12,500		\$ 34,750				\$ 47,250
John W. Chisholm <sup>(2)</sup>	\$ 3,750		\$ 34,750				\$ 38,500

(1) Mr. Strasheim served as the Chairman of the Audit Committee in 2006, and as a result, he received in additional cash fee of \$1,250 per quarter.

(2) Effective December 19, 2006, the Board of Directors voted to increase the number of Directors constituting our Board of Directors from seven to eight and appointed Mr. Chisholm to fill the vacancy

created by the increase in the number of Directors.

- (3) On December 29, 2006, each of our non-employee Directors was granted a stock option to purchase 2,500 shares of common stock at an exercise price of \$13.90 per share, the closing price of our common stock on December 29, 2006. Initially, the stock options were exercisable for a term of ten years from the date of grant. On January 15, 2007, the Compensation Committee unanimously consented to an amendment to the stock options, making the stock options exercisable for a term of ten years from January 1, 2007, rather than from the date of grant.

- (4) The amounts set forth in column



(d) represent the dollar amounts we recognized for financial statement reporting purposes for 2006 in accordance with FAS 123R with respect to the stock options granted to our non-employee Directors. The grant date fair value, as calculated in accordance with FAS 123R, for the stock options granted to our non-employee Directors in 2006 was \$38 thousand per option.

#### **Compensation of Directors**

We use a combination of cash and equity-based incentive compensation to attract and retain qualified candidates to serve on our Board of Directors. In setting compensation for our Directors, we consider the substantial amount of time that Directors expend in fulfilling their duties to Natural Gas Services Group and our stockholders, as well as the skill-sets required to fulfill these duties.

##### **Cash Compensation Paid to Directors**

We pay our non-employee Directors a quarterly cash fee for their attendance at each meeting at our Board of Directors. Up until July 1, 2006, the quarterly cash fee payable to our non-employee Directors equaled \$2,500 per quarter. On June 21, 2006, our Board of Directors approved an increase in the cash fee payable to our non-employee Directors. Effective July 1, 2006, the quarterly cash fee payable to our non-employee Directors was increased from \$2,500 to \$3,750 per quarter.

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In addition, the Chairman of the Audit Committee is entitled to an additional quarterly cash fee of \$1,250.  
**Equity Based Compensation Paid to Directors**

Each non-employee Director is entitled to receive an annual stock option covering 2,500 shares of our common stock for their services as a Director. The options granted to our non-employee Directors are granted under our 1998 Stock Option Plan.

Directors who are employees of Natural Gas Services Group do not receive any compensation for their services as Directors.

**Other**

All Directors are reimbursed for expense incurred in connection with attending meetings.

Natural Gas Services Group provides liability insurance for its directors and officers. The cost of this coverage for 2006 was approximately \$129 thousand.

We do not offer non-employee Directors travel accident insurance, life insurance or a pension or retirement plan.

**Compensation Agreements with Management**

On August 24, 2005, we entered into a three year employment agreement with Stephen C. Taylor to serve as our President and Chief Executive Officer. The employment agreement provides for an annual base salary of \$155 thousand; an annual bonus of up to 50% of Mr. Taylor's annual base salary; four weeks of vacation each year; a vehicle allowance; moving expense reimbursement of up to \$20 thousand; reimbursement for three monthly mortgage payments made by Mr. Taylor for his prior residence in Houston, Texas; and standard medical and other benefits provided to all of our employees. The agreement contains provisions restricting the use of confidential information, requiring that business opportunities and intellectual property developed by Mr. Taylor become our property; and prohibiting Mr. Taylor from competing with us during his employment and for the two years following the date he ceases to be employed by us within the areas consisting of Midland and Ector Counties, Texas, Tulsa County, Oklahoma and all adjacent counties. The agreement is subject to termination upon certain fundamental changes; the death or mental or physical incapacity or inability of Mr. Taylor; the voluntary resignation or retirement of Mr. Taylor; or the termination of Mr. Taylor's employment for cause, within the meaning of the agreement. If Mr. Taylor's employment is terminated as the result of a fundamental change or other than for cause, he is entitled to receive a single lump sum cash payment equal to 200% of his base salary. As an inducement to obtain Mr. Taylor's services, we also agreed to grant to Mr. Taylor a stock option to purchase 45 thousand shares of common stock. We granted the option to Mr. Taylor, without stockholder approval, on August 24, 2005. The option is exercisable in three equal annual installments, commencing on January 13, 2006. The exercise price of the options is \$9.22, the fair market value of our common stock on January 13, 2005, the date we initially hired Mr. Taylor. The option expires ten years from the date of grant. Mr. Taylor's base salary increased to \$210 thousand on January 15, 2007.

When we acquired SCS on January 3, 2005, Paul D. Hensley, one of the former stockholders of SCS, entered into a three year employment agreement with SCS to serve as the President of SCS. Mr. Hensley is also currently a director of SCS and a Director of Natural Gas Services Group, Inc. The employment agreement provides for an initial annual base salary in the amount of \$126,700 and participation by Mr. Hensley in our employee benefit plans as in effect from time to time. The agreement also contains provisions restricting the use of confidential information; requiring that business opportunities and intellectual property developed by Mr. Hensley become the property of SCS; and prohibiting Mr. Hensley from competing with us within an area consisting of Tulsa County, Oklahoma and all adjacent counties. The agreement may be terminated by us for cause, within the meaning of the agreement, and automatically terminates upon the occurrence of any fundamental change with respect to SCS or Natural Gas Services Group. The agreement also automatically terminates upon the death, voluntary resignation or retirement of Mr. Hensley or the inability of Mr. Hensley to perform his duties for a consecutive period of 120 days or a non-consecutive period of 180 days during any twelve month period.

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On January 3, 2005, James R. Hazlett, one of the former stockholders of SCS, also entered into a three year employment agreement with SCS to continue in his position as a Vice President of SCS. In June 2005, Mr. Hazlett also became Vice President-Technical Services of Natural Gas Services Group. The employment agreement provides for an initial annual base salary in the amount of \$105 thousand and participation by Mr. Hazlett in our employee benefit plans. The agreement contains provisions restricting the use of confidential information; requiring that business opportunities and intellectual property developed by Mr. Hazlett becomes the property of SCS; and prohibiting Mr. Hazlett from competing with us within an area consisting of Tulsa County, Oklahoma and all adjacent counties. The agreement may be terminated by us for cause, within the meaning of the agreement, and automatically terminates upon the occurrence of any fundamental change with respect to SCS or Natural Gas Services Group. The agreement also automatically terminates upon the death, voluntary resignation or retirement of Mr. Hazlett or the inability of Mr. Hazlett to perform his duties for a consecutive period of 120 days or a non-consecutive period of 180 days during any twelve month period. Mr. Hazlett's base salary increased to \$115 thousand on December 1, 2006.

**Limitations on Directors and Officers Liability**

Our Articles of Incorporation provide our officers and directors with certain limitations on liability to us or any of our stockholders for damages for breach of fiduciary duty as a director or officer involving certain acts or omissions of any such director or officer.

This limitation on liability may have the effect of reducing the likelihood of derivative litigation against directors and officers and may discourage or deter shareholders or management from bringing a lawsuit against directors and officers for breach of their duty of care even though such an action, if successful, might otherwise have benefited our stockholders and us.

Our Articles of Incorporation and bylaws provide certain indemnification privileges to our directors, employees, agents and officers against liabilities incurred in legal proceedings. Also, our directors, employees, agents or officers who are successful, on the merits or otherwise, in defense of any proceeding to which he or she was a party, are entitled to receive indemnification against expenses, including attorneys' fees, incurred in connection with the proceeding.

We are not aware of any pending litigation or proceeding involving any of our directors, officers, employees or agents as to which indemnification is being or may be sought, and we are not aware of any other pending or threatened litigation that may result in claims for indemnification by any of our directors, officers, employees or agents.

Even though we maintain directors and officers' liability insurance, the indemnification provisions contained in the Articles of Incorporation and bylaws of Natural Gas Services Group, Inc. remain in place.

Insofar as indemnification for liabilities arising under the Securities Act may be permitted to our directors, officers and controlling persons pursuant to the foregoing provisions, or otherwise, we have been advised that in the opinion of the Securities and Exchange Commission such indemnification is against public policy as expressed in the Securities Act and is, therefore, unenforceable.

**Table of Contents****ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS**

The following table sets forth, as of March 12, 2007, the beneficial ownership of our common stock (i) by each of our directors and executive officers; (ii) by all of our executive officers and directors as a group; and (iii) by all persons known by us to beneficially own more than five percent of our common stock.

Name and Address of Beneficial Owner	Amount and Nature of Beneficial Ownership <sup>(1)</sup>	Percent of Class
Charles G. Curtis	76,357 <sup>(2)</sup>	*
William F. Hughes	202,000 <sup>(3)</sup>	1.67%
Gene A. Strasheim	11,000 <sup>(4)</sup>	*
Stephen C. Taylor	31,000 <sup>(5)</sup>	*
Richard L. Yadon	278,683 <sup>(6)</sup>	2.31%
Paul D. Hensley	326,829 <sup>(7)</sup>	2.71%
Alan A. Baker	2,500 <sup>(8)</sup>	*
John Chisholm	2,500 <sup>(9)</sup>	*
Earl R. Wait	45,870 <sup>(10)</sup>	*
James R. Hazlett	51,976 <sup>(11)</sup>	*
Westcliff Capital Management, LLC	927,150 <sup>(12)</sup>	7.68%
Keeley Asset Management Corp.	755,000 <sup>(13)</sup>	6.26%
Wellington Management Company, LLP	1,328,000 <sup>(14)</sup>	11.01%
All directors and executive officers as a group (10 persons)	1,028,715 <sup>(15)</sup>	8.46%

\* Less than one percent

(1) The number of shares listed includes all shares of common stock owned by, or which may be acquired within 60 days of March 12, 2007 upon the exercise of warrants and options held by the stockholder (or group). Beneficial ownership is calculated in accordance with

the rules of the Securities and Exchange Commission. As of March 12, 2007, none of the shares of common stock owned by our officers and directors had been pledged as collateral to secure repayment of loans.

(2) Includes 12,500 shares that may be acquired upon the exercise of stock options granted under our 1998 Stock Option Plan. Mr. Curtis address is 1 Penrose Lane, Colorado Springs, Colorado 80906.

(3) Includes 190,500 shares indirectly owned by Mr. Hughes through the William and Cheryl Hughes Family Trust and 10 thousand shares that may be acquired upon the exercise of stock options granted under our 1998 Stock

Option Plan.  
Mr. and  
Mrs. Hughes are  
co-trustees of  
the William and  
Cheryl Hughes  
Family Trust  
and have shared  
voting and  
investment  
powers with  
respect to the  
shares held by  
the trust. Mr.  
and  
Mrs. Hughes are  
beneficiaries of  
the trust along  
with their two  
children.  
Mr. Hughes  
address is 42921  
Normandy  
Lane, Lancaster,  
California  
93536.

- (4) Includes 7,500  
shares that may  
be acquired  
upon exercise of  
stock options  
granted under  
our 1998 Stock  
Option Plan.  
Mr. Strasheim's  
address is 165  
Huntington  
Place, Colorado  
Springs,  
Colorado  
80906.

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- (5) Includes 30,000 shares that may be acquired upon exercise of a stock option granted to Mr. Taylor as an inducement for his employment. Mr. Taylor's address is 2911 South County Road 1260, Midland, Texas 79706.
- (6) Includes 10,000 shares that may be acquired upon the exercise of stock options granted under our 1998 Stock Option Plan. Mr. Yadon's address is 4444 Verde Glen Ct., Midland, Texas 79707.
- (7) Mr. Hensley's address is 3005 N. 15<sup>th</sup> Street, Broken Arrow, Oklahoma 74012.
- (8) All of such shares may be acquired upon exercise of a stock option granted under our 1998 Stock Option Plan. Mr. Baker's address is 2702 Briar Knoll Ct.,

Sugar Land,  
Texas 77479.

(9) All of such  
shares may be  
acquired upon  
exercise of a  
stock option  
granted under  
our 1998 Stock  
Option Plan.  
Mr. Chisholm's  
address is 539  
Green Isle  
Beach,  
Montgomery,  
Texas 77356

(10) Includes 15,000  
shares that may  
be acquired  
upon exercise of  
a stock option  
granted under  
our 1998 Stock  
Option Plan.  
Mr. Wait's  
address is 2911  
South County  
Road 1260,  
Midland, Texas  
79706.

(11) Mr. Hazlett's  
address is 2911  
South County  
Road 1260,  
Midland, Texas  
79706.

(12) As reported in  
Schedule 13G  
filed with the  
Securities and  
Exchange  
Commission on  
February 6,  
2007, Westcliff  
Capital  
Management,  
LLC has shared



voting and  
dispositive  
powers with  
respect to such  
shares.

Westcliff, as  
investment  
manager of  
various client  
accounts, and  
Richard S.  
Spencer III, as  
Westcliff's  
manager and  
majority owner,  
may be deemed  
to beneficially  
own the stock  
owned by such  
accounts, in that  
they may be  
deemed to have  
the power to  
direct the voting  
or disposition of  
that stock.

- (13) As reported in  
Schedule 13G  
filed with the  
Securities and  
Exchange  
Commission on  
February 13,  
2007, Keeley  
Asset  
Management  
Corp., an  
investment  
adviser, and  
Keeley Small  
Cap Value  
Fund, Inc., an  
investment  
company, have  
shared voting  
and dispositive  
powers with  
respect to such  
shares.

(14) As reported in Amendment No. 1 to Schedule 13G filed with the Securities and Exchange Commission on February 14, 2007, Wellington Management Company, LLP, in its capacity as investment adviser, may be deemed to beneficially own such shares and has shared voting powers with respect to 758,000 shares and shared dispositive powers with respect to 1,328,000 shares.

(15) Includes 90,000 shares of common stock that may be acquired upon the exercise of stock options.

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

#### **Acquisition of Screw Compression Systems, Inc.**

In October 2004, we entered into a Stock Purchase Agreement with Screw Compression Systems, Inc. or "SCS", and the three stockholders of SCS, Paul D. Hensley, James R. Hazlett and Tony Vohjesus. Under this agreement, we purchased all of the outstanding shares of capital stock of SCS from Messrs. Hensley, Hazlett and Vohjesus. Mr. Hensley is currently the president of SCS and a Director of Natural Gas Services Group. Mr. Hazlett became Vice President Technical Services of Natural Gas Services Group in June 2005 and also continues to serve as a vice President of SCS. Mr. Vohjesus remains employed by SCS as a vice president. The acquisition was completed on January 3, 2005 and SCS is now operated as a wholly owned subsidiary of Natural Gas Services Group.

Under terms of the Stock Purchase Agreement, we appointed Mr. Hensley as a Director of Natural Gas in January, 2005 to fill a vacancy existing on its Board of Directors, to hold office until the 2005 annual meeting of stockholders. Mr. Hensley was elected as a Director at the annual meeting of stockholders held in June 2005.



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Based on Mr. Hensley's pro rata ownership of SCS, he received \$5.6 million in cash; 426,829 shares of Natural Gas Services Group common stock; and a promissory note issued by Natural Gas Services Group in the principal amount of \$2.1 million, bearing interest at the rate of 4.00% per annum, maturing January 3, 2008 and secured by a letter of credit in the initial aggregate face amount of \$1.4 million. Mr. Hazlett received \$800 thousand in cash; 60,976 shares of Natural Gas Services Group common stock; and a promissory note in the principal amount of \$300 thousand, bearing interest at the rate of 4.00% per annum, maturing January 3, 2008 and secured by a letter of credit in the initial aggregate face amount of \$200 thousand. Mr. Vohjesus received \$1.6 million thousand in cash 121,951 shares of Natural Gas Services Group common stock; and a promissory note in the principal amount of \$600 thousand, bearing interest at the rate of 4.00% per annum, maturing January 3, 2008 and secured by a letter of credit in the initial aggregate face amount of \$400 thousand. The promissory notes are payable in three equal annual installments, with the first installment due and payable on January 3, 2006. Subject to the consent of the holder of each respective note, principal payments may be made by Natural Gas Services Group in shares of common stock valued at the average daily closing prices of the common stock on the American Stock Exchange for the twenty consecutive trading days commencing thirty days before the due date of the principal payment, or by combination of cash and shares of common stock. On January 3, 2006, Mr. Hensley received \$700 thousand in principal and \$84 thousand in interest; Mr. Hazlett received \$100 thousand in principal and \$12 thousand in interest; and Mr. Vohjesus received \$200 thousand in principal and \$24 thousand in interest. On January 3, 2007, Mr. Hensley received \$700 thousand in principal and \$56 thousand in interest; Mr. Hazlett received \$100 thousand in principal and \$8 thousand in interest; and Mr. Vohjesus received \$200 thousand in principal and \$16 thousand in interest.

Excluding accrued and unpaid interest, at March 12, 2007, we were indebted to Mr. Hensley in the aggregate principal amount of \$700 thousand, which is secured by a letter of credit in the amount of \$700 thousand; we were indebted to Mr. Hazlett in the aggregate principal amount of \$100 thousand, which is secured by a letter of credit in the amount of \$100 thousand; and we were indebted to Mr. Vohjesus in the aggregate principal amount of \$200 thousand, which is secured by a letter of credit in the amount of \$200 thousand.

Under terms of a Stockholders' Agreement entered into as required by the Stock Purchase Agreement, for a period of two years following the closing, each of Messrs. Hensley, Hazlett and Vohjesus had the right, subject to certain limitations, to include or piggyback the shares of common stock he received in the transaction in any registration statement we filed with the Securities and Exchange Commission. The Stockholders' Agreement also provides that Messrs. Hensley, Hazlett and Vohjesus will not for a period of three years acquire or agree, offer, seek or propose to acquire beneficial ownership of any assets or businesses or any additional securities issued by us, or any rights or options to acquire such ownership; contest any election of directors by the stockholders of Natural Gas Services Group; or induce or attempt to induce any other person to initiate any stockholder proposal or a tender offer for any of our voting securities; or enter into any discussions, negotiations, arrangements or understandings with any third party with respect to any of the foregoing.

### **Director Independence**

Our business, property and affairs are managed by or under the direction of the Board of Directors. Members of the Board are kept informed of our business through discussions with Mr. Taylor, our Chairman of the Board, Chief Executive Officer and President, and other officers, by reviewing materials provided to them and by participating in meetings of the Board and its committees. Four non-employee directors, Charles G. Curtis, William F. Hughes, Jr., Gene A. Strasheim and Richard L. Yadon, served on our Board of Directors throughout fiscal year 2006, and two other non-employee directors, Alan A. Baker and John W. Chisholm, served as directors for a portion of the year.

Messrs. Curtis, Hughes, Strasheim, Yadon, Baker and Chisholm have been determined to meet the definition of an independent director under rules of the American Stock Exchange, the independence standards applicable to us. These determinations are based primarily on responses of the Directors to questions regarding employment and compensation history, affiliations and family and other relationships, comparisons of the independence criteria under the AMEX rules to the particular circumstances of each Director and on discussions among the Directors.

In considering and determining the independence of Mr. Curtis and Mr. Yadon, the Audit Committee reviewed and took into account their exercise of warrants as described under Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchase of Equity Securities Sale of Unregistered Securities on page 18 of

this Annual Report on Form 10-K.

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**Procedures for Reviewing Certain Transactions**

On March 7, 2007, we adopted a written policy for the review, approval or ratification of related party transactions. All of our officers, directors and employees are subject to the policy. Under this policy, the Audit Committee will review all related party transactions for potential conflict of interest situations. Generally, our policy defines a related party transaction as a transaction in which we are a participant and in which a related party has an interest. A related party is:

a director, officer or employee of Natural Gas Services or a nominee to become a director;

an owner of more than 5% of our outstanding common stock;

certain family members of any of the above persons; and

any entity in which any of the above persons is employed or is a partner or principal or in which such person has a 5% or greater ownership interest.

***Approval Procedures***

Before entering into a related party transaction, the related party or the department within Natural Gas Services responsible for the potential transaction must notify the Chief Executive Officer or the Audit Committee of the facts and circumstances of the proposed transaction. If the amount involved is equal to or less than \$100 thousand, the proposed transaction will be submitted to the Chief Executive Officer. If the amount involved exceeds \$100 thousand, the proposed transaction will be submitted to the Audit Committee. Matters to be submitted will include:

the related party's relationship to Natural Gas Services and interest in the transaction;

the material terms of the proposed transaction;

the benefits to Natural Gas Services of the proposed transaction;

the availability of other sources of comparable properties or services; and

whether the proposed transaction is on terms comparable to terms available to an unrelated third party or to employees generally.

The Chief Executive Officer or the Audit Committee, as applicable, will then consider all of the relevant facts and circumstances available, including the matters described above and, if applicable, the impact on a director's independence. Neither the Chief Executive Officer nor any member of the Audit Committee is permitted to participate in any review, consideration or approval of any related party transaction if such person or any of his or her immediate family members is the related party. After review, the Chief Executive Officer or the Audit Committee, as applicable, may approve, modify or disapprove the proposed transaction. Only those related party transactions that are in, or are not inconsistent with, the best interests of Natural Gas Services and its stockholders will be approved.

***Ratification Procedures***

If an officer or director of Natural Gas Services becomes aware of a related party transaction that has not been previously approved or ratified by the Chief Executive Officer or the Audit Committee then, if the transaction is pending or ongoing, the transaction must be submitted, based on the amount involved, to either the Chief Executive Officer or the Audit Committee and the Chief Executive Officer or the Audit Committee will consider the matters described above. Based on the conclusions reached, the Chief Executive Officer or the Audit Committee will evaluate all options, including ratification, amendment or termination of the related party transaction. If the transaction is completed, the Chief Executive Officer or the Audit Committee, as applicable, will evaluate the transaction, taking into account the same factors as described above, to determine if rescission of the transaction or any disciplinary action is appropriate, and will request that we evaluate our controls and procedures to determine the reason the transaction was not submitted to the Chief Executive Officer or the Audit Committee for prior approval and whether any changes to the procedures are recommended.



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**ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES**

Our principal accountant for the fiscal years ended December 31, 2006 and 2005 was Hein & Associates LLP.

**Audit Fees**

The aggregate fees billed for professional services rendered by Hein & Associates LLP for the audit of our financial statements for our fiscal years ended December 31, 2006 and 2005 and the review of the financial statements on Forms 10-Q and 10-QSB, respectively, for the fiscal quarters in such fiscal years were approximately \$265 thousand and \$177 thousand, respectively. These fees also include update audit procedures performed by Hein & Associates LLP for the issuance of consents for the inclusion of audit opinions in various registration statements we filed with the Securities and Exchange Commission during these years and consultation regarding Sarbanes-Oxley internal controls implementation.

**Audit Related Fees**

The aggregate fees billed for assurance and related services by Hein & Associates LLP during our fiscal years ended December 31, 2006 and 2005 were approximately \$50 thousand and \$155 thousand, respectively. These fees were mainly related to the audits for the acquisition of SCS, procedures performed in connection with a registration statement on Form S-1 filed with the Securities and Exchange Commission.

**Tax Fees**

We were not billed by Hein & Associates LLP for any tax services during the year ended December 31, 2005 or December 31, 2006.

**All Other Fees**

No other fees were billed by Hein & Associates LLP, during our fiscal years ended December 31, 2005 and 2006, other than as described above.

**Audit Committees Pre-Approval Policies and Procedures**

As of December 31, 2006 our Audit Committee had not established pre-approval policies and procedures for the engagement of our principal accountant to render audit or non-audit services. However, in accordance with Section 10A(i) of the Exchange Act, our Audit Committee, as a whole, approves the engagement of our principal accountant prior to the accountant rendering audit or non-audit services.

Certain rules of the Securities and Exchange Commission provide that an auditor is not independent of an audit client if the services it provides to the client are not appropriately approved, subject, however, to a *de minimus* exception contained in the rules. The Audit Committee pre-approved all services provided by Hein & Associates LLP in 2006 and the *de minimus* exception was not used.



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**PART IV**

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

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

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

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

(a)(3) Exhibits

See Item 15(b) below.

(b) Exhibits:

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

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

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

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with the Securities and Exchange Commission on March 30, 2005)

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

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

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Current Report on Form 8-K, dated January 3, 2006, and filed with the Securities and Exchange Commission on January 6, 2006)

- 10.30 Seventh Amended and Restated Loan Agreement (Incorporated by reference to Exhibit 10.1 of the Registrant's Form 8-K dated October 26, 2006 and filed with the Securities and Exchange Commission on November 1, 2006)
- 14.0 Code of Ethics (Incorporated by reference to Exhibit 14.0 of the Registrant's Form 10-KSB for the fiscal year ended December 31, 2004, and filed with the Securities and Exchange Commission on March 30, 2005)

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Exhibit No.	Description
21.0	Subsidiaries (Incorporated by reference to Exhibit 21.0 of the Registrant's Form 10-KSB for the fiscal year ended December 31, 2004, and filed with the Securities and Exchange Commission on March 30, 2005)
*23.1	Consent of Hein & Associates LLP
*31.1	Certification of Chief Executive Officer required by Section 302 of the Sarbanes-Oxley Act of 2002
*31.2	Certification of Chief Financial Officer required by Section 302 of the Sarbanes-Oxley Act of 2002
*32.1	Certification required by Section 906 of the Sarbanes-Oxley Act of 2002
*32.2	Certification required by Section 906 of the Sarbanes-Oxley Act of 2002
* Filed herewith.	

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**SIGNATURES**

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

Date: March 12, 2007

**NATURAL GAS SERVICES GROUP,  
INC.**

/s/ Stephen C. Taylor

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

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

<b>Signature</b>	<b>Title</b>	<b>Date</b>
/s/ Stephen C. Taylor Stephen C. Taylor	Chairman of the Board of Directors, Chief Executive Officer and President (Principal Executive Officer)	March 12, 2007
/s/ Earl R. Wait Earl R. Wait	Vice President Accounting (Principal Financial Officer)	March 12, 2007
/s/Charles G. Curtis Charles G. Curtis	Director	March 12, 2007
/s/William F. Hughes, Jr. William F. Hughes, Jr.	Director	March 12, 2007
/s/Richard L. Yadon Richard L. Yadon	Director	March 12, 2007
/s/Paul D. Hensley Paul D. Hensley	Director	March 12, 2007
/s/Gene A. Strasheim Gene A. Strasheim	Director	March 12, 2007
/s/Alan A. Baker	Director	March 12, 2007

Alan A. Baker

Director

March 12, 2007

John W. Chisholm

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors

Natural Gas Services Group, Inc.

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

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2005 and 2006, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2006, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Natural Gas Services Group, Inc. and Subsidiaries internal control over financial reporting as of December 31, 2006, based on *criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)* and our report dated March 12, 2007 expressed an unqualified opinion on management's assessment of the effectiveness of the Company's internal control over financial reporting and an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

/s/ **HEIN & ASSOCIATES LLP**

Dallas, Texas

March 12, 2007

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**NATURAL GAS SERVICES GROUP, INC. AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**  
(amounts in thousands, except per share data)

	<b>December 31,</b>	
	<b>2005</b>	<b>2006</b>
<b>ASSETS</b>		
<b>Current Assets:</b>		
Cash and cash equivalents	\$ 3,271	\$ 4,391
Short-term investments		25,052
Trade accounts receivable, net of doubtful accounts of \$75 and \$110, respectively	6,192	8,463
Inventory, net of allowance for obsolescence of \$361 and \$347, respectively	14,723	16,943
Prepaid expenses and other	456	321
Total current assets	24,642	55,170
Rental equipment, net of accumulated depreciation of \$7,598 and \$11,320, respectively	41,201	59,866
Property and equipment, net of accumulated depreciation of \$2,458 and \$3,679, respectively	6,424	6,714
Goodwill, net of accumulated amortization of \$325	10,039	10,039
Intangibles, net of accumulated amortization of \$492 and \$819, respectively	3,978	3,650
Other assets	85	113
Total assets	\$ 86,369	\$ 135,552
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
<b>Current Liabilities:</b>		
Current portion of long-term debt and subordinated notes	\$ 5,680	\$ 4,442
Line of credit	300	
Accounts payable and accrued liabilities	4,917	4,914
Current income tax liability	207	1,056
Deferred income	103	225
Total current liabilities	11,207	10,637
Long term debt, less current portion	20,225	12,950
Subordinated notes, less current portion	2,000	1,000
Deferred income tax payable	7,247	9,764
Commitments (Note 11) Stockholders equity:		
Common stock, 30,000 shares authorized, par value \$0.01; 9,022 and 12,046 shares issued and outstanding, respectively	90	120
Additional paid-in capital	34,667	82,560
Retained earnings	10,933	18,521
Total stockholders equity	45,690	101,201

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

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**NATURAL GAS SERVICES GROUP, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF INCOME**  
(amounts in thousands, except per share data)

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

**Earnings per common share:**

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Basic	\$ 0.59	\$ 0.59	\$ 0.67
Diluted	\$ 0.52	\$ 0.52	\$ 0.66

**Weighted average common shares outstanding:**

Basic	5,591	7,564	11,405
Diluted	6,383	8,481	11,472

See accompanying notes to these consolidated financial statements.

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**Table of Contents****NATURAL GAS SERVICES GROUP, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY****For the Years Ended December 31, 2004, 2005 and 2006**

(amounts in thousands)

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

Issuance of common stock, net of offering costs	2,895	29	47,134		47,163
Net income				7,588	7,588

**BALANCES,**

December 31, 2006	\$	12,046	\$	120	\$	82,560	\$	18,521	\$	101,201
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See accompanying notes to these consolidated financial statements.

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**NATURAL GAS SERVICES GROUP, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(amounts in thousands)

	<b>For the Years Ended December 31,</b>		
	<b>2004</b>	<b>2005</b>	<b>2006</b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net income	\$ 3,374	\$ 4,446	\$ 7,588
<b>Adjustments to reconcile net income to net cash provided by operating activities:</b>			
Depreciation and amortization	2,444	4,224	6,020
Deferred taxes	1,120	2,408	2,544
Employee stock option expense		135	376
Loss (gain) on disposal of assets	71	(28)	13
Gross profit from sale of rental equipment			(1,263)
<b>Changes in current assets:</b>			
Trade accounts and other receivables	(1,182)	(1,352)	(2,271)
Inventory	(1,915)	(5,699)	(2,220)
Prepaid expenses and other	(34)	(362)	135
<b>Changes in current liabilities:</b>			
Accounts payable and accrued liabilities	1,264	337	(3)
Current income tax liability	20	187	849
Deferred income	(185)	(855)	122
Other assets	(279)	348	(46)
<b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>	<b>4,698</b>	<b>3,789</b>	<b>11,844</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Purchase of property and equipment	(11,596)	(17,708)	(27,684)
Purchase of short-term investments			(38,252)
Redemption of short-term investments			13,200
Assets acquired, net of cash		(7,584)	
Proceeds from sale of property and equipment	50	264	4,305
Changes in restricted cash	(2,000)	2,000	
<b>NET CASH USED IN INVESTING ACTIVITIES</b>	<b>(13,546)</b>	<b>(23,028)</b>	<b>(48,431)</b>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Net proceeds from line of credit	550	300	1,375
Proceeds from long-term debt	6,592	21,517	68
Repayments of long-term debt	(2,589)	(13,077)	(9,581)
Repayment of line of credit	(300)		(1,675)
Dividends paid on preferred stock	(53)		
Proceeds from exercise of stock options and warrants	5,157	13,085	357
Proceeds from sale of stock, net of transaction costs			47,163
<b>NET CASH PROVIDED BY FINANCING ACTIVITIES</b>	<b>9,357</b>	<b>21,825</b>	<b>37,707</b>
<b>NET CHANGE IN CASH</b>	<b>509</b>	<b>2,586</b>	<b>1,120</b>

<b>CASH AT BEGINNING OF PERIOD</b>	176	685	3,271
<b>CASH AT END OF PERIOD</b>	\$ 685	\$ 3,271	\$ 4,391

**SUPPLEMENTAL DISCLOSURES OF CASH FLOW  
INFORMATION:**

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

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

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

See accompanying notes to these consolidated financial statements.

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**NATURAL GAS SERVICES GROUP, INC. AND SUBSIDIARIES**

**1. Summary of Significant Accounting Policies**

***Organization and Principles of Consolidation***

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

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

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

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

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

***Nature of Operations***

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

***Use of Estimates***

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

***Cash Equivalents***

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

***Short-term Investments***

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

**Table of Contents*****Accounts Receivable***

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

***Revenue Recognition***

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

***Description of Rental Arrangements***

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

***Major Customers and Concentration of Credit Risk***

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

***Inventory***

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

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

***Property and Equipment***

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

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

***Goodwill***

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

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

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

***Intangibles***

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

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

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

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

***Patents***

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

***Restricted Cash***

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

**Table of Contents*****Other Assets***

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

***Warranty***

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

***Financial Instruments***

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

***Advertising Costs***

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

***Per Share Data***

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

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

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

**Table of Contents*****Income Taxes***

The Company files a consolidated tax return with its subsidiaries. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to temporary differences between the financial statement carrying amounts of assets and liabilities and their respective tax bases, and operating losses and tax credit carry-forwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled.

***Reclassification***

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

***Recently Issued Accounting Pronouncements***

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

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

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

***2. Acquisitions***

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

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

**Table of Contents**

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

\$8 million in cash;

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

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

This transaction was completed January 3, 2005 and Natural Gas Services Group, Inc. began reporting combined financial information with SCS in January 2005. The total purchase price was \$16.1 million and the Company recorded goodwill of approximately \$6.9 million, of which none is expected to be deductible for tax purposes and intangible assets of approximately \$4.2 million, reflecting the additional value to our previously existing operations achieved with this acquisition's ability to expand production capacity and product line. Intangible assets relate to developed technology, acquired customer contracts, distribution agreements, non-compete agreements and the trade name of SCS. The trade name of SCS was valued at \$0.7 million and will not be amortized as it was deemed to have an indefinite life. The remaining intangible assets of \$3.5 million had a weighted average life on the date of acquisition of sixteen years.

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

**(Unaudited)****Pro Forma Results**

(in thousands, except per share data)

	Twelve Months Ended December 31, 2004
Revenue	\$ 37,382
Net income available to common stockholders	4,148
Net income per common share, basic	0.67
Net income per common share, diluted	0.59
Summary of net assets acquired is as follows:	
Current assets	\$ 8,274
Other assets	3,047
Intangibles	4,218
Goodwill	7,468
Total assets	23,007
Current liabilities	3,180
Notes payable	1,403
Other liabilities	1,884
Total liabilities	6,467



Net assets			16,540
Acquisition expenses			(418)
Purchase price		\$	16,122

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**Table of Contents****3. Rental Activity**

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

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

**4. Property and Equipment**

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

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

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

**5. Line of Credit**

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

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

**Table of Contents****6. Long-term Debt**

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

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

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

2007	\$ 3,442
2008	3,378

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

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**Table of Contents****7. Subordinated Notes**

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

On January 3, 2005, the Company issued subordinated promissory notes to the owners of SCS as part of the consideration for the acquisition of Screw Compression Systems, Inc. The aggregate principal amount was \$3 million bearing interest at the rate of 4.00% per annum. Beginning January 1, 2006, a principal payment of \$1 million is due and payable each year until maturity on January 1, 2008, plus the current outstanding interest. The subordinated promissory notes are secured by a letter of credit in the face amount of \$2 million. As of December 31, 2006, \$2 million was outstanding on these notes.

**8. Income Taxes**

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

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

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

	2004	2005	2006
Deferred income tax assets:			
Net operating loss	\$ 2,669	\$ 984	\$
Alternative minimum tax credit		91	99
Other	7	60	242
Total deferred income tax assets	2,676	1,135	341
Deferred income tax liabilities:			
Property and equipment	(5,483)	(6,736)	(8,571)
Goodwill and other intangible assets	(142)	(1,575)	(1,508)
Other	(9)	(71)	(26)

Total deferred income tax liabilities	(5,634)	(8,382)	(10,105)
Net deferred income tax liabilities	\$ (2,958)	\$ (7,247)	\$ (9,764)

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

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

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**Table of Contents****9. Stockholders Equity*****Initial Public Offering***

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

***Secondary Public Offering***

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

***Conversion***

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

***Warrants***

In March 2001 and April 2002, five-year warrants to purchase 68.5 thousand shares of common stock at \$2.50 per share and 16.5 thousand shares at \$3.25 per share, respectively, were issued to certain board members and stockholders as compensation for their debt guarantees. All of these warrants have been exercised as of December 31, 2006.

***Preferred Stock***

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

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

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

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

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

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

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

## **10. Stock-Based Compensation**

### ***Stock Options***

Effective January 1, 2006, the Company adopted the fair value recognition provisions of Statement of Financial Accounting Standard 123(R) *Share-Based Payment* ( SFAS 123(R) ) using the modified prospective transition method. In addition, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 107

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

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



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

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

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

	<b>Years Ended December 31</b>	
	<b>2004</b>	<b>2005</b>
Net income, as reported	\$ 3,374	\$ 4,446
Less preferred dividends	53	
Income available to common stockholders	3,321	4,446
Compensation expenses regained under Opinion 25		135
Deduct: Total stock-based employee compensation expense determined under fair value method for all awards (net of tax)	(38)	(295)
Income available to common stockholders, pro forma	\$ 3,283	\$ 4,286
Earnings per common share:		
Basic, as reported	\$ 0.59	\$ 0.59
Basic, pro forma	\$ 0.59	\$ 0.57
Diluted, as reported	\$ 0.52	\$ 0.52
Diluted, pro forma	\$ 0.51	\$ 0.51
Weighted average fair value of options granted during the year	\$ 4.75	\$ 10.37

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

*Stock Option Plan*

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

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

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

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

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

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

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

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

Range of Exercise Prices	Shares	Options Outstanding		Options Exercisable	
		Weighted Average Remaining Contractual Life (years)	Weighted Average Exercise Price	Weighted Average Exercise Price	Weighted Average Exercise Price

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\$0.00 5.58	42,000	5.83	\$ 3.98	42,000	\$ 3.98
5.59 9.43	72,670	8.32	8.83	36,332	8.74
9.44 16.96	59,500	9.77	14.60	10,000	16.96
\$0.00-16.96	174,170	8.22	\$ 9.63	88,332	\$ 7.41

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

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

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

**11. Commitments****401(k) Plan**

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

**Rented Facilities**

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

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

**12. Other Income**

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

**Table of Contents****13. Segment Information**

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

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

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

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

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

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

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

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

Income before provision for income taxes	8,585	244	14,592	(11,546)	11,875
*Segment assets	\$	\$	\$	\$ 135,552	\$ 135,552

\* Management does not track assets by segment.

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

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

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INDEX TO EXHIBITS

(a) Exhibits

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



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Form of warrant issued in April 2002 for guaranteeing debt (Incorporated by reference to Exhibit 10.13 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)

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

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

- 10.20 Guaranty Agreement, dated as of January 3, 2005, made by Screw Compression Systems, Inc., for the benefit of Western National Bank (Incorporated by reference to Exhibit 10.4 of the Registrant's Current Report on Form 8-K, dated January 3, 2005, and filed with the Securities and Exchange Commission on January 7, 2005)
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Exhibit No.	Description
10.21	Fifth Amended and Restated Loan Agreement (Incorporated by reference to Exhibit 10.2 of the Registrant's Form 8-K dated January 3, 2006 and filed with the Securities and Exchange Commission January 6, 2006)
10.22	First Modification to Fourth Amended and Restated Loan Agreement (Incorporated by reference Exhibit 10.1 of the Registrant's Form 8-K dated May 1, 2005 and filed with Securities and Exchange Commission May 13, 2005)
10.23	Employment Agreement between Stephen C. Taylor and Natural Gas Services Group, Inc. (Incorporated by reference to Exhibit 10.1 of the Registrant's Form 8-K Report, dated August 24, 2005, and filed with the Securities and Exchange Commission on August 30, 2005)
10.24	Employment Agreement between James R. Hazlett and Natural Gas Services Group, Inc. (Incorporated by reference to Exhibit 10.1 of the Registrant's Form 8-K Report, dated June 14, 2005, and filed with the Securities and Exchange Commission on November 14, 2005)
10.25	Stockholders Agreement, dated January 3, 2005 among Paul D. Hensley, Tony Vohjesus, Jim Hazlett and Natural Gas Services Group, Inc. (Incorporated by reference to Exhibit 4.3 of the Registrant's Form 8-K Report, dated January 3, 2005, and filed with the Securities and Exchange Commission on January 7, 2005)
10.26	Promissory Note, dated January 3, 2005, in the original principal amount of \$300 thousand made by Natural Gas Services Group, Inc. payable to Jim Hazlett (Incorporated by reference to Exhibit 10.3 of the Registrant's Form 8-K Report, dated June 14, 2005, and filed with the Securities and Exchange Commission on November 14, 2005)
10.27	Retirement Agreement, dated December 14, 2005, between Wallace C. Sparkman and Natural Gas Services Group, Inc. (Incorporated by reference to Exhibit 10.1 of the Registrant's Form 8-K Report, dated December 14, 2005, and filed with the Securities and Exchange Commission on December 15, 2005)
10.28	Sixth Amended and Restated Loan Agreement, dated as of January 3, 2006 (Incorporated by reference to Exhibit 10.3 of the Registrant's Current Report on Form 8-K, dated January 3, 2006, and filed with the Securities and Exchange Commission on January 6, 2006)
10.29	Guaranty Agreement, dated as of January 3, 2006, and made by Screw Compression Systems, Inc. for the benefit of Western National Bank (Incorporated by reference to Exhibit 10.4 of the Registrant's Current Report on Form 8-K, dated January 3, 2006, and filed with the Securities and Exchange Commission on January 6, 2006)
10.30	Seventh Amended and Restated Loan Agreement (Incorporated by reference to Exhibit 10.1 of the Registrant's Form 8-K dated October 26, 2006 and filed with the Securities and Exchange Commission on November 1, 2006)
14.0	Code of Ethics (Incorporated by reference to Exhibit 14.0 of the Registrant's Form 10-KSB for the fiscal year ended December 31, 2004, and filed with the Securities and Exchange Commission on March 30, 2005)

21.0	Subsidiaries (Incorporated by reference to Exhibit 21.0 of the Registrant's Form 10-KSB for the fiscal year ended December 31, 2004, and filed with the Securities and Exchange Commission on March 30, 2005)
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Exhibit No.	Description
*23.1	Consent of Hein & Associates LLP
*31.1	Certification of Chief Executive Officer required by Section 302 of the Sarbanes-Oxley Act of 2002
*31.2	Certification of Chief Financial Officer required by Section 302 of the Sarbanes-Oxley Act of 2002
*32.1	Certification required by Section 906 of the Sarbanes-Oxley Act of 2002
*32.2	Certification required by Section 906 of the Sarbanes-Oxley Act of 2002
*	Filed herewith.