NATURAL GAS SERVICES GROUP INC
Form 10-K
March 09, 2009

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

[x] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2008
or
[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from________________________to__________________________
Commission file number: 1-31398

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

Colorado (State or other jurisdiction of incorporation or organization)	75-2811855 (I.R.S. Employer Identification No.)
508 W. Wall St, Suite 550 Midland, Texas (Address of principal executive offices)	79701 (Zip Code)
Registrant's telephone number, including area code:	(432) 262-2700

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

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

Securities registered pursuant to section 12(g) of the Act: None.

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

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 o No þ

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 þ No o

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 þ Non-Accelerated Filer ¨ Smaller Reporting Company ¨

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

The aggregate market value of voting and non-voting common equity held by non-affiliates of the Registrant as of March 2, 2009 was approximately $83,205,571, based on the closing price of the common stock on the same date.

At March 2, 2009, there were 12,093,833 shares of common stock outstanding.

Documents Incorporated by Reference

Certain information called for in Items 10, 11, 12, 13 and 14 of Part III are incorporated by reference from the registrant’s definitive proxy statement for the annual meeting of shareholders to be held on June 16, 2009.

FORM 10-K

NATURAL GAS SERVICES GROUP, INC.

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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 forward-looking statements. You should read statements that contain these words carefully and should not place undue reliance on these statements because they discuss future expectations, contain projections of results of operations or of our financial condition and/or state other "forward-looking" information. We do not undertake any obligation to update or revise publicly any forward-looking statements. Although we believe our expectations reflected in these forward-looking statements are based on reasonable assumptions, no assurance can be given that these expectations or assumptions will prove to have been correct. Important factors that could cause actual results to differ materially from the expectations reflected in the forward-looking statements include, but are not limited to, the following factors and the other factors described in this Annual Report on Form 10-K under the caption "Risk Factors":

- conditions in the oil and natural gas industry, including the demand for natural gas and wide fluctuations in the prices of oil and natural gas;
- 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;
- fabrication and manufacturing costs;
- general economic conditions;
- events similar to September 11, 2001; and
- fluctuations in interest rates.

We believe that it is important to communicate our expectations of future performance to our investors. However, events may occur in the future that we are unable to accurately predict or that we are unable to control. When considering our forward-looking statements, you should keep in mind the risk factors and other cautionary statements in this Annual Report on Form 10-K.

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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,” the “Company”, “we,” “us,” “our” or “ours” refer to Natural Gas Services Group, Inc. Certain specialized terms used describing our natural gas compressor business are defined in "Glossary of Industry Terms" on page 6.

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.

We were incorporated in Colorado on December 17, 1998

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 focused on the custom fabrication sales business. By acquiring SCS, we increased our fabrication facilities by over 91,000 square feet. We have primarily used this additional space for SCS’ core business of custom fabrication but have from time to time fabricated a minimal number of rental units. On June 30, 2007, we merged SCS into Natural Gas Services Group, Inc.

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 $85.3 million in 2008 from $10.3 million in 2002, the year we completed our initial public offering. During the same period, income from operations increased to $24.6 million from $1.8 million. Our compressor rental fleet has grown from 302 compressors at the end of 2002 to 1,730 compressors at December 31, 2008.

Net income for the year ended December 31, 2008 increased 27.0% to $15.6 million ($1.28 per diluted share), as compared to $12.3 million ($1.01 per diluted share) for the year ended December 31, 2007.

At December 31, 2008, current assets were $47.0 million, which included $1.1 million of cash and $2.3 million in short-term investments. Current liabilities were $15.9 million, and long-term debt, net of current portion, was $6.2 million. Our stockholders' equity as of December 31, 2008 was $130.5 million.

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

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. We believe that natural gas is a more environmentally friendly source of energy which is likely to result in increases in demand. Being primarily a provider of services and equipment to natural gas producers, we are more significantly impacted by changes in natural gas prices than by changes in crude oil and condensate prices. Longer term natural gas prices will be determined by the supply and demand for natural gas as well as the prices of competing fuels, such as oil and coal.

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

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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

We identify our segments based upon major revenue sources as Gas Compressor Rental, Engineered Equipment Sales, Service and Maintenance and Corporate. Please refer to Footnote 11 on page F-16 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 under contracts typically having minimum initial terms of six to 24 months. Historically, in our experience, most customers retain the equipment beyond the expiration of the initial term. By outsourcing their compression needs, we believe our customers are able to increase their revenues by producing a higher volume of natural gas due to greater equipment run-time. Outsourcing also allows our customers to reduce their compressor downtime, operating and maintenance costs and capital investments and more efficiently meet their changing compression needs. As of December 31, 2008, the utilization rate of our rental fleet was 84.9%.

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

As of December 31, 2008, we had 1,730 natural gas compressors in our rental fleet totaling approximately 217,085 horsepower, as compared to 1,353 natural gas compressors totaling approximately 160,733 horsepower at December 31, 2007. As of December 31, 2008, we had 1,469 natural gas compressors totaling approximately 184,831 horsepower rented to 112 third parties, compared to 1,194 natural gas compressors totaling approximately 140,853 horsepower rented to 94 third parties at December 31, 2007.

Engineered Equipment Sales. This segment includes the following components:

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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.

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- 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

Our intentions to grow our revenue and profitability are based on the following business strategies:

- Expand rental fleet. We intend to increase the size of our rental fleet by fabricating compressor units in numbers that correspond to the growth of the market and in relation to market share gains we may experience. We believe our growth will continue to be primarily driven through our placement of small to medium horsepower wellhead natural gas compressors for non-conventional natural gas production, which is the single largest and fastest growing segment of U.S. gas production according to data from the Energy Information Administration.

- Geographic expansion. We will continue to consolidate our operations in existing areas, as well as pursue focused expansion into new geographic regions as opportunities are identified.

- Expand our 'secondary' product lines. In addition to our primary rental and engineered product business lines, we will emphasize the growth of our other products, e.g., flares, CiP compressor products and general compressor maintenance and repair services.

- Selectively pursue acquisitions. We will continue to evaluate potential acquisitions that would provide us withaccess 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-serviced by our larger competitors which, coupled with our personalized services and in-depth knowledge of our customers' operating needs and growth plans, have allowed us to enhance our relationships with existing customers as well as attract new customers. The size, type and geographic diversity of our rental fleet enable us to provide customers with a range of compression units that can serve a wide variety of applications. We are able to select the correct equipment for the job, rather than the customer trying to fit its application to our equipment.

- Diversified product line. Our compressors are available as high and low pressure rotary screw and reciprocating packages. They are designed to meet a number of applications, including wellhead production, natural gas gathering, natural gas transmission, vapor recovery and gas and plunger lift. In addition, our compressors can be built to handle a variety of gas mixtures, including air, nitrogen, carbon dioxide, hydrogen sulfide and hydrocarbon gases. A diversified product line helps us compete by being able to satisfy widely varying pressure, volume and production conditions that customers encounter.

- Purpose built rental compressors. Our rental compressor packages have been designed and built to address the primary requirements of our customers in the producing regions in which we operate. Our units are compact in design and are easy, quick and inexpensive to move, install and start-up. Our control systems are technically advanced and allow the operator to start and stop our units remotely and/or in accordance with well conditions. We believe our rental fleet is also one of the newest with an average age of less than four years old.

- Experienced management team. On average, our executive and operating management team has over 30 years of oilfield services industry experience. We believe our management team has successfully demonstrated its ability to grow our business both organically and through selective acquisitions.

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- Broad geographic presence. We presently provide our products and services to a customer base of oil and natural gas exploration and production companies operating in New Mexico, Texas, Michigan, Colorado, Wyoming, Utah, Oklahoma, Pennsylvania, West Virginia and Kansas. Our footprint allows us to service many of the natural gas producing regions in the United States. We believe that operating in diverse geographic regions allows us better utilization of our compressors, minimal incremental expenses, operating synergies, volume-based purchasing, leveraged inventories and cross-trained personnel.

- Long-standing customer relationships. We have developed long-standing relationships providing compression equipment to many major and independent oil and natural gas companies. Our customers generally continue to rent our compressors after the expiration of the initial terms of our rental agreements, which we believe reflects their satisfaction with the reliability and performance of our services and products.

Major Customers

Sales and rental income to XTO Energy, Inc. and Energen Resources Corporation in the year ended December 31, 2006 amounted to 39% and 12% of consolidated revenue, respectively. Sales and rental income to XTO Energy, Inc. and Devon Energy, Inc. in the year ended December 31, 2007 amounted to 40% and 12% of consolidated revenue, respectively. Sales and rental income to XTO Energy, Inc. and Devon Energy, Inc. in the year ended December 31, 2008 amounted to 26% and 14% of consolidated revenue, respectively. No other single customer accounted for more than 10% of our revenues in 2006, 2007 or 2008. XTO Energy, Inc. amounted to 64% and 35% of our consolidated accounts receivable as of December 31, 2007 and 2008, respectively, and Equipos y Sistemas Dinamicos amounted to 14% of our consolidated accounts receivable as of December 31, 2008. No other customer amounted to more than 10% of our consolidated accounts receivable as of December 31, 2007 and 2008. 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.

Sales and Marketing

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

Competition

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

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

Backlog

As of December 31, 2008, we had a sales backlog of approximately $18.0 million. We expect to fulfill substantially all of the entire backlog in 2009. 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. Given the recent dramatic downturn in oil and natural gas prices, there can be no assurance that a significant number of the orders representing such backlog will not be cancelled. In addition, the major components of our compressors are acquired from suppliers through periodic purchase orders that in many instances require three or four months of lead time prior to delivery of the order. Thus, to the extent that we suffer an unusual number of order cancellations after we have placed our component purchase orders, we may be left with an excessive inventory of component parts.

Employees

As of December 31, 2008, we had 309 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 and which includes environment cleanup, but excludes product warranty insurance because the majority of components on our compressor unit are covered by the manufacturers. We also maintain insurance with respect to our facilities. Based on our historical experience, we believe that our insurance coverage is adequate. However, there is a risk that our insurance may not be sufficient to cover any particular loss or that insurance may not cover all losses. In addition, insurance rates have in the past been subject to wide fluctuation, and changes in coverage could result in less coverage, increases in cost or higher deductibles and retentions.

Government Regulation

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

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

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

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

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

· owners and operators of sites,

· persons who disposed of or arranged for the disposal of "hazardous substances" found at sites.

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

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

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

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

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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 this patent to be material to our business as a whole.

Suppliers and Raw Materials

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

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 associated with owning 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 your investment in 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 could 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 completions activity;
- inclement weather;
- domestic and worldwide economic activity;
- regulatory and other federal and state requirements in the United States;
- the ability of the Organization of Petroleum Exporting Countries and other large producers to set and maintain production levels and prices for oil;
- political conditions in or affecting oil and natural gas producing countries;
- terrorist activities in the United States and elsewhere;
- the cost of developing alternate energy sources;

- environmental regulation; and
- tax policies.

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

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

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

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

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

Our industry is highly cyclical, with periods of high demand and high pricing followed by periods of low demand and low pricing. Periods of low demand intensify the competition in the industry and often result in rental equipment being idle for long periods of time. We may be required to enter into lower rate rental contracts in response to market conditions, and our sales may decrease as a result of such conditions.

Due to the short-term nature of most of our rental contracts, changes in market conditions can quickly affect our business. As a result of the cyclicality 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, wash down wastes, and sandblast material. We attempt to use generally accepted operating and disposal practices and, with respect to acquisitions, will attempt to identify and assess whether there is any environmental risk before completing an acquisition. Based on the nature of the industry, however, hydrocarbons or other wastes may have been disposed of or released on or under properties owned or leased by us or on or under other locations where such wastes have been taken for disposal. The waste on these properties may be subject to federal or state environmental laws that could require us to remove the wastes or remediate sites where they have been released. We could be exposed to liability for cleanup costs, natural resource and other damages as a result of our conduct or the conduct of, or conditions caused by, prior owners, lessees or other third parties. Environmental laws and regulations have changed in the past, and they are likely to change in the future. If current existing regulatory requirements or enforcement policies change, we may be required to make significant unanticipated capital and operating expenditures.

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

- issuance of administrative, civil and criminal penalties;

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

Risks Associated With Our Company

We might be unable to employ qualified 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.

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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 2009, capital expenditures related to rental compression equipment will be determined primarily by the activity of our customers, and we do not anticipate that demand exceeding what we can fund with internally generated funds. The amount and timing of any of these capital expenditures may vary depending on a variety of factors, including the level of activity in the oil and natural gas exploration and production industry and the presence of alternative uses for our capital, including any acquisitions that we may pursue.

Historically, we have funded our capital expenditures through internally generated funds, borrowings under bank credit facilities and the proceeds of equity financings. Although we believe that cash flows from our operations will provide us with sufficient cash to fund our planned capital expenditures for 2009, 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 2009, 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 may negatively impact our current and future financial stability.

As of December 31, 2008, we had an aggregate of approximately $17.0 million of outstanding indebtedness, and accounts payable and accrued expenses of approximately $12.4 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, 2008, 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.

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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.

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

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

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

As of December 31, 2008, 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. We had two customers that accounted for approximately 26% and 14% of our consolidated revenue for the year ended December 31, 2008, and approximately 40% and 12% of our consolidated revenue for the year ended December 31, 2007. 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.

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Excessive cancellations of backlog orders may have a material adverse effect on our operations.

As of December 31, 2008, we had a sales backlog of approximately $18.0 million. Given the recent dramatic downturn in oil and natural gas prices, we may experience a significant number of order cancellations by our customers as they cut back their operations or encounter financial difficulties. Cancellations of a significant amount of sales backlog could have a material negative impact on our results of operations. In addition, the major components of our compressors are acquired from suppliers through periodic purchase orders that in many instances require three to four months of lead time prior to delivery of the order. Thus, to the extent that we suffer an unusual number or order cancellations after we have placed our component purchase orders, we could be left with an excessive inventory of components which would negatively impact our financial condition and results of operations.

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

We depend on the continued employment and performance of key members of our executive and senior management team. If any of our key managers resign or become unable to continue in his present role and is not adequately replaced, our business operations could be materially adversely affected. We do not carry any key-man insurance on any of our officers or directors.

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

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

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

Liability to customers under warranties 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. 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.

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We did not indentify any impairment based on an independent valuation as of June 2006 and internal evaluations in December 2007 and 2008 of our reporting units with goodwill and other identifiable intangibles. Future impairment tests could result in impairments of our intangible assets or goodwill. We expect to continue to amortize our intangible assets with finite lives over the same time periods as previously used, and we will test our intangible assets with indefinite lives for impairment at least once each year. In addition, we are required to assess the consumptive life, or longevity, of our intangible assets with finite lives and adjust their amortization periods accordingly. Our net goodwill and intangible assets were recorded on our balance sheet at approximately $13.4 million and $13.1 million as of December 31, 2007 and 2008, respectively. Our identifiable intangibles are currently amortized at a rate of $299,000 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.

A reduction in demand for oil or natural gas or prices for those commodities and credit markets could adversely affect our business.

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

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

Many of our customers finance their exploration and development activities through cash flow from operations, the incurrence of debt or the issuance of equity. During times when the oil or natural gas markets weaken, our customers are more likely to experience a downturn in their financial condition. Many of our customers' equity values have substantially declined in recent months, and the capital markets have been unavailable as a source of financing to these customers. The combination of a reduction in cash flow resulting from declines in commodity prices, a reduction in borrowing bases under reserve-based credit facilities and the lack of availability of debt or equity financing will result in a reduction in our customers' spending for our products and services in 2009. For example, our customers could seek to preserve capital by canceling month-to-month contracts, canceling or delaying scheduled maintenance of their existing natural gas compression equipment or determining not to enter into any new natural gas compression service contracts or purchase new compression equipment.

Risks Associated With Our Common Stock

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

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

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

Substantial sales of our common stock in the public market, or the perception by the market that those sales could occur, may lower our stock price or make it difficult for us to raise additional equity capital in the future. These potential sales could include sales of shares of our common stock by our Directors and officers, who beneficially owned approximately 7.0% of the outstanding shares of our common stock as of March 2, 2009.

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.

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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.

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

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

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

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

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

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

- directors are elected for three-year terms, with approximately one-third of the board of directors standing for election each year;
- cumulative voting is not allowed, which limits the ability of minority shareholders to elect any directors;
- the unanimous vote of the board of directors or the affirmative vote of the holders of not less than 80% of the votes entitled to be cast by the holders of all shares entitled to vote in the election of directors is required to change the size of the board of directors; and
- directors may be removed only for cause and only by the holders of not less than 80% of the votes entitled to be cast on the matter.

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

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ITEM 2. PROPERTIES

The table below describes the material facilities owned or leased by Natural Gas Services Group as of December 31, 2008:

Location	Status	Square Feet	Uses
Tulsa, Oklahoma	Owned and Leased	91,780	Compressor fabrication, rental and services
Midland, Texas	Owned	58,000	Compressor fabrication, rental and services
Midland, Texas (1)	Owned	24,600	Compressor fabrication, rental and services
Lewiston, Michigan	Owned	15,360	Compressor fabrication, rental and services
Midland, Texas	Leased	13,135	Corporate offices
Bloomfield, New Mexico	Lease	4,672	Office and parts and services
Bridgeport, Texas	Leased	4,500	Office and parts and services
Midland, Texas	Owned	4,100	Parts and services
		216,147	

(1) We currently are not using this facility and have it listed for sale.

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

ITEM 3. LEGAL PROCEEDINGS

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

On February 21, 2008, we received notice of a lawsuit filed against us on January 28, 2008 in Montmorency County, Michigan, 26th Circuit Court, Case No. 08-0001901-NZ, styled Dyanna Louise Williams, Plaintiff, v. Natural Gas Services Group, Inc. and Great Lakes Compression, Defendants. In this lawsuit, plaintiff alleges breach of contract, breach of fiduciary duty and negligence. Plaintiff seeks damages in the amount of $100,000 for lost insurance benefits and an unspecified amount of exemplary damages. As the basis for her claims, plaintiff generally alleges that she is the third party beneficiary of a life insurance policy obtained by her deceased ex-husband through Natural Gas Services Group's insurance program, and that as a result of Natural Gas Service Group's negligence and failure to use due care in processing an application for life insurance prior to her ex-husband's death, she was denied $100,000 of life insurance proceeds. Plaintiff now seeks to recover $100,000 from Natural Gas Services Group, plus an unspecified amount of exemplary damages. On January 21, 2009, we received the Order and Judgment from the Court granting our Motion for Summary Judgment and dismissing the Williams suit with prejudice. This means that all claims are dismissed and may not be reasserted. We have not established a reserve with respect to plaintiff's claims.

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 2008.

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PART II

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

Our common stock currently trades on the New York Stock Exchange under the symbol "NGS". Prior to October 30, 2008 our common stock traded on the American Stock Exchange (AMEX). The following table sets forth for the periods indicated the high and low sales prices for our common stock as reported by these Exchanges.

2006	Low	High
First Quarter	$ 16.57	$ 22.80
Second Quarter	13.77	18.00
Third Quarter	12.01	16.69
Fourth Quarter	12.76	16.43
2007		
First Quarter	$ 11.68	$ 15.00
Second Quarter	13.55	19.90
Third Quarter	13.55	18.81
Fourth Quarter	16.45	19.61
2008		
First Quarter	$ 16.63	$ 23.35
Second Quarter	22.28	32.56
Third Quarter	15.77	29.70
Fourth Quarter	6.60	16.81

As of December 31, 2008 in accordance with our transfer agent records, we had 20 record holders of our common stock. This number does not include any beneficial owners for whom shares of common stock may be held in "nominee" or "street" name. On March 2, 2009, the last reported sale price of our common stock as reported by the New York Stock Exchange was $6.88 per share.

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Dividends

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

Equity Compensation Plans

The following table summarizes certain information regarding our equity compensation plans as of December 31, 2008:

Plan Category	(a) Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights	(b) Weighted-average Exercise Price of Outstanding Options, Warrants and Rights	(c) Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column (a))
Equity compensation plans approved by security holders	219,501(1)	$ 15.71	337,500
Stock options granted during the year ended December 31, 2008		$ 8.46	113,000
Equity compensation plans not approved by security holders	45,000(2)	$ 9.22	
Total	264,501	$ 14.61	224,500

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

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

Repurchase of Equity Securities

No repurchases of our securities were made by us or on our behalf by any "affiliated purchaser" during the fourth quarter of the fiscal year ended December 31, 2008.

Sale of Unregistered Securities

We made no sales of unregistered securities during the year ended December 31, 2008.

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, 2008. This information is only a summary and it is important that you read this information along with our audited consolidated financial statements and related notes, and "Management's Discussion and Analysis of Financial Condition and Results of Operations" under Item 7 below, which discusses factors affecting the comparability of the information presented. The selected financial information provided is not necessarily indicative of our future results of operations or financial performance.

	Year Ended December 31,				
	2004	2005(1)	2006	2007	2008
	(in thousands, except per share amounts)				
CONSOLIDATED STATEMENTS OF INCOME AND OTHER INFORMATION:					
Revenues	$ 15,958	$ 49,311	$ 62,729	$ 72,489	$ 85,336
Costs of revenue, exclusive of depreciation shown separately below	6,951	31,338	39,308	41,106	44,994
Gross margin(2)	9,007	17,973	23,421	31,383	40,342
Depreciation and amortization	2,444	4,224	6,020	7,470	9,925
Other operating expenses	2,652	4,890	5,270	5,324	5,842
Operating income	3,911	8,859	12,131	18,589	24,575
Total other income (expense)(3)	603	(1,798)	(256)	144	355
Income before income taxes	4,514	7,061	11,875	18,733	24,220
Income tax expense	1,140	2,615	4,287	6,455	8,627
Net income	3,374	4,446	7,588	12,278	15,593
Preferred dividends	53				
Net income available to common stockholders	$ 3,321	$ 4,446	$ 7,588	$ 12,278	$ 15,593

Net income per common share:					
Basic	$ 0.59	$ 0.59	$ 0.67	$ 1.02	$ 1.29
Diluted	$ 0.52	$ 0.52	$ 0.66	$ 1.01	$ 1.28
Weighted average shares of common stock outstanding:					
Basic	5,591	7,564	11,405	12,071	12,090
Diluted	6,383	8,481	11,472	12,114	12,143
EBITDA(4)	$ 7,796	$ 13,282	$ 19,541	$ 27,358	$ 34,887

	As of December 31,				
	2004	2005	2006	2007	2008
	(in thousands)				
BALANCE SHEET INFORMATION:					
Current assets	$ 7,295	$ 24,642	$ 55,170	$ 55,222	$ 47,032
Total assets	43,255	86,369	135,552	153,233	181,050
Long-term debt (including current portion)	15,017	28,205	18,392	13,950	17,013
Stockholders’ equity	22,903	45,690	101,201	114,380	130,450

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(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" in our 2007 10-K and "Item 13. Certain Relationships, and Related Transactions, and Director Independence – Acquisition of Screw Compression Systems, Inc." in this Annual Report on Form 10-K.
(2) Gross margin is defined, reconciled to net income and discussed further below under "-- Non-GAAP Financial Measures".
(3) Total other income (expense) for the year ended December 31, 2004 includes $1.5 million in life insurance proceeds paid to us upon the death of our former Chief Executive Officer.
(4) EBITDA is defined, reconciled to net income and discussed further below under "-- Non-GAAP Financial Measures".

Non-GAAP Financial Measures

Our definition and use of EBITDA

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

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

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

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

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

- EBITDA does not reflect our cash expenditures, or future requirements for capital expenditures or contractualcommitments;

- EBITDA does not reflect changes in, or cash requirements for, our working capital needs;

- EBITDA does not reflect the cash requirements necessary to service interest or principal payments on our debts;and;

- although depreciation and amortization are non-cash charges, the assets being depreciated and amortized willoften have to be replaced in the future, and EBITDA does not reflect any cash requirements for suchreplacements.

There are other material limitations to using EBITDA as a measure of performance, including the inability to analyze the impact of certain recurring items that materially affect our net income or loss, and the lack of comparability of results of operations of different companies. Please read the table below under “Reconciliation” to see how EBITDA reconciles to our net income, the most directly comparable GAAP financial measure.

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Our definition and use of gross margin

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

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

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

Reconciliation

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

	Year Ending December 31,				
	2004	2005	2006	2007	2008
	(in thousands)				
Net Income	$ 3,374	$ 4,446	$ 7,588	$ 12,278	$ 15,593
Interest expense, net	838	1,997	1,646	1,155	742
Income taxes	1,140	2,615	4,287	6,455	8,627
Depreciation and amortization	2,444	4,224	6,020	7,470	9,925
EBITA	$ 7,796	$ 13,282	$ 19,541	$ 27,358	$ 34,887
Other operating expenses	2,652	4,890	5,270	5,324	5,842
Other expenses (income)	(1,441)	(199)	(1,390)	(1,299)	(387)
Gross Margin	$ 9,007	$ 17,973	$ 23,421	$ 31,383	$ 40,342

ITEM 7.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion is intended to assist you in understanding our financial position and results of operations for each of the years ended December 31, 2006, 2007, and 2008. 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, 2008, we had 1,469 natural gas compressors totaling approximately 184,831 horsepower rented to 112 third parties, compared to 1,194 natural gas compressors totaling approximately 140,853 horsepower rented to 94 third parties at December 31, 2007.

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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,		
	2006	2007	2008
	(in thousands)		
Sales	$ 38,214	$ 41,088	$ 41,380
Rental	23,536	30,437	42,864
Service and maintenance	979	964	1,092
Total	$ 62,729	$ 72,489	$ 85,336

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

The oil and 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 service and equipment companies.

In general, we expect our overall business activity and revenues to track the level of activity in the natural gas industry, with changes in domestic natural gas production and consumption levels and prices more significantly affecting our business than changes in crude oil and condensate production and consumption levels and prices. We also believe that demand for compression services and products is driven by declining reservoir pressure in maturing natural gas producing fields and, more recently, by increased focus by producers on non-conventional natural gas production, such as 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 2007 and 2008, but in 2009 demand may decline due to lower oil and natural gas prices and decreased demand for natural gas. We believe the long-term trend in our markets is favorable.

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For fiscal year 2009, our forecasted capital expenditures will be directly dependent upon our customers' compression requirements and are not anticipated to exceed our internally generated cash flows. Any required capital will be for additions to our compressor rental fleet and/or addition or replacement of service vehicles. We believe that cash flows from operations will be sufficient to satisfy our capital and liquidity requirements through 2009. We may require additional capital to fund any unanticipated expenditures, including any acquisitions of other businesses, although that capital may not be available to us when we need it or on acceptable terms.

Our Performance Trends and Outlook

Given the current economic environment in North America and anticipated impact of lower natural gas prices and capital spending by customers, we expect lower overall activity levels in 2009 than in 2008. Currently, we believe the recent decline in commodity prices and the impact of uncertain credit and capital market conditions resulting from the financial crisis will negatively impact the level of capital spending by our customers in 2009 in comparison to 2008 levels. We believe that an extended recession would lower capital spending by our customers and therefore negatively impact demand for our products and services. As we anticipate industry capital spending will decline in 2009 from 2008 levels, we believe our fabrication business segment will likely see order cancellations and requests by our customers to delay delivery on existing backlog, as well as an overall reduction in demand and profitability. These conditions are also expected to negatively impact our rental operations business, although the effects could be less severe on that business because it is not directly related to capital expenditures and it has historically experienced more stable demand than that for certain other energy service products and services.

Results of Operations

Year Ended December 31, 2008 Compared to the Year Ended December 31, 2007

The table below shows our revenues, percentage of total revenues, gross margin, exclusive of depreciation, and gross margin percentage of each of our segments for the years ended December 31, 2008 and December 31, 2007. Gross margin is the difference between revenue and cost of sales, exclusive of depreciation.

	Revenue				Gross Margin, Exclusive of Depreciation(1)			
	Year Ended December 31,				Year Ended December 31,			
	2007		2008		2007		2008	
	(dollars in thousands) (unaudited)							
Sales	$41,088	56.7%	$41,380	48.5%	$12,964	31.6%	$13,328	32.2%
Rental	30,437	42.0%	42,864	50.2%	18,055	59.3%	26,671	62.2%
Service and maintenance	964	1.3%	1,092	1.3%	364	37.8%	343	31.4%
Total	$72,489		$85,336		$31,383	43.3%	$40,342	47.3%

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

Total revenues for the year ended December 31, 2008 increased 17.7% to $85.3 million, as compared to $72.5 million for the year ended December 31, 2007. The increase mainly reflects the increase in our rental revenues.

Sales revenue increased from $41.1 million to $41.4 million, or less than 1.0%, for the year ended December 31, 2008, compared to the year ended December 31, 2007. This increase is mainly represented by a 38.7% increase in part sales which is only 1.9% of our total sales. The total category includes (1) compressor unit sales (including used rental equipment), (2) flare sales, (3) parts sales, and (4) compressor rebuilds.

Rental revenue increased from $30.4 million to $42.9 million, or 40.8%, for the year ended December 31, 2008, compared to the year ended December 31, 2007. The increase is mainly the result of units added to our rental fleet and rented to third parties. As of December 31, 2008, we had 1,730 natural gas compressors in our rental fleet totaling approximately 217,085 horsepower, as compared to 1,353 natural gas compressors totaling approximately 160,733 horsepower at December 31, 2007. As of December 31, 2008, we had 1,469 natural gas compressors rented compared to 1,194 at December 31, 2007. The average monthly rental rate per unit increased to $2,900 at December 31, 2008 compared to $2,300 at December 31, 2007. This increase resulted from the addition of larger horsepower units to our rental fleet and therefore has a higher rental rates.

Service and maintenance revenue increased from $964,000 to $1.1 million, or 13.3%, for the year ended December 31, 2008, compared to the year ended December 31, 2007. This increase is the result of gain in service revenue for all districts except Midland.

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The overall gross margin percentage, exclusive of depreciation, increased to 47.3% for the year ended December 31, 2008, as compared to 43.3% for the year ended December 31, 2007. This increase is result of two factors: (1) rentals which have a higher margin than our other sources of revenue increased (rental revenue increased to 50.2% from 42.0% of our total revenue for the year ended December 31, 2008 compared to the same period ended December 31, 2007); and (2) our rental margin increased to 62.2% from 59.3% for the year ended December 31, 2008 compared to the same period ended December 31, 2007. This margin increase is the result of greater efficiencies in our field service operations and from increasing our rental rates.

Selling, general and administrative expense increased to $5.8 million or 6.8% of total revenue from $5.3 million or 7.3% of our total revenue, for the year ended December 31, 2008 compared to the year ended December 31, 2007. Our selling expenses increased 29.4% and our general and administrative expenses increased 5.5% for year ended December 31, 2008, compared to same period in 2007. Selling expenses mainly increased as result of increased commissions on larger sales numbers and changes to the commission structure. General and administrative expenses increased mainly as a result of additions to the administrative staff, salary increases and stock option expense.

Depreciation and amortization expense increased 32.9% from $7.5 million to $9.9 million for the year ended December 31, 2008, compared to the same period in 2007. There was a net increase of 377 natural gas compressor units to our rental fleet between December 31, 2007 and 2008, thus increasing our depreciable base.

Other income decreased approximately $911,000 for the year ended December 31, 2008, compared to the same period in 2007. This decrease was mainly the result of reduced interest income from our short-term investment account. Our short-term investments decreased to $2.3 million at December 31, 2008, compared to $18.7 million at December 31, 2007. This reduction resulted from the capital funding of our natural gas compressor rental fleet.

Interest expense decreased by $412,000, or 35.7%, for the year ended December 31, 2008, compared to the same period in 2007, mainly due to a decrease in our loan balances. Our loan balance decreased $4.0 million, and our line increased, during the later part of the year, from $600,000 to $7 million.

Provision for income tax increased by $2.2 million, or 33.7%, and is mainly the result of the increase in taxable income.

Year Ended December 31, 2007 Compared to the Year Ended December 31, 2006

The table below shows our revenues, percentage of total revenues, gross margin, exclusive of depreciation, and gross margin percentage of each of our segments for the years ended December 31, 2007 and December 31, 2006. Gross margin is the difference between revenue and cost of sales, exclusive of depreciation.

	Revenue				Gross Margin, Exclusive of Depreciation(1)			
	Year Ended December 31,				Year Ended December 31,			
	2006		2007		2006		2007	
	(dollars in thousands) (unaudited)							
Sales	$38,214	60.9%	$41,088	56.7%	$8,585	22.5%	$12,964	31.6%
Rental	23,536	37.5.%	30,437	42.0%	14,592	62.0%	18,055	59.3%
Service and maintenance	979	1.6%	964	1.3%	244	24.9%	364	37.8%
Total	$62,729		$72,489		$23,421	37.3%	$31,383	43.3%

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

Total revenues for the year ended December 31, 2007 increased 15.6% to $72.5 million, as compared to $62.7 million for the year ended December 31, 2006. The increase in revenue reflects the increase in our rental revenue and unit sales to third parties.

Sales revenue increased from $38.2 million to $41.1 million, or 7.5%, for the year ended December 31, 2007, compared to the year ended December 31, 2006. This increase was mainly sales of natural gas compressor units from our Tulsa location, but this category includes (1) compressor unit sales (including used rental equipment), (2) flare sales, (3) parts sales, and (4) compressor rebuilds.

Service and maintenance revenue decreased from $979,000 to $964,000, or 1.5%, for the year ended December 31, 2007, compared to the year ended December 31, 2006. This reduction was mainly the result of our strategy implemented in 2006 to move away from pursuing third party service work.

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Rental revenue increased from $23.5 million to $30.4 million, or 29.3%, for the year ended December 31, 2007, compared to the year ended December 31, 2006. The increase was mainly the result of units added to our rental fleet and rented to third parties. As of December 31, 2007, we had 1,353 natural gas compressors in our rental fleet totaling approximately 160,733 horsepower, as compared to 1,111 natural gas compressors totaling approximately 129,158 horsepower at December 31, 2006. As of December 31, 2007, we had 1,194 natural gas compressors rented compared to 974 at December 31, 2006. The average monthly rental rate per unit increased to $2,400 at December 31, 2007 compared to $2,300 at December 31, 2006. This increase resulted from the addition of larger units to our rental fleet which command higher rental rates.

The overall gross margin percentage, exclusive of depreciation, increased to 43.3% for the year ended December 31, 2007, as compared to 37.3% for the year ended December 31, 2006. This increase was mainly the result of higher margins from our natural gas compressor unit sales. Our natural gas compressor unit sales gross margins increased to 31.6% for the year ended December 31, 2007, as compared to 22.5% for the year ended December 31, 2006, as a result of our improvement in labor efficiencies.

Selling, general and administrative expense remained flat at $5.3 million for the years ended December 31, 2006 and 2007. Our selling expenses decreased 34.9%, but were offset by an increase of 8.8% in general and administrative expenses for the year ended December 31, 2007, compared to the same period in 2006. Selling expenses decreased as a result of changes in the sales staff, department manager and sales commission structure. General and administrative expenses increased mainly as a result of additions to the administrative staff, salary increases and stock option expense.

Depreciation and amortization expense increased 24.1% from $6.0 million to $7.5 million for the year ended December 31, 2007, compared to the year ended December 31, 2006. There was a net increase of 242 natural gas compressor units to our rental fleet between December 31, 2006 and 2007, thus increasing our depreciable base.

Other income decreased approximately $91,000 for the year ended December 31, 2007, compared to the same period in 2006. This decrease was mainly the result of reduced interest income from our short-term investment account. Our short-term investments decreased to $18.7 million at December 31, 2007, compared to $25.1 million at December 31, 2006. This reduction resulted from the capital funding of our natural gas compressor rental fleet.

Interest expense decreased by $491,000, or 29.8%, for the year ended December 31, 2007, compared to the same period in 2006, mainly due to a decrease in our loan balance. Our loan balance decreased $3.8 million during the year ended December 31, 2007.

Provision for income tax increased by $2.2 million, or 50.6%, and is the result of the increase in taxable income, and offset by a lower income tax rate. Our effective income tax rate decreased from 36% in 2006 to 34% in 2007. This decrease was driven by a higher federal domestic production activity deduction and a lower state tax assessment.

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 receivable;
- accounting for income taxes;
- valuation of long-lived and intangible assets and goodwill; and
- valuation of inventory

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Revenue Recognition

Revenue from the sales of custom and fabricated compressors and flare systems is recognized upon shipment of the equipment to customers. 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, 2008, two customers accounted for approximately 35% and 14%, respectively, of our consolidated accounts receivable, and at December 31, 2007, one customer accounted for approximately 64% of our consolidated accounts receivable. A significant change in the liquidity or financial position of this customer could have a material adverse impact on the collectability of our accounts receivables and our future operating results.

Accounting for Income Taxes

As part of the process of preparing our 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 did not indentify any impairment based on an independent valuation as of June 2006 and internal evaluations in December 2007 and 2008 of our reporting units with goodwill and other identifiable intangibles. Future impairment tests could result in impairments of our intangible assets or goodwill. We expect to continue to amortize our intangible assets with finite lives over the same time periods as previously used, and we will test our intangible assets with indefinite lives for impairment at least once each year. In addition, we are required to assess the consumptive life, or longevity, of our intangible assets with finite lives and adjust their amortization periods accordingly. Our net goodwill and intangible assets were recorded on our balance sheet at approximately $13.4 million and $13.1 million as of December 31, 2007 and 2008, respectively. Our identifiable intangibles are currently amortized at a rate of $299,000 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.

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Inventories

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

Recently Issued Accounting Pronouncements

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements, which defines fair value, establishes a framework for measuring fair value in GAAP, and expands disclosures about fair value measurements. This Statement applies under other accounting pronouncements that require or permit fair value measurements and is effective for fiscal years beginning after November 15, 2007. In February 2008, the FASB issued FASB Staff Position No. FAS 157-2, which defers the effective date of SFAS 157 for nonfinancial assets and non financial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually) to fiscal years beginning after November 15, 2008 and interim periods within those fiscal years. We adopted the required provisions of SFAS 157 on January 1, 2008 and the adoption did not have a significant impact on our financial statements.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities-Including an amendment of FASB Statement No. 115 (“SFAS 159”). SFAS 159 permits entities to measure eligible assets and liabilities at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings. SFAS 159 is effective for fiscal years beginning after November 15, 2007. We adopted SFAS 159 on January 1, 2008 and did not adopt the fair value option, thus, the adoption did not have a significant impact on our financial statements.

In December 2007, the FASB issued SFAS No. 141(R), Business Combinations, which replaces SFAS No. 141, Business Combinations, requires an acquirer to recognize the assets acquired, the liabilities assumed, and any non-controlling interest in the acquiree at the acquisition date, measured at their fair values as of that date, with limited exceptions. This Statement also requires the acquirer in a business combination achieved in stages to recognize the identifiable assets and liabilities, as well as the non-controlling interest in the acquiree, at the full amounts of their fair values. SFAS No. 141(R) makes various other amendments to authoritative literature intended to provide additional guidance or to confirm the guidance in that literature to that provided in this Statement. This Statement applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. We do not expect this SFAS will have a significant impact on our financial statements.

In December 2007, FASB issued SFAS No. 160, Non-controlling Interests in Consolidated Financial Statements, which amends Accounting Research Bulletin No. 51, Consolidated Financial Statements, to improve the relevance, comparability, and transparency of the financial information that a reporting entity provides in its consolidated financial statements. SFAS No. 160 establishes accounting and reporting standards that require the ownership interests in subsidiaries not held by the parent to be clearly identified, labeled and presented in the consolidated statement of financial position within equity, but separate from the parent’s equity. This statement also requires the amount of consolidated net income attributable to the parent and to the non-controlling interest to be clearly identified and presented on the face of the consolidated statement of income. Changes in a parent’s ownership interest while the parent retains its controlling financial interest must be accounted for consistently, and when a subsidiary is deconsolidated, any retained non-controlling equity investment in the former subsidiary must be initially measured at fair value. The gain or loss on the deconsolidation of the subsidiary is measured using the fair value of any non-controlling equity investment. The Statement also requires entities to provide sufficient disclosures that clearly identify and distinguish between the interests of the parent and the interests of the non-controlling owners. This Statement applies prospectively to all entities that prepare consolidated financial statements and applies prospectively for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. We do not expect this SFAS will have a significant impact on our financial statements.

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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

Our working capital positions as of December 31, 2007 and 2008 are set forth below.

		2007		2008
		(in thousands)		
Current Assets:				
Cash and cash equivalents	$	245	$	1,149
Short-term investments		18,661		2,300
Trade accounts receivable, net		11,322		11,321
Inventory, net		20,769		31,931
Prepaid income taxes		3,584		244
Prepaid expenses and other		641		87
Total current assets		55,222		47,032
Current Liabilities:				
Current portion of long-term debt and subordinated notes		4,378		3,378
Line of credit		600		
Accounts payable		4,072		8,410
Accrued liabilities		3,990		3,987
Current portion of tax liability		3,525		110
Deferred income		81		38
Total current liabilities		16,646		15,923
Total working capital	$	38,576	$	31,109

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

For the year ended December 31, 2008, we invested approximately $46.3 million in equipment for our rental fleet, service vehicles and additions to our facilities. We financed this activity with the proceeds from our March 2006 public offering of common stock and funds from operations and we borrowed approximately $7.0 million from our bank in 2008. We also repaid approximately $5.4 million of our existing debt during 2008.

Cash flows

At December 31, 2007, we had cash and cash equivalents of approximately $245,000, working capital of $38.6 million and total debt of $14.6 million, of which approximately $5.0 million was classified as current. At that same date, we also had letters of credit outstanding in the aggregate face amount of $1.0 million. We had positive net cash flow from operating activities of approximately $18.3 million during 2007. This was primarily from net income of $12.3 million, plus depreciation and amortization of $7.5 million, an increase in deferred taxes of $2.9 million, in increase in accounts payable and accrued liabilities including income taxes of $5.8 million, offset by an increase in trade accounts receivable of $2.9 million, and increase in inventory of $3.8 million, and an increase in prepaid expense of $3.9 million.

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At December 31, 2008, we had cash and cash equivalents of approximately $1.1 million, working capital of $31.1 million and total debt of $17.0 million, of which approximately $3.4 million was classified as current. We had positive net cash flow from operating activities of approximately $28.3 million during 2008. This was primarily from net income of $15.6 million, plus depreciation and amortization of $9.9 million, an increase in deferred taxes of $8.4 million, and an increase in prepaid expenses and other of $3.9 million offset by an increase in inventory of $11.2 million.

Short term investments decreased to $2.3 million from December 31, 2007 to December 31, 2008. This amount is the remaining proceeds from our March 2006 secondary public offering. The initial net proceeds from the offering were $47.1 million, from which we used $5.0 million to repay bank debt and the remainder of which has been used for capital expenditures invested in our natural gas compressor rental fleet.

Trade accounts receivable remained flat at $11.3 million at December 31, 2008 and 2007.

Inventory and work in progress increased $11.1 million to $31.9 million as of the end of 2008, as compared to $20.8 million as of the end of 2007. This increase is mainly a reflection of increased fabrication activity in both of our engineered products and rental compression equipment lines.

Long-term debt increased $2.4 million to $17.0 million at December 31, 2008, compared to $14.6 million at December 31, 2007. The current portion of long-term debt decreased $1.6 million to $3.4 million at December 31, 2008 compared to $5.0 million at December 31, 2007, mainly the result of normal amortization of debt and a payment of $600,000 from our line of credit and additional borrowing from our line of credit of $7.0 million.

Recession strategy

For fiscal year 2009, our overall plan, during the downturn in the economy, is to reduce expenses in line with the lower anticipated activity, fabricate rental fleet equipment only in direct response to market requirements, emphasize marketing of our idle gas compressor units and eliminate bank borrowing. Capital expenditures for the year ended December 31, 2009 are not anticipated to exceed our internal cash generating capacity. We believe that cash flows from operations will be sufficient to satisfy our capital and liquidity requirements through 2009. We may require additional capital to fund any unanticipated expenditures, including any acquisitions of other businesses. We currently have a $40 million dollar bank line of credit with an available balance of $33 million.

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:

	Obligation Due in Period						
	(in thousands)						
Cash Contractual Obligations	2009	2010	2011	2012	2013	Thereafter	Total
Term loan facility (secured)	$ 3,378	$ 3,378	$ 2,816	$	$	$	$ 9,572
Interest on term loan facility	321	186	51				558

Line of credit (secured)		7,000					7,000
Interest on line of credit	280	93					373
Purchase obligations	956	956	956	956	814		4,638
Other long term debt						441	441
Facilities and office leases	433	357	259	235	168	13	1,465
Total	$ 5,368	$ 11,970	$ 4,082	$ 1,191	$ 982	$ 454	$24,047

Senior Bank Borrowings

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

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Revolving Line of Credit Facility. Our revolving line of credit facility allows us to borrow, repay and re-borrow funds drawn under this facility. The total amount that we can 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, 2008, the amount available for revolving line of credit advances was $33.0 million. The amount of the borrowing base is based primarily upon our receivables, equipment and inventory. The borrowing base is re-determined by the bank on a monthly basis. If, as a result of the re-determination 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 May 1, 2010. Since April 1, 2008, our interest rate on the revolving line of credit is equal to prime rate minus one quarter of one percent (.25%) but never lower than four percent (4.0%) nor higher than eight and three quarter percent (8.75%). We had $7.0 million and $600,000 outstanding as of December 31, 2008 and 2007, respectively, on this revolving line of credit facility. The interest rates were 4.00% and 7.5% as of December 31, 2008 and 2007, respectively.

$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. Re-borrowings are not permitted under this facility. Principal under this term loan facility is due and payable in 59 monthly installments of $282,000 each which commenced on November 1, 2006 and continuing through September 1, 2011. Since April 1, 2008, our interest rate on the term loan is equal to prime rate minus one half of one percent (.50%) but never lower than four percent (4%) nor higher than eight and three quarter percent (8.75%). 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, 2008 and 2007, respectively, this term loan facility had a principal balance of $9.6 million and $13.0 million. The interest rates were 4.0% and 7.5% as of December 31, 2008 and 2007, respectively.

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 and by the real estate and related plant facilities.

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

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 1.6 to 1.0;
- at the end of each month, consolidated tangible net worth (as defined in the Loan Agreement) of at least $85.0 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 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, 2008, we were in compliance with all 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.

As of December 31, 2008, we had a long-term liability of $150,000 to Midland Development Corporation. This amount is to be recognized as income contingent upon certain staffing requirements in the future. In addition, we entered into a purchase agreement with a vendor on July 30, 2008 pursuant to which we agreed to purchase up to $4.8 million of our paint and coating requirements exclusively from the vendor. In connection with the execution of the agreement, the vendor paid us a $300,000 fee which is considered to be a discount toward future purchases from the vendor. Based on our historical paint and coating requirements, we estimate meeting the $4.8 million purchase obligation within five years. The $300,000 payment we received is recorded as a long-term liability and will decrease as the purchase commitment is fulfilled. The long-term liability remaining as of December 31, 2008 was $291,000.

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Subordinated Debt - Related Parties

We had subordinated debt which was included in the current portion of long-term debt for the year ended December 31, 2007. The $3.0 million principal amount of this debt was in the form of promissory notes issued to the three stockholders of Screw Compression Systems who are currently our employees, as part of the consideration for the acquisition of SCS we completed on January 3, 2005. The principal of each note was payable in three equal annual installments which commenced on January 3, 2006. Accrued and unpaid interest on the unpaid principal balance of each note was payable on the same dates as, and in addition to, the installments of principal. On January 3, 2008, we paid the third and last installment of the annual payments.

Components of Our Principal Capital Expenditures

The table below shows the components of our principal capital expenditures for the three years ended December 31, 2008:

	Actual		
Expenditure Category	2006	2007	2008
	(in thousands		
Rental equipment, vehicles and shop equipment	$ 27,684	$ 25,307	$ 46,271

The level of our expenditures will vary in future periods depending on energy market conditions and other related economic factors. Based upon existing economic and market conditions, we believe that our operating cash flow will be sufficient to fully fund our net investing cash requirements for 2009. 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, 2008, the off-balance sheet arrangements and transactions that we have entered into include operating lease agreements and purchase agreements. We do not believe that these arrangements are reasonably likely to materially affect our liquidity or availability of, or requirements for, capital resources.

We entered into a purchase agreement with a vendor on July 30, 2008 pursuant to which we agreed to purchase up to $4.8 million of our paint and coating requirements exclusively from the vendor. In connection with the execution of the agreement, the vendor paid us a $300,000 fee which is considered to be a discount toward future purchases from the vendor. Based on our historical paint and coating requirements, we estimate meeting the $4.8 million purchase obligation within five years. The $300,000 payment we received is recorded as a long-term liability and will decrease as the purchase commitment is fulfilled. The long-term liability remaining as of December 31, 2008 was $291,000.

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 Prime Rate less 1/2 % for our term loan facility and Prime Rate less 1/4 % for 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, 2008, we were not using any derivatives to manage interest rate risk.

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Financial Instruments and Debt Maturities

Our financial instruments consist of cash and cash equivalents, short-term investments, 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, 2008 and 2007, 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 23.

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.

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, 2008, pursuant to Exchange Act Rule 13a-15. Based upon that evaluation, the President and Chief Executive Officer and our Principal Accounting Officer And Treasurer have concluded that our disclosure controls and procedures as of December 31, 2008, are effective to ensure that information required to be disclosed by us in the reports filed or submitted by us under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the SEC’s rules and forms and include controls and procedures designed to ensure that information required to be disclosed by us in such reports is accumulated and communicated to our management, including our principal executive and financial officers as appropriate to allow timely decisions regarding required disclosures. Due to the inherent limitations of control systems, not all misstatements may be detected. Those inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple errors or mistakes. Additionally, controls could be circumvented by the individual acts of some persons or by collusion of two or more people. Our controls and procedures can only provide reasonable, not absolute, assurance that the above objectives have been met.

Changes in Internal Control Over Financial Reporting

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

Management's Report on Internal Control Over Financial Reporting

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

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

- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America, and that our receipt and expenditures are being made only in accordance with authorizations of management and our Board of Directors; and

- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on the financial statements.

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

Our management assessed the effectiveness of our internal control over financial reporting as December 31, 2008 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, 2008, our internal control over financial reporting was effective.

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Report of Independent Registered Public Accounting Firm

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

We have audited Natural Gas Services Group, Inc.'s (the "Company") internal control over financial reporting as of December 31, 2008, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Natural Gas Services Group, Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

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

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

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

In our opinion, Natural Gas Services Group, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2008, based on the COSO criteria.

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, 2007 and 2008, and the related consolidated statements of income, stockholders' equity and cash flows for each of the three years in the period ended December 31, 2008 of Natural Gas Services Group, Inc. and our report dated March 2, 2009 expressed an unqualified opinion.

/s/ HEIN & ASSOCIATES LLP

Dallas, Texas
March 2, 2009

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ITEM 9B. OTHER INFORMATION

None.

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information required by this item is incorporated herein by reference to the sections "Election of Directors," "Executive Officers," "Corporate Governance" and "The Board of Directors and its Committees" in our definitive proxy statement which will be filed with the Securities and Exchange Commission within 120 days after December 31, 2008.

ITEM 11. EXECUTIVE COMPENSATION

The information required by this item is incorporated herein by reference to the section "Executive Compensation" in our definitive proxy statement which will be filed with the Securities and Exchange Commission within 120 days after December 31, 2008.

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

The information required by this item is incorporated herein by reference to the section "Principal Shareholders and Security Ownership of Management" in our definitive proxy statement which will be filed with the Securities and Exchange Commission within 120 days after December 31, 2008.

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

The information required by this item is incorporated herein by reference to the sections "Related Person Transactions" and "Corporate Governance" in our definitive proxy statement which will be filed with the Securities and Exchange Commission within 120 days after December 31, 2008.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by this item is incorporated herein by reference to the section "Principal Accountant Fees and Services" in our definitive proxy statement which will be filed with the Securities and Exchange Commission within 120 days after December 31, 2008.

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PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES

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

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

For a list of 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	Non-Statutory Stock Option Agreement (Incorporated by reference to Exhibit 10.2 to Form 8-K Report filed with the SEC on August 30, 2005)
10.1	1998 Stock Option Plan, as amended (Incorporated by reference to Exhibit 10.1 of the Registrant’s Form 8-K Report dated September 20, 2006 on file with the SEC September 26, 2006)
10.2	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 September 30, 2004)
10.3	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)
10.4	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)
10.5	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)

10.6 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)

10.7 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)

10.8 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 September 14, 2005, and filed with the Securities and Exchange Commission on November 14, 2005)

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Exhibit No.	Description
10.9	Promissory Note, dated January 3, 2005, in the original principal amount of $300,000 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 September 14, 2005, and filed with the Securities and Exchange Commission on November 14, 2005)
10.10	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)
10.11	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
10.12	Eighth Amended and Restated Loan Agreement between Natural Gas Services Group, Inc. and Western National Bank.
10.13	Revolving Line of Credit Promissory Note issued to Western National Bank.
10.14	Employment Agreement between Natural Gas Services Group, Inc. and Stephen C. Taylor dated October 25, 2008 (Incorporated by reference to Exhibit 10.1 of the Registrant's Current Report on Form 8-K filed with the Securities and Exchange Commission on October 30, 2008)
*10.15	Lease Agreement, dated March 26, 2008, between WNB Tower, LTD (as landlord) and Natural Gas Services Group, Inc. (as tenant) in connection with the lease of the Company's principal offices in Midland, Texas.
14.0	Code of Ethics (Incorporated by reference to Exhibit 14.0 of the Registrant's Form 10-KSB for the fiscal year ended December 31, 2004, and filed with the Securities and Exchange Commission on March 30, 2005)
*23.1	Consent of Hein & Associates LLP
*31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
*31.2	Certification of Principal Accounting Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
*32.1	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
*32.2	Certification of Principal Accounting Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

* Filed herewith.

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SIGNATURES

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

NATURAL GAS SERVICES GROUP, INC.

Date: March 2, 2009	By:	/s/ Stephen C. Taylor Stephen C. Taylor Chairman of the Board, President and Chief Executive Officer (Principal Executive Officer)

Pursuant to the requirements of the Securities and Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated:

Signature	Title	Date
/s/ Stephen C. Taylor Stephen C. Taylor	Chairman of the Board of Directors, Chief Executive Officer and President (Principal Executive Officer)	March 2, 2009
/s/ Earl R. Wait Earl R. Wait	Vice President – Accounting (Principal Accounting Officer)	March 2, 2009
/s/Charles G. Curtis Charles G. Curtis	Director	March 2, 2009
/s/William F. Hughes, Jr. William F. Hughes, Jr.	Director	March 2, 2009
/s/Richard L. Yadon Richard L. Yadon	Director	March 2, 2009
/s/Paul D. Hensley Paul D. Hensley	Director	March 2, 2009
/s/Gene A. Strasheim Gene A. Strasheim	Director	March 2, 2009
/s/Alan A. Baker Alan A. Baker	Director	March 2, 2009
/s/John W. Chisholm John W. Chisholm	Director	March 2, 2009

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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

We have audited the accompanying consolidated balance sheets of Natural Gas Services Group, Inc. (the "Company") as of December 31, 2007 and 2008, and the related consolidated statements of income, stockholders' equity and cash flows for each of the three years in the period ended December 31, 2008. These 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 audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2007 and 2008, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2008, 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), Natural Gas Services Group, Inc.'s, internal control over financial reporting as of December 31, 2008, 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 2, 2009 expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

/s/ HEIN & ASSOCIATES LLP

Dallas, Texas
March 2, 2009

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NATURAL GAS SERVICES GROUP, INC.
CONSOLIDATED BALANCE SHEETS
(in thousands)

	December 31, 2007	December 31, 2008
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 245	$ 1,149
Short-term investments	18,661	2,300
Trade accounts receivable, net of doubtful accounts of $110 and $177, respectively	11,322	11,321
Inventory, net of allowance for obsolescence of $273 and $500, respectively	20,769	31,931
Prepaid income taxes	3,584	244
Prepaid expenses and other	641	87
Total current assets	55,222	47,032
Rental equipment, net of accumulated depreciation of $16,810 and $24,624, respectively	76,025	111,967
Property and equipment, net of accumulated depreciation of $4,792 and $6,065, respectively	8,580	8,973
Goodwill, net of accumulated amortization of $325, both periods	10,039	10,039
Intangibles, net of accumulated amortization of $1,145 and $1,198, respectively	3,324	3,020
Other assets	43	19
Total assets	$ 153,233	$ 181,050
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Current portion of long-term debt and subordinated notes	$ 4,378	$ 3,378
Current portion of line of credit	600	—
Accounts payable	4,072	8,410
Accrued liabilities	3,990	3,987
Current income tax liability	3,525	110
Deferred income	81	38
Total current liabilities	16,646	15,923
Long term debt, less current portion	9,572	6,194
Line of credit, less current portion	—	7,000
Deferred income tax payable	12,635	21,042
Other long term liabilities	—	441
Total liabilities	38,853	50,600
Commitments and contingencies (Notes 4, 5, 10 and 13)		
Stockholders' equity:		
	—	—

Preferred stock, 5,000 shares authorized, no shares issued or outstanding		
Common stock, 30,000 shares authorized, par value $0.01; 12,085 and 12,094 shares issued and outstanding, respectively	121	121
Additional paid-in capital	83,460	83,937
Retained earnings	30,799	46,392
Total stockholders' equity	114,380	130,450
Total liabilities and stockholders' equity	$ 153,233	$ 181,050

See accompanying notes to these consolidated financial statements.

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

	For the Years Ended December 31, 2006	2007	2008
Revenue:			
Sales, net	$ 38,214	$ 41,088	$ 41,380
Rental income	23,536	30,437	42,864
Service and maintenance income	979	964	1,092
Total revenue	62,729	72,489	85,336
Operating costs and expenses:			
Cost of sales, exclusive of depreciation stated separately below	29,629	28,124	28,052
Cost of rentals, exclusive of depreciation stated separately below	8,944	12,382	16,193
Cost of service and maintenance, exclusive of depreciation stated separately below	735	600	749
Selling, general and administrative expense	5,270	5,324	5,842
Depreciation and amortization	6,020	7,470	9,925
Total operating costs and expenses	50,598	53,900	60,761
Operating income	12,131	18,589	24,575
Other income (expense):			
Interest expense	(1,646)	(1,155)	(742)
Other income	1,390	1,299	387
Total other income (expense)	(256)	144	(355)
Income before provision for income taxes	11,875	18,733	24,220
Provision for income taxes:			
Current	1,743	3,525	220
Deferred	2,544	2,930	8,407
Total income tax expense	4,287	6,455	8,627
Net income	7,588	12,278	15,593
Earnings per common share:			
Basic	$ 0.67	$ 1.02	$ 1.29
Diluted	$ 0.66	$ 1.01	$ 1.28
Weighted average common shares outstanding:			
Basic	11,405	12,071	12,090
Diluted	11,472	12,114	12,143

See accompanying notes to these consolidated financial statements.

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

	Preferred Stock		Common Stock		Additional		Total
	Shares	Amount	Shares	Amount	Paid-In Capital	Retained Earnings	Stockholders' Equity
BALANCES, 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 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
Exercise of common stock options and warrants	—	—	39	1	247	—	248
Compensation expense on issuance of common stock options	—	—	—	—	541	—	541
Income tax benefit realized from the exercise of stock options	—	—	—	—	112	—	112
Net income	—	—	—	—	—	12,278	12,278
BALANCES, December 31, 2007	—	$ —	12,085	$ 121	$ 83,460	$ 30,799	$ 114,380
Exercise of common stock options	—	—	9	—	54	—	54
Compensation expense on issuance of common stock options	—	—	—	—	423	—	423

Net income	—	—	—	—	—	15,593	15,593
BALANCES, December 31, 2008	—	$ —	12,094	$ 121	$ 83,937	$ 46,392	$ 130,450

See accompanying notes to these consolidated financial statements.

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

	For the Years Ended December 31, 2006	2007	2008
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income	$ 7,588	$ 12,278	$ 15,593
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	6,020	7,470	9,925
Deferred taxes	2,544	2,930	8,407
Employee stock options expense	376	541	423
Loss (gain) on disposal of assets	13	(1)	7
Changes in current assets:			
Trade accounts receivables, net	(2,271)	(2,859)	1
Inventory, net	749	(3,826)	(11,162)
Prepaid expenses and other	135	(3,904)	3,894
Changes in current liabilities:			
Accounts payable and accrued liabilities	(3)	3,228	4,335
Current income tax liability	849	2,581	(3,415)
Deferred income	122	(144)	(43)
Other	(46)	(25)	285
NET CASH PROVIDED BY OPERATING ACTIVITIES	16,076	18,269	28,250
CASH FLOWS FROM INVESTING ACTIVITIES:			
Purchase of property and equipment	(27,684)	(25,307)	(46,271)
Purchase of short-term investments	(38,252)	(2,609)	(2,620)
Redemption of short-term investments	13,200	9,000	18,981
Proceeds from sale of property and equipment	73	95	47
NET CASH USED IN INVESTING ACTIVITIES	(52,663)	(18,821)	(29,863)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Proceeds from line of credit	1,375	600	7,500
Proceeds from long-term debt	68	—	—
Proceeds from other long term liabilities, net	—	—	441
Repayments of long-term debt	(9,581)	(4,442)	(4,378)
Repayment of line of credit	(1,675)	—	(1,100)
Proceeds from exercise of stock options and warrants	357	248	54
Proceeds from sale of stock, net of transaction costs	47,163	—	—
NET CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES	37,707	(3,594)	2,517
NET CHANGE IN CASH	1,120	(4,146)	904
CASH AT BEGINNING OF PERIOD	3,271	4,391	245

CASH AT END OF PERIOD	$	4,391	$	245	$	1,149
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:						
Interest paid	$	1,692	$	1,191	$	802
Income taxes paid	$	894	$	4,620	$	294

See accompanying notes to these consolidated financial statements.

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NATURAL GAS SERVICES GROUP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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", “NGSG”, "Natural Gas Services Group", "we" or "our") (a Colorado corporation). Natural Gas Services Group, Inc. was formed on December 17, 1998 for the purposes of combining the operations of certain manufacturing, service and leasing entities.

On January 3, 2005, we 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 operated as a wholly owned subsidiary until June 30, 2007, when it was merged into Natural Gas Services Group, Inc.

All significant intercompany accounts and transactions were eliminated in consolidation.

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

Nature of Operations

Natural Gas Services Group, Inc. is a leading provider of small to medium horsepower compression equipment to the natural gas industry. We focus primarily on the non-conventional natural gas production business in the United States (such as coalbed methane, gas shales and tight gas). We manufacture, fabricate and rent natural gas compressors that enhance the production of natural gas wells. NGSG provides maintenance services for its natural gas compressors. In addition, we sell custom fabricated natural gas compressors to meet customer specifications dictated by well pressures, production characteristics and particular applications. We also manufacture and sell flare systems for oil and gas plant and production facilities.

Use of Estimates

The preparation of our consolidated financial statements in conformity with generally accepted accounting principles requires our 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 allowance for inventory obsolescence. It is at least reasonably possible these estimates could be revised in the near term and the revisions could be material.

Cash Equivalents

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

Short-term Investments

We have short-term investments invested primarily in high grade short term commercial paper for the maximum return on investments which are held to maturity that will coincide with our projected cash requirements, and have a maturity of less than one year.

Accounts Receivable

Our trade receivables consist of customer obligations for the sale of compressors and flare systems due under normal trade terms, and operating leases for the use of our natural gas compressors. The receivables are not collateralized except as provided for under lease agreements. However, we require deposits of as much as 50% for large custom contracts. We extend credit based on management's assessment of the customer's financial condition, receivable aging, customer disputes and general business and economic conditions. Management believes the allowance for doubtful accounts for trade receivables of $110,000 and $177,000 at December 31, 2007 and 2008, respectively, is adequate.

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NATURAL GAS SERVICES GROUP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

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

Major Customers and Concentration of Credit Risk

Sales to two customers in the year ended December 31, 2006 amounted to a total of 39% and 12% of consolidated revenue, respectively. Sales to two customers in the year ended December 31, 2007 amounted to a total of 40% and 12% of consolidated revenue, respectively. Sales to two customers in the year ended December 31, 2008 amounted to a total of 26% and 14% of consolidated revenue, respectively. No other single customer accounted for more than 10% of our revenues in 2006, 2007 or 2008. One customer amounted to 64% of our consolidated accounts receivable as of December 31, 2007, and two customers amounted to 35% and 14% of our accounts receivable as of December 31, 2008, respectively. No other customers amounted to more than 10% of our consolidated accounts receivable as of December 31, 2007 and 2008. We generally do not obtain collateral, but require deposits of as much as 50% on large custom contracts. We extend credit based on management's assessment of the customer's financial condition, receivable aging, customer disputes and general business and economic conditions.

Inventory

Inventory is valued at the lower of cost or market. The cost of inventories is determined by the weighted average method. A reserve is recorded against inventory balances for estimated obsolescence. This reserve is based on specific identification and historical experience and totaled $273,000 and $500,000 at December 31, 2007 and 2008, respectively. Finished goods at December 31, 2008 consists of 19 completed compressor units which are available for sale or for use in our rental fleet. At December 31, 2007 and 2008, respectively, inventory consisted of the following (in thousands):

	2007	2008
Raw materials	$ 17,492	$ 26,124
Finished goods	—	2,417
Work in process	3,277	3,390
	$ 20,769	$ 31,931

Property and Equipment

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

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

Goodwill

Goodwill represents the cost in excess of fair value of the identifiable net assets acquired in three acquisitions.

Goodwill and intangibles are tested for impairment annually or whenever events indicate impairment may have occurred. We completed the most recent test for goodwill impairment based on management's evaluation as of December 31, 2008, at which time no impairment was indicated.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Intangibles

At December 31, 2008, NGSG has intangible assets (excluding patents) with a gross carrying value of $4.2 million, which relate to developed technology, acquired customer contracts, distribution agreements and non-compete agreements. The carrying amount net of accumulated amortization at December 31, 2008 was $3.0 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 fourteen years as of December 31, 2008. Amortization expense recognized in each of the years ending December 31, 2006, 2007, and 2008 was $299,000. In addition, NGSG has an intangible asset with a gross carrying value of $654,000 at December 31, 2008 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).

2009	$ 299
2010	260
2011	179
2012	125
2013	125
Thereafter	1,378
	$ 2,366

Our policy is to periodically review the net realizable value of intangibles, through an assessment of the estimated future cash flows related to such assets. In the event that assets are found to be carried at amounts in excess of estimated undiscounted future cash flows, then the assets will be adjusted for impairment to a level commensurate with a discounted cash flow analysis of the underlying assets. Based upon our most recent analysis, we believe no impairment of intangible assets exists as of December 31, 2008.

Patents

We have patents for a flare tip ignition device and flare tip burner pilot. The costs of the patents were being amortized on a straight-line basis over nine years, the remaining life of the patents when acquired. Amortization expense for patents of $27,000 was recognized for the years ended December 31, 2006 and 2007, and $4,000 for the year ended December 31, 2008. The patents were fully amortized as of December 31, 2008.

Other Assets

Included in other assets are debt issuance costs, net of accumulated amortization, and deposits totaling approximately $43,000 and $19,000 at December 31, 2007 and 2008, 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

We accrue amounts for estimated warranty claims based upon current and historical product warranty costs and any other related information known. The warranty reserve was $165,000 at December 31, 2007 and 2008.

Financial Instruments and Concentrations of Credit Risk

Management believes that generally the fair value of the our cash, short-term investments, trade receivables, payables and notes payable at December 31, 2007 and 2008 approximate their carrying values due to the short-term nature of the instruments or the use of prevailing market interest rates. At certain times during the year, our demand deposits held in banks exceeded the federally insured limit of $100,000 ($250,000 as of December 31, 2008). We believe that the credit risk in temporary and short-term cash investments that we have with financial institutions is minimal.

Advertising Costs

Advertising costs are expensed as incurred. Total advertising expense was $41,000, $26,000 and $31,000 in 2006, 2007 and 2008, respectively.

Other Income

Other income in 2007 and 2008 primarily consisted of interest income from our short-term investment account.

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NATURAL GAS SERVICES GROUP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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 an anti-dilutive effect of 10,000 and 25,000 common stock options for the years ended December 31, 2006 and 2007, respectively, and none in 2008.

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

	Year Ended December 31,		
	2006	2007	2008
Numerator:			
Net income	$ 7,588	$ 12,278	$ 15,593
Denominator for basic net income per common share:			
Weighted average common shares outstanding	11,405	12,071	12,090
Denominator for diluted net income per share:			
Weighted average common shares outstanding	11,405	12,071	12,090
Dilutive effect of stock options and warrants	67	43	53
Diluted weighted average shares	11,472	12,114	12,143
Earnings per common share:			
Basic	$ 0.67	$ 1.02	$ 1.29
Diluted	$ 0.66	$ 1.01	$ 1.28

Income Taxes

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

Fair Value Measurement

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

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

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

As of December 31, 2008, our short-term investments consisted of certificates of deposit classified within level 1 of the fair value hierarchy.

Reclassification

Certain amounts in prior period financial statements have been reclassified to conform to the 2008 financial statement classification with no impact to operating income or net income.

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NATURAL GAS SERVICES GROUP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Recently Issued Accounting Pronouncements

In September 2006, the FASB issued Statement of Financial Accounting Standards ("SFAS") No. 157, Fair Value Measurements ("SFAS No. 157"), which defines fair value, establishes a framework for measuring fair value in GAAP, and expands disclosures about fair value measurements. This Statement applies under other accounting pronouncements that require or permit fair value measurements and is effective for fiscal years beginning after November 15, 2007. In February 2008, the FASB issued FASB Staff Position No. FAS 157-2, which defers the effective date of SFAS No. 157 for non-financial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually) to fiscal years beginning after November 15, 2008 and interim periods within those years. We adopted the required provisions of SFAS No. 157 on January 1, 2008 and the adoption did not have a significant impact on our financial statements. See Note 1 for additional information regarding fair value measurements.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities-Including an amendment of FASB Statement No. 115 ("SFAS No. 159"). SFAS No. 159 permits entities to measure eligible assets and liabilities at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. We adopted SFAS No. 159 on January 1, 2008 and the adoption did not have a significant impact on our financial statements.

In December 2007, the FASB issued SFAS No. 141(R), Business Combinations ("SFAS No. 141(R)"), which replaces SFAS No. 141, Business Combinations, and requires an acquirer to recognize the assets acquired, the liabilities assumed, and any non-controlling interest in the acquiree at the acquisition date, measured at their fair values as of that date, with limited exceptions. This Statement also requires the acquirer in a business combination achieved in stages to recognize the identifiable assets and liabilities, as well as the non-controlling interest in the acquiree, at the full amounts of their fair values. SFAS No. 141(R) makes various other amendments to authoritative literature intended to provide additional guidance or to confirm the guidance in that literature to that provided in this Statement. This Statement applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. We do not expect the adoption of SFAS No. 141(R) will have a significant impact on our financial statements.

In December 2007, FASB issued SFAS No. 160, Non-controlling Interests in Consolidated Financial Statements ("SFAS No. 160"), which amends Accounting Research Bulletin No. 51, Consolidated Financial Statements, to improve the relevance, comparability, and transparency of the financial information that a reporting entity provides in its consolidated financial statements. SFAS No. 160 establishes accounting and reporting standards that require the ownership interests in subsidiaries not held by the parent to be clearly identified, labeled and presented in the consolidated statement of financial position within equity, but separate from the parent's equity. This statement also requires the amount of consolidated net income attributable to the parent and to the non-controlling interest to be clearly identified and presented on the face of the consolidated statement of income. Changes in a parent's ownership interest while the parent retains its controlling financial interest must be accounted for consistently, and when a subsidiary is deconsolidated, any retained non-controlling equity investment in the former subsidiary must be initially measured at fair value. The gain or loss on the deconsolidation of the subsidiary is measured using the fair value of any non-controlling equity investment. The Statement also requires entities to provide sufficient disclosures that clearly identify and distinguish between the interests of the parent and the interests of the non-controlling owners.

This Statement applies prospectively to all entities that prepare consolidated financial statements and applies prospectively for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. We do not expect the adoption of SFAS No. 160 will have a significant impact on our financial statements.

2. Rental Activity

We rent natural gas compressor packages to entities in the petroleum industry. These rental arrangements are classified as operating leases and generally have original terms of six months to two years and continue on a month-to-month basis thereafter. Future minimum rent payments for arrangements not on a month-to-month basis at December 31, 2008 are as follows (in thousands):

Years Ending December 31,	
2009	$ 3,813
2010	264
Total	$ 4,077

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NATURAL GAS SERVICES GROUP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

3. Property and Equipment

Property and equipment consists of the following at December 31, 2007 and 2008 (in thousands):

	2007	2008
Land and building	$ 5,305	$ 5,036
Leasehold improvements	431	662
Office equipment and furniture	1,028	1,122
Software	458	525
Machinery and equipment	1,587	1,963
Vehicles	4,563	5,730
Less accumulated depreciation	(4,792)	(6,065)
Total	$ 8,580	$ 8,973

Depreciation expense for property and equipment and the compressors described in Note 2 was $5.7 million, $7.1 million and $9.6 million for the years ended December 31, 2006, 2007 and 2008, respectively.

4. Credit Facility

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

Line of Credit

Our revolving line of credit facility allows us to borrow, repay and reborrow funds drawn under this facility, as amended. The total amount that we can 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, 2008, the amount available for revolving line of credit advances was $33.0 million. 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 May 1, 2010. Since April 1, 2008, our interest rate on the revolving line of credit is equal to prime rate minus one quarter of one percent (.25%) but never lower than four percent (4.0%) nor higher than eight and three quarter percent (8.75%). We had $7.0 million and $600,000 outstanding as of December 31, 2008 and 2007, respectively, on this revolving line of credit facility. The interest rates were 4.0% and 7.5% as of December 31, 2008 and 2007, respectively.

The line of credit and note listed below are with the same bank and include certain covenants, the most restrictive of which require that we maintain certain working capital, debt to equity and cash flow ratios and certain minimum net worth. We were in compliance with covenants at December 31, 2007 and 2008, respectively.

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 term loan facility is due and payable in 59 monthly installments of $282,000 each, which commenced November 1, 2006 and continuing through September 1, 2011. Since April 1, 2008, our interest rate on the term loan is equal to prime rate minus one half of one percent (.50%) but never lower than four percent (4%) nor higher than eight and three quarter percent (8.75%) and seven and one half percent (7.5%) and four percent (4.0%) at December 31, 2008 and 2007, respectively. 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, 2008 and 2007, respectively, this term loan facility had a principal balance of $9.6 million and $13.0 million. The interest rates were 4.0% and 7.5% as of December 31, 2008 and 2007, respectively.

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 and by the real estate and related plant facilities.

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

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NATURAL GAS SERVICES GROUP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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 1.6 to 1.0;
- At the end of each month, a consolidated tangible net worth (as defined in the Loan Agreement) of at least $85 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 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, 2008 and 2007, we were in compliance with all 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.

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

2009	$ 3,378
2010	3,378
2011	2,816
Total	$ 9,572

5. Other Long-term Liabilities

As of December 31, 2008, we had a long-term liability of $150,000 to Midland Development Corporation. This amount is to be recognized as income contingent upon certain staffing requirements in the future. In addition, we entered into a purchase agreement with a vendor on July 30, 2008 pursuant to which we agreed to purchase up to $4.8 million of our paint and coating requirements exclusively from the vendor. In connection with the execution of the agreement, the vendor paid us a $300,000 fee which is considered to be a discount toward future purchases from the vendor. Based on our historical paint and coating requirements, we estimate meeting the $4.8 million purchase obligation within five years. The $300,000 payment we received is recorded as a long-term liability and will decrease as the purchase commitment is fulfilled. The long-term liability remaining as of December 31, 2008 was $291,000.

6. Subordinated Notes – Related Parties

On January 3, 2005, we issued subordinated promissory notes to Paul D. Hensley, James R. Hazlett and Tony Vohjesus, the owners of SCS, as part of the consideration for the acquisition of Screw Compression Systems, Inc. As of January 3, 2005, Screw Compression Systems, Inc. became a wholly owned subsidiary of NGSG. Mr. Hensley is currently the Senior Vice President of Technical Services and a Director of Natural Gas Services Group, Inc. Mr. Hazlett is the Vice President of Technical Services. Mr. Vohjesus is a Manager of Product Services. The aggregate principal amount was $3.0 million bearing interest at the rate of 4.00% per annum. Beginning January 3, 2006, a principal payment of $1.0 million is due and payable each year until maturity on January 3, 2008 plus the current outstanding interest. The subordinated promissory notes are secured by a letter of credit in the face amount of $2.0

million. As of December 31, 2007, $1.0 million was outstanding on these notes. We repaid these notes in full at maturity in January 2008.

7. Income Taxes

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

	2006	2007	2008
Current provision:			
Federal	$ 1,475	$ 3,168	$ —
State	268	357	220
	1,743	3,525	220
Deferred provision:			
Federal	2,403	2,775	8,347
State	141	155	60
	2,544	2,930	8,407
	$ 4,287	$ 6,455	$ 8,627

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NATURAL GAS SERVICES GROUP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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):

	2006	2007	2008
Deferred income tax assets:			
Alternative minimum tax credit	$ 99	$ —	$ —
Net operating loss carryover	—	—	2,331
Other	242	362	650
Total deferred income tax assets	$ 341	$ 362	$ 2,981
Deferred income tax liabilities:			
Property and equipment	(8,571)	(11,623)	(22,723)
Goodwill and other intangible assets	(1,508)	(1,407)	(1,299)
Other	(26)	33	(1)
Total deferred income tax liabilities	(10,105)	(12,997)	(24,023)
Net deferred income tax liabilities	$ (9,764)	$ (12,635)	$ (21,042)

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

	2006	2007	2008
Statutory rate	34 %	34 %	34 %
State and local taxes	3 %	2 %	2 %
Other	(1) %	(2)%	0 %
Effective rate	36 %	34 %	36 %

We have a net operating loss carryover of approximately $2.3 million available to offset future income for federal income tax reporting purposes, which will expire in 2028, if not previously utilized. A benefit of approximately $45,000 was generated from the exercise of stock options and will be reclassed to additional paid in capital when the benefit is realized.

Our policy regarding income tax interest and penalties is to expense those items as general and administrative expense but to identify them for tax purposes. During the twelve months ended December 31, 2008, there were no income tax interest and penalty items in the income statement or as a liability on the balance sheet.

We file income tax returns in the U.S. federal jurisdiction and various state jurisdictions. With few exceptions, we are no longer subject to U.S. federal or state income tax examination by tax authorities for years before 2005. We are not currently involved in any income tax examinations.

8. Stockholders' Equity

Initial Public Offering

In October, 2002, we closed an initial public offering in which we 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 150,000 shares of common stock at $6.25 per share and warrants at $0.3125 per share. The warrants, when purchased by the underwriter, contained an exercise price of $7.81 per share. The underwriter's warrants were exercised or expired in October 2007. The underwriter's options expired in October 2007. As of December 31, 2008, there were no underwriter options or warrants outstanding.

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 428,000 shares to cover over-allotments, if any. On March 27, 2006, the underwriter exercised its over-allotment option and on March 30, 2006, we sold an additional 428,000 shares resulting in proceeds to NGSG 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 was used to reduce our bank debt by $5.0 million.

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Preferred Stock

We have a total of 5.0 million authorized preferred shares with rights and preferences as designated by the Board of Directors. As of December 31, 2007 and 2008, there were no outstanding preferred shares.

9. Stock-Based Compensation

Stock Option Plan

Our 1998 Stock Option Plan (the Plan), which is stockholder approved, permits the grant of stock options to its employees for up to 550,000 shares of common stock. We believe that such awards better align the interests of our employees with our stockholders. Option awards are generally granted with an exercise price equal to the market price of our stock at the date of grant; those option awards generally vest based on three years of continuous service and have ten-year contractual terms. Certain option and share awards provide for accelerated vesting if there is a change in control of NGSG (as defined in the Plan). The last date that grants can be made under the Plan is March 1, 2016. As of December 31, 2008, 224,500 shares were still available for issue under the 1998 Stock Option Plan.

The fair value of each option award is estimated on the date of grant using the Black-Scholes option valuation model that uses the assumptions noted in the following table. The risk-free rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant. The expected life of options granted is based on the vesting period and historical exercise and post vesting employment termination behavior for similar grants. We use historical 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.

Weighted average Black –Scholes fair value assumption	2006	2007	2008
Risk free rate	8.25%	5.83%	3.90%
Expected life	4 yrs	5 yrs	5 yrs
Expected volatility	50.3%	47.6%	48.0%
Expected dividend yield	0.0%	0.0%	0.0%

A summary of option activity under the Plan as of December 31, 2008 and changes during the year then ended is presented below:

	Number of Stock Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (years)	Aggregate Intrinsic Value (in thousands)
Outstanding at December 31, 2007	167,502	$ 11.25	7.77	$ 1,401
Granted	113,000	18.81		
Exercised	(8,833)	6.04		
Forfeited or expired	(7,168)	12.85		

Outstanding at December 31, 2008	264,501	$	14.61	7.94	*
Exercisable at December 31, 2008	158,333	$	12.15	7.00	*

* Market price as of December 31, 2008 exceeded the weighted average exercise price, and as such, resulted in the aggregate intrinsic value being negative or "out-of-the-money".

We granted 40,000 options to an officer on January 15, 2008 at an exercise price of $20.06 with a three year vesting period. We granted 15,000 options to the board of directors on March 18, 2008 at an exercise price of $20.48 vesting through December 2008. We granted 30,000 options to officers and 28,000 options to employees on September 10, 2008 at an exercise price of $17.51 with a three year vesting period.

The weighted average grant date fair value of options granted during the years 2006, 2007 and 2008 was $4.75, $8.49 and $8.46, respectively. The total intrinsic value, or the difference between the exercise price and the market price on the date of exercise, of options exercised during the years ended December 31, 2006, 2007 and 2008 was approximately $79,000, $213,000 and $149,000, respectively. Cash received from stock options exercised during the years ended December 31, 2006, 2007 and 2008 was $58,000, $152,000 and $53,000, respectively.

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NATURAL GAS SERVICES GROUP, INC.
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The following table summarizes information about the options outstanding at December 31, 2008:

		Options Outstanding			Options Exercisable	
Range of Exercise Prices	Shares	Weighted Average Remaining Contractual Life (years)	Weighted Average Exercise Price		Shares	Weighted Average Exercise Price
$ 0.00 – 5.58	22,000	3.95	$ 4.11		22,000	$ 4.11
5.59 – 9.43	60,000	6.46	9.11		60,000	9.11
9.44 – 15.60	44,501	8.03	14.33		36,333	14.19
15.61 – 20.48	138,000	9.19	18.76		40,000	19.27
$ 0.00 - 20.48	264,501	7.94	$ 14.61		158,333	$ 12.15

The summary of the status of our unvested stock options as of December 31, 2008 and changes during the year then ended is presented below:

	Unvested Stock Options	Weighted Average Grant Date Fair Value
Unvested at December 31, 2007	41,000	$ 9.19
Granted	113,000	8.46
Vested	(43,498)	10.20
Forfeited	(4,334)	5.35
Unvested at December 31, 2008	106,168	$ 8.15

We recognized stock compensation expense from stock options vesting of $376,000, $541,000 and $423,000, respectively, for the years ended December 31, 2006, 2007 and 2008. The total income tax benefit recognized in the income statement for stock based compensation was $135,000, $184,000 and $148,000, respectively, for the years ended December 31, 2006, 2007 and 2008. As of December 31, 2008, there was approximately $694,000 of total unrecognized compensation cost related to unvested stock options. We expect to recognize such cost over a weighted-average period of 1.7 years. The actual income tax benefit realized for the tax deductions from stock options exercised was approximately $27,000, $112,000, respectively, for the years ended December 31, 2006, 2007, and none for the year ended December 31, 2008.

10. Commitments

401(k) Plan

We offer a 401(k) Plan to all employees that have reached the age of eighteen and have completed six months of service. The participants may contribute up to 100% of their salary subject to IRS limitations. Employer contributions are subject to Board discretion and are subject to a vesting schedule of 20% each year after the first year and 100% after six years. We contributed $125,000, $161,000, and $234,000 to the 401(k) Plan in 2006, 2007 and 2008, respectively.

Rented Facilities

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

2009	$ 433
2010	357
2011	259
2012	235
2013	168
Thereafter	13
Total	$ 1,465

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NATURAL GAS SERVICES GROUP, INC.
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Rent expense under such leases was $212,000, $244,000, and $363,000 for the years ended December 31, 2006, 2007, and 2008, respectively.

11. Segment Information

SFAS 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 about which separate financial information is available that is evaluated regularly by chief operating decision makers in the allocation of resources and the assessment of performance. Our management identifies segments based upon major revenue sources as shown in the tables below. However, management does not track assets by segment.

For the Year Ended December 31, 2006

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

For the Year Ended December 31, 2007

	Sales	Rental	Service & Maintenance	Corporate	Total
			(in thousands of dollars)		
Revenue	$ 41,088	$ 30,437	$ 964	$ —	$ 72,489
Operating costs and expenses	28,124	12,382	600	12,794	53,900
Other income/(expense)	—	—	—	144	144
Income before provision for income taxes	$ 12,964	$ 18,055	$ 364	$ (12,650)	$ 18,733

For the Year Ended December 31, 2008

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

12. Quarterly Financial Data (in thousands, except per share data) - Unaudited

2006	Q1	Q2	Q3	Q4	Total
Total 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

2007	Q1	Q2	Q3	Q4	Total
Total revenue	$ 16,712	$ 17,624	$ 18,651	$ 19,502	$ 72,489
Operating income	4,203	4,134	5,232	5,020	18,589
Net income applicable to common shares	2,681	2,646	3,337	3,614	12,278
Net income per share - Basic	0.22	0.22	0.28	0.30	1.02
Net income per share - Diluted	0.22	0.22	0.28	0.30	1.01

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

13. Legal Proceedings

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

On February 21, 2008, we received notice of a lawsuit filed against us on January 28, 2008 in Montmorency County, Michigan, 26th Circuit Court, Case No. 08-0001901-NZ, styled Dyanna Louise Williams, Plaintiff, v Natural Gas Services Group, Inc. and Great Lakes Compression, Defendants. In this lawsuit, plaintiff alleges breach of contract, breach of fiduciary duty and negligence. Plaintiff seeks damages in the amount of $100,000 for lost insurance benefits and an unspecified amount of exemplary damages. As the basis for her claims, plaintiff generally alleges that she is the third party beneficiary of a life insurance policy obtained by her deceased ex-husband through Natural Gas Services Group's insurance program, and that as a result of Natural Gas Service Group's negligence and failure to use due care in processing an application for life insurance prior to her ex-husband's death, she was denied $100,000 of life insurance proceeds. Plaintiff now seeks to recover $100,000 from Natural Gas Services Group, plus an unspecified amount of exemplary damages. On January 21, 2009, we received the Order and Judgment from the Court granting our Motion for Summary Judgment and dismissing the Williams suit with prejudice. This means that all claims are dismissed and may not be reasserted. We have not established a reserve with respect to plaintiff’s claims.

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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	Non-Statutory Stock Option Agreement (Incorporated by reference to Exhibit 10.2 to Form 8-K Report filed with the SEC on August 30, 2005)
10.1	1998 Stock Option Plan, as amended (Incorporated by reference to Exhibit 10.1 of the Registrant’s Form 8-K Report dated September 20, 2006 on file with the SEC September 26, 2006)
10.2	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 September 30, 2004)
10.3	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)
10.4	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)
10.5	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)
10.6	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)
10.7	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)
10.8	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 September 14, 2005, and filed with the Securities and Exchange Commission on November 14, 2005)
10.9	

Promissory Note, dated January 3, 2005, in the original principal amount of $300,000 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 September 14, 2005, and filed with the Securities and Exchange Commission on November 14, 2005)

10.10 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)

10.11 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

10.12 Eighth Amended and Restated Loan Agreement between Natural Gas Services Group, Inc. and Western National Bank.

10.13 Revolving Line of Credit Promissory Note issued to Western National Bank.

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Exhibit No.	Description
10.14	Employment Agreement between Natural Gas Services Group, Inc. and Stephen C. Taylor dated October 25, 2008 (Incorporated by reference to Exhibit 10.1 of the Registrant’s Current Report on Form 8-K filed with the Securities and Exchange Commission on October 30, 2008)
*10.15	Lease Agreement, dated March 26, 2008, between WNB Tower, LTD (as landlord) and Natural Gas Services Group, Inc. (as tenant) in connection with the lease of the Company’s principal offices in Midland, Texas.
14.0	Code of Ethics (Incorporated by reference to Exhibit 14.0 of the Registrant's Form 10-KSB for the fiscal year ended December 31, 2004, and filed with the Securities and Exchange Commission on March 30, 2005)
*23.1	Consent of Hein & Associates LLP
*31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
*31.2	Certification of Principal Accounting Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
*32.1	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
*32.2	Certification of Principal Accounting Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

* Filed herewith.