

NATURAL GAS SERVICES GROUP INC
Form 10-Q
November 03, 2010

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

FORM 10-Q

(X) QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2010

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., Ste 550
Midland, Texas 79701
(Address of principal executive offices)
(432) 262-2700
(Registrant's telephone number, including area code)

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

Yes No

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

Yes No

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

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

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

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

APPLICABLE ONLY TO CORPORATE ISSUERS

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

| Class | Outstanding at November 2, 2010 |
|--------------------------------|------------------------------------|
| Common Stock, \$0.01 par value | 12,123,899 |

NATURAL GAS SERVICES GROUP, INC.

Part I - FINANCIAL INFORMATION

Item 1. Financial Statements

Unaudited Condensed Balance Sheets Page 1

Unaudited Condensed Income Statements Page 2

Unaudited Condensed Statements of Cash Flows Page 3

Notes to Unaudited Condensed Financial Statements Page 4

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations Page 9

Item 3. Quantitative and Qualitative Disclosures about Market Risk Page 15

Item 4. Controls and Procedures Page 16

Part II - OTHER INFORMATION

Item 1. Legal Proceedings Page 17

Item 1A. Risk Factors Page 17

Item 6. Exhibits Page 18

Signatures Page 20

PART I – FINANCIAL INFORMATION

Item 1. Financial Statements

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

| | December 31, 2009 | September 30, 2010 |
|-------------------------------------------------------------------------------------------------------------------------|-------------------------|--------------------------|
| ASSETS | | |
| Current Assets: | | |
| Cash and cash equivalents | \$ 23,017 | \$ 22,863 |
| Trade accounts receivable, net of allowance for doubtful accounts of \$363 and \$149, respectively | 7,314 | 5,139 |
| Inventory, net of allowance for obsolescence of \$345 and \$291, respectively | 24,037 | 22,825 |
| Prepaid income taxes | 1,556 | 1,937 |
| Prepaid expenses and other | 279 | 361 |
| Total current assets | 56,203 | 53,125 |
| Rental equipment, net of accumulated depreciation of \$34,008 and \$41,515, respectively | 110,263 | 115,079 |
| Property and equipment, net of accumulated depreciation of \$7,210 and \$7,536, respectively | 7,626 | 6,994 |
| Goodwill, net of accumulated amortization of \$325, both periods | 10,039 | 10,039 |
| Intangibles, net of accumulated amortization of \$1,497 and \$1,692, respectively | 2,721 | 2,526 |
| Other assets | 19 | 26 |
| Total assets | \$ 186,871 | \$ 187,789 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current Liabilities: | | |
| Current portion of long-term debt | \$ 3,378 | \$ 3,378 |
| Line of credit | 7,000 | — |
| Accounts payable | 2,239 | 3,143 |
| Accrued liabilities | 1,485 | 2,539 |
| Current income tax liability | 1,708 | 546 |
| Deferred income | 90 | 1,650 |
| Total current liabilities | 15,900 | 11,256 |
| Long-term debt, less current portion | 2,817 | 283 |
| Deferred income tax payable | 25,498 | 27,583 |
| Other long-term liabilities | 558 | 536 |
| Total liabilities | 44,773 | 39,658 |
| Stockholders' Equity: | | |
| Preferred stock, 5,000 shares authorized, no shares issued or outstanding | — | — |
| Common stock, 30,000 shares authorized, par value \$0.01; 12,101 and 12,111 shares issued and outstanding, respectively | 121 | 121 |

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

| | | |
|--------------------------------------------|------------|------------|
| Additional paid-in capital | 84,570 | 85,542 |
| Retained earnings | 57,407 | 62,468 |
| Total stockholders' equity | 142,098 | 148,131 |
| Total liabilities and stockholders' equity | \$ 186,871 | \$ 187,789 |

See accompanying notes to these unaudited condensed financial statements.

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

| | Three months ended September 30, | | Nine months ended September 30, | |
|------------------------------------------------------------------------------------|-------------------------------------|----------|------------------------------------|----------|
| | 2009 | 2010 | 2009 | 2010 |
| Revenue: | | | | |
| Sales, net | \$ 5,285 | \$ 3,695 | \$ 16,813 | \$ 6,936 |
| Rental income | 10,840 | 10,326 | 35,597 | 30,103 |
| Service and maintenance income | 255 | 224 | 752 | 656 |
| Total revenue | 16,380 | 14,245 | 53,162 | 37,695 |
| Operating costs and expenses: | | | | |
| Cost of sales, exclusive of depreciation stated separately below | 3,641 | 2,201 | 11,423 | 4,329 |
| Cost of rentals, exclusive of depreciation stated separately below | 3,870 | 4,188 | 12,711 | 11,784 |
| Cost of service and maintenance, exclusive of depreciation stated separately below | 174 | 144 | 521 | 450 |
| Selling, general, and administrative expense | 1,582 | 1,359 | 4,813 | 4,379 |
| Depreciation and amortization | 2,902 | 2,990 | 8,795 | 8,770 |
| Total operating costs and expenses | 12,169 | 10,882 | 38,263 | 29,712 |
| Operating income | 4,211 | 3,363 | 14,899 | 7,983 |
| Other income (expense): | | | | |
| Interest expense | (148) | (40) | (462) | (168) |
| Other income (expense) | 9 | 53 | (97) | 96 |
| Total other income (expense) | (139) | 13 | (559) | (72) |
| Income before provision for income taxes | 4,072 | 3,376 | 14,340 | 7,911 |
| Provision for income taxes | 1,429 | 1,223 | 5,028 | 2,852 |
| Net income | \$ 2,643 | \$ 2,153 | \$ 9,312 | \$ 5,059 |
| Earnings per share: | | | | |
| Basic | \$ 0.22 | \$ 0.18 | \$ 0.77 | \$ 0.42 |
| Diluted | \$ 0.22 | \$ 0.18 | \$ 0.77 | \$ 0.41 |
| Weighted average shares outstanding: | | | | |
| Basic | 12,097 | 12,108 | 12,095 | 12,105 |
| Diluted | 12,135 | 12,196 | 12,127 | 12,204 |

See accompanying notes to these unaudited condensed financial statements.

NATURAL GAS SERVICES GROUP, INC.
CONDENSED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

| | 2009 | Nine months ended September 30, | 2010 |
|-----------------------------------------------------------------------------------|------------------|------------------------------------|------------------|
| CASH FLOWS FROM OPERATING ACTIVITIES: | | | |
| Net income | \$ 9,312 | | \$ 5,059 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Depreciation and amortization | 8,795 | | 8,770 |
| Deferred taxes | 5,028 | | 2,085 |
| Employee stock options expense | 479 | | 874 |
| Gain on disposal of assets | (52) | | (47) |
| Changes in current assets and liabilities: | | | |
| Trade accounts receivables, net | 5,029 | | 2,175 |
| Inventory, net | 5,965 | | 1,437 |
| Prepaid income taxes and prepaid expenses | (821) | | (463) |
| Accounts payable and accrued liabilities | (9,371) | | 1,958 |
| Current income tax liability | (256) | | (1,162) |
| Deferred income | 273 | | 1,560 |
| Other | — | | (5) |
| NET CASH PROVIDED BY OPERATING ACTIVITIES | 24,381 | | 22,241 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | | |
| Purchase of property and equipment | (7,847) | | (12,985) |
| Redemption of short-term investments | 2,300 | | — |
| Proceeds from sale of property and equipment | 142 | | 47 |
| NET CASH USED IN INVESTING ACTIVITIES | (5,405) | | (12,938) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | | |
| Proceeds from line of credit | 500 | | — |
| Proceeds from other long-term liabilities, net | 119 | | (22) |
| Repayments of long-term debt | (2,533) | | (2,534) |
| Repayments of line of credit | (489) | | (7,000) |
| Proceeds from exercise of stock options | 10 | | 99 |
| NET CASH USED IN FINANCING ACTIVITIES | (2,393) | | (9,457) |
| NET CHANGE IN CASH | 16,583 | | (154) |
| CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD | 1,149 | | 23,017 |
| CASH AND CASH EQUIVALENTS AT END OF PERIOD | \$ 17,732 | | \$ 22,863 |
| SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION: | | | |

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

| | | | | |
|-------------------|----|-----|----|-------|
| Interest paid | \$ | 414 | \$ | 202 |
| Income taxes paid | \$ | 925 | \$ | 2,137 |

NON-CASH TRANSACTIONS

| | | | | |
|-------------------------------------------|----|-------|----|-----|
| Transfer of rental equipment to inventory | \$ | 1,286 | \$ | 225 |
|-------------------------------------------|----|-------|----|-----|

See accompanying notes to these unaudited condensed financial statements.

NATURAL GAS SERVICES GROUP, INC.

Notes to Condensed Financial Statements
(unaudited)

(1) Basis of Presentation and Summary of Significant Accounting Policies

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

The accompanying unaudited condensed financial statements present the condensed results of our company taken from our books and records. In our opinion, such information includes all adjustments, consisting of only normal recurring adjustments, which are necessary to make our financial position at September 30, 2010 and the results of our operations for the three and nine months ended September 30, 2009 and 2010 not misleading. As permitted by the rules and regulations of the Securities and Exchange Commission (SEC) the accompanying condensed financial statements do not include all disclosures normally required by generally accepted accounting principles in the United States of America (GAAP). These financial statements should be read in conjunction with the financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2009 on file with the SEC. In our opinion, the condensed financial statements are a fair presentation of the financial position, results of operations and cash flows for the periods presented.

The results of operations for the three and nine months ended September 30, 2010 are not necessarily indicative of the results of operations to be expected for the full fiscal year ending December 31, 2010.

Revenue recognition

Revenue from the sales of custom and fabricated compressors, and flare systems is recognized upon shipment of the equipment to customers or when all conditions have been met 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. Revenue from the sale of rental units is included in sales revenue when equipment is shipped or title is transferred to the customer.

Fair Value of Financial Instruments

Our financial instruments consist principally of cash and cash equivalents, accounts receivable, accounts payable and notes payable. Pursuant to ASC 820, the fair value of our cash equivalents is determined based on "Level 1" inputs, which consist of quoted prices in active markets for identical assets. We believe that the recorded values of all of our other financial instruments approximate their current fair values because of their nature and respective relatively short maturity dates or durations.

Recently Issued Accounting Pronouncements

In April 2009, the FASB issued ASC 810, Amendments to FASB Interpretation No. 46(R) (SFAS 167). ASC 810 requires a qualitative approach to identifying a controlling financial interest in a variable interest entity (VIE), and

requires ongoing assessment of whether an entity is a VIE and whether an interest in a VIE makes the holder the primary beneficiary of the VIE. SFAS 167 is effective for annual reporting periods beginning after November 15, 2009. The adoption of ASC 810 did not have a material impact on our financial statements.

In September 2009, the FASB issued guidance to change financial reporting by enterprises involved with VIEs. The standard replaces the quantitative-based risks and rewards calculation for determining which enterprise has a controlling financial interest in a VIE with an approach focused on identifying which enterprise has the power to direct the activities of a VIE and the obligation to absorb losses of the entity or the right to receive the entity's residual returns. This standard was effective for us on January 1, 2010. We do not have any interests in variable interest entities; therefore, this standard did not have any impact on our financial statements.

NATURAL GAS SERVICES GROUP, INC.

In January 2010, the FASB issued authoritative guidance intended to improve disclosures about fair value measurements. The guidance requires entities to disclose significant transfers in and out of fair value hierarchy levels and the reasons for the transfers and to present information about purchases, sales, issuances and settlements separately in the reconciliation of fair value measurements using significant unobservable inputs (Level 3). Additionally, the guidance clarifies that a reporting entity should provide fair value measurements for each class of assets and liabilities and disclose the inputs and valuation techniques used for fair value measurements using significant other observable inputs (Level 2) and significant unobservable inputs (Level 3). This guidance was effective for us on January 1, 2010 except for the disclosures about purchases, sales, issuances and settlements in the Level 3 reconciliation, which will be effective for interim and annual periods beginning after December 15, 2010. As this guidance provides only disclosure requirements, the adoption of this standard did not impact our results of operations, cash flows or financial position.

In March 2010, the FASB issued authoritative guidance intended to clarify the scope exception related to embedded credit derivative features related to the transfer of credit risk in the form of subordination of one financial instrument to another. The guidance addresses how to determine which embedded credit derivative features, including those in collateralized debt obligations and synthetic collateralized debt obligations, are considered to be embedded derivatives that should not be analyzed under Accounting Standards Codification Topic 815, "Derivatives and Hedging" Subtopic 15-25 for potential bifurcation and separate accounting. This guidance is effective for each reporting entity at the beginning of its fiscal quarter beginning after September 15, 2010. We do not have any embedded credit derivative features with respect to our financial instruments; therefore, this standard is not expected to have any impact on our financial statements.

(2) Stock-Based Compensation

Stock Options:

A summary of option activity under our 1998 Stock Option plan for the nine months ended September 30, 2010 is presented below.

| | Number of Stock Options | Weighted Average Exercise Price | Weighted Average Remaining Contractual Life (years) | Aggregate Intrinsic Value (in thousands) |
|---------------------------------|-------------------------------|------------------------------------------|-----------------------------------------------------------------|---------------------------------------------------|
| Outstanding, December 31, 2009 | 437,877 | \$ 13.88 | 8.02 | \$ 2,260 |
| Granted | 60,000 | 18.32 | 8.00 | — |
| Exercised | (9,854) | 9.91 | — | 64 |
| Cancelled/Forfeited | (17,167) | 18.11 | — | 2 |
| Outstanding, September 30, 2010 | 470,856 | \$ 14.38 | 7.48 | \$ 1,129 |
| Exercisable, September 30, 2010 | 307,940 | \$ 12.82 | 6.77 | \$ 1,032 |

We granted 30,000 options to our Chief Executive Officer on January 28, 2010 at an exercise price of \$19.94 with a three year vesting period. We granted 30,000 options to the non-executive members of the board of directors on March 23, 2010 at an exercise price of \$16.74 vesting quarterly through December 2010.

NATURAL GAS SERVICES GROUP, INC.

The following table summarizes information about the stock options outstanding at September 30, 2010:

| Range of Exercise Prices | Shares | Options Outstanding | | Options Exercisable | |
|--------------------------|---------|-----------------------------------------------------|---------------------------------|---------------------|---------------------------------|
| | | Weighted Average Remaining Contractual Life (years) | Weighted Average Exercise Price | Shares | Weighted Average Exercise Price |
| \$ 0.01 – 5.58 | 19,000 | 2.31 | \$ 4.24 | 19,000 | \$ 4.24 |
| 5.59 – 9.43 | 121,023 | 6.64 | 8.49 | 121,023 | 8.49 |
| 9.44 – 15.60 | 72,500 | 7.13 | 12.52 | 52,500 | 13.50 |
| 15.61 – 20.48 | 258,333 | 8.36 | 18.40 | 115,417 | 18.48 |
| \$ 0.01 – 20.48 | 470,856 | 7.48 | \$ 14.38 | 307,940 | \$ 12.82 |

The summary of the status of our unvested stock options as of September 30, 2010 and changes during the nine months ended September 30, 2010 is presented below.

| | Shares | Weighted Average Grant Date Fair Value |
|--------------------------------|-----------|----------------------------------------|
| Unvested stock options: | | |
| Unvested at December 31, 2009 | 230,210 | \$ 7.40 |
| Granted | 60,000 | 7.30 |
| Vested | (116,377) | 5.98 |
| Forfeited | (10,917) | 7.35 |
| Unvested at September 30, 2010 | 162,916 | \$ 8.38 |

As of September 30, 2010, there was \$961,000 of unrecognized compensation cost related to unvested options. Such cost is expected to be recognized over a weighted-average period of 1.84 years. Total compensation expense for stock options was \$479,000 and \$676,000 for the nine months ended September 30, 2009 and 2010, respectively.

Restricted Stock:

On January 4, 2010, we awarded and issued 8,276 shares of restricted stock to three officers and one employee. The restricted stock awarded vests one year from the date of grant. On January 18, 2010, we awarded and issued 5,000 shares of restricted stock to our Chief Executive Officer. The restricted stock vests one year from the date of the grant. Compensation expense related to these restricted stock awards was \$198,000 for the nine months ended September 30, 2010. As of September 30, 2010, there was a total of \$61,000 of unrecognized compensation expenses related to these shares of restricted stock. This remaining compensation expense is expected to be recognized over the remaining three months of 2010.

NATURAL GAS SERVICES GROUP, INC.

(3) Inventory

Our inventory, net of allowance for obsolescence of \$345,000 at December 31, 2009 and \$291,000 at September 30, 2010, consisted of the following amounts:

| | December 31, 2009 | September 30, 2010 |
|-----------------|----------------------|-----------------------|
| | (in thousands) | |
| Raw materials | \$ 21,633 | \$ 20,156 |
| Finished goods | 1,584 | — |
| Work in process | 820 | 2,669 |
| | \$ 24,037 | \$ 22,825 |

During the nine months ended September 30, 2010, we wrote off \$178,000 of obsolete inventory against the allowance for obsolescence.

(4) Credit Facility

Revolving Line of Credit Facility. Our \$40 million line of credit expired on July 1, 2010 and was not renewed. The outstanding principal balance was paid in full on July 1, 2010.

\$16.9 Million Multiple Advance Term Loan Facility. As of September 30, 2010 this term loan facility had a principal balance of \$3.7 million and the interest rate was 4.00%.

As of September 30, 2010, we were in compliance with all covenants in our Loan Agreement.

(5) Other Long-term Liabilities

As of September 30, 2010, we had a long-term liability of \$275,000 to Midland Development Corporation. This amount is to be recognized as income contingent upon certain staffing requirements in the future. In addition, we entered into a purchase agreement with a vendor on July 30, 2008 pursuant to which we agreed to purchase up to \$4.8 million of our paint and coating requirements exclusively from the vendor. In connection with the execution of the agreement, the vendor paid us a \$300,000 fee which is considered to be a discount toward future purchases from the vendor. Based on our historical 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 September 30, 2010 was \$261,000.

(6) Earnings per Share

The following table reconciles the numerators and denominators of the basic and diluted earnings per share computation.

| | Three months Ended September 30, | | Nine months ended September 30, | |
|--|-------------------------------------|------|------------------------------------|------|
| | 2009 | 2010 | 2009 | 2010 |

Numerator: (in thousands, except per share data)

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

| | | | | |
|-------------------------------------------------------|---------|---------|---------|---------|
| Net income | \$2,643 | \$2,153 | \$9,312 | \$5,059 |
| Denominator for basic net income per common share: | | | | |
| Weighted average common shares outstanding | 12,097 | 12,108 | 12,095 | 12,105 |
| Denominator for diluted net income per share: | | | | |
| Weighted average common shares outstanding | 12,097 | 12,108 | 12,095 | 12,105 |
| Dilutive effect of stock options and restricted stock | 38 | 88 | 32 | 99 |
| Diluted weighted average shares | 12,135 | 12,196 | 12,127 | 12,204 |

Earnings per common share:

| | | | | |
|---------|--------|--------|--------|--------|
| Basic | \$0.22 | \$0.18 | \$0.77 | \$0.42 |
| Diluted | \$0.22 | \$0.18 | \$0.77 | \$0.41 |

(7) Segment Information

FASB ASC 280, Segment Reporting, 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 three months ended September 30, 2010 (in thousands):

| | Sales | Rental | Service & Maintenance | Corporate | Total |
|---------------------------------------------|----------|-----------|--------------------------|------------|-----------|
| Revenue | \$ 3,695 | \$ 10,326 | \$ 224 | \$ — | \$ 14,245 |
| Operating costs and expenses | 2,201 | 4,188 | 144 | 4,349 | 10,882 |
| Other income/(expense) | — | — | — | 13 | 13 |
| Income before provision for income taxes | \$ 1,494 | \$ 6,138 | \$ 80 | \$ (4,336) | \$ 3,376 |

For the three months ended September 30, 2009 (in thousands):

| | Sales | Rental | Service & Maintenance | Corporate | Total |
|---------------------------------------------|----------|-----------|--------------------------|------------|-----------|
| Revenue | \$ 5,285 | \$ 10,840 | \$ 255 | \$ — | \$ 16,380 |
| Operating costs and expenses | 3,641 | 3,870 | 174 | 4,484 | 12,169 |
| Other income/(expense) | — | — | — | (139) | (139) |
| Income before provision for income taxes | \$ 1,644 | \$ 6,970 | \$ 81 | \$ (4,623) | \$ 4,072 |

For the nine months ended September 30, 2010 (in thousands):

| | Sales | Rental | Service & Maintenance | Corporate | Total |
|---------------------------------------------|----------|-----------|--------------------------|-------------|------------|
| Revenue | \$ 6,936 | \$ 30,103 | \$ 656 | \$ — | \$ 37,695 |
| Operating costs and expenses | 4,329 | 11,784 | 450 | 13,149 | 29,712 |
| Other income/(expense) | — | — | — | (72) | (72) |
| Income before provision for income taxes | \$ 2,607 | \$ 18,319 | \$ 206 | \$ (13,221) | \$ 7,911 |
| *Segment Assets | \$ — | \$ — | \$ — | \$ 187,789 | \$ 187,789 |

For the nine months ended September 30, 2009 (in thousands):

| | Sales | Rental | Service & Maintenance | Corporate | Total |
|---------------------------------------------|-----------|-----------|--------------------------|-------------|------------|
| Revenue | \$ 16,813 | \$ 35,597 | \$ 752 | \$ — | \$ 53,162 |
| Operating costs and expenses | 11,423 | 12,711 | 521 | 13,608 | 38,263 |
| Other income/(expense) | — | — | — | (559) | (559) |
| Income before provision for income taxes | \$ 5,390 | \$ 22,886 | \$ 231 | \$ (14,167) | \$ 14,340 |
| *Segment Assets | \$ — | \$ — | \$ — | \$ 184,273 | \$ 184,273 |

* Management does not track assets by segment

NATURAL GAS SERVICES GROUP, INC.

(8) Legal Proceedings

From time to time, we are a party to various other 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 adverse effect on our financial position, results of operations or cash flow. We are not currently a party to any material legal proceedings and we are not aware of any other threatened litigation.

(9) Securities offering

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

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

The discussion and analysis of our financial condition and results of operations are based on, and should be read in conjunction with, our condensed financial statements and the related notes included elsewhere in this report and in our Annual Report on Form 10-K for the year ended December 31, 2009 filed with the SEC.

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 September 30, 2010, we had 1,266 natural gas compressors totaling 167,869 horsepower rented to 101 third parties compared to 1,239 natural gas compressors totaling 157,028 horsepower rented to 90 third parties at September 30, 2009.

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. The 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 two to three 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.

NATURAL GAS SERVICES GROUP, INC.

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

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

Demand for our products and services was strong throughout most of 2008, but in 2009 and the first half of 2010 the demand declined due to lower natural gas prices, decreased demand for natural gas and the economic recession.

For fiscal year 2010, 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 2010. We may require additional capital to fund any unanticipated expenditures, including any acquisitions of other businesses, although that capital may not be available to us when we need it or on acceptable terms.

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

Results of Operations

Three months ended September 30, 2009, compared to the three months ended September 30, 2010.

The table below shows our revenues and percentage of total revenues of each of our segments for the three and nine months ended September 30, 2009 and September 30, 2010.

| | Revenue (in thousands) | | | |
|-------------------------|------------------------------------------|-----|------------------------------------------|-----|
| | Three months ended September 30, 2009 | | Three months ended September 30, 2010 | |
| | \$ | % | \$ | % |
| Sales | \$ 5,285 | 32% | \$ 3,695 | 26% |
| Rental | 10,840 | 66% | 10,326 | 72% |
| Service and Maintenance | 255 | 2% | 224 | 2% |
| Total | \$ 16,380 | | \$ 14,245 | |

Total revenue decreased from \$16.4 million to \$14.2 million, or 13.0%, for the three months ended September 30, 2010, compared to the same period ended September 30, 2009. This was mainly result of decreased compressor unit sales and compressor rental revenue. Sales revenue decreased 30.1%, rental revenue decreased 4.7%, and service and

maintenance revenue decreased 12.2%.

Sales revenue decreased from \$5.3 million to \$3.7 million, or 30.1%, for the three months ended September 30, 2010, compared to the same period ended September 30, 2009. This decrease is mainly the result of lower demand for our products due to industry declines in capital expenditures which resulted in fewer compressor units sold to third parties from our Tulsa operations. Sales included: (1) compressor unit sale, (2) flare sales, (3) parts, and (4) compressor rebuilds.

Rental revenue decreased from \$10.8 million to \$10.3 million, or 4.7%, for the three months ended September 30, 2010, compared to the same period ended September 30, 2009. This decrease is the result of rental price concessions to our customers. We ended the quarter with 1,849 compressor packages in our rental fleet, up from 1,772 units at September 30, 2009. The rental fleet had a utilization of 68.5% as of September 30, 2010 compared to 69.9% utilization as of September 30, 2009. This utilization decrease is mainly the result of compressor rental units that have not yet returned to service. We expect when natural gas prices increase we will again rent the available units.

NATURAL GAS SERVICES GROUP, INC.

The overall operating margin percentage decreased to 23.6% for the three months ended September 30, 2010, from 25.7% for the same period ended September 30, 2009. The lower margin is mainly the result of the decline in total revenue and the fact that lower sales means SG&A and depreciation, which are mainly fixed, become a larger percentage of our total cost.

Selling, general, and administrative expense decreased from \$1.6 million to \$1.4 million, or 14.1% for the three months ended September 30, 2010, as compared to the same period ended September 30, 2009. This decrease is mainly due to lower commissions, administrative salaries, and legal fees.

Depreciation and amortization expense increased to \$3.0 million for the three months ended September 30, 2010, compared to \$2.9 million for the same period ended September 30, 2009. This was the result of a few new gas compressor rental units being added to the rental fleet from September 30, 2009 to September 30, 2010. We added a net 77 compressors to our rental fleet during the twelve month period.

Interest expense decreased 73.0% for the three months ended September 30, 2010, compared to the same period ended September 30, 2009, mainly due to the repayment of \$7 million on our line of credit during 2010 and the continuing amortization of our term loan.

Provision for income tax decreased from \$1.4 million to \$1.2, or 14.4%, and is the result of the decrease in taxable income. We had an effective rate of 36% for the three months ended September 30, 2010 and 35% for same period in 2009.

Nine months ended September 30, 2009, compared to the nine months ended September 30, 2010.

The table below shows our revenues and percentage of total revenues of each of our segments for the nine months ended September 30, 2009 and September 30, 2010.

| | Revenue (in thousands) | | | | | |
|-------------------------|-----------------------------------------|--------|-----|------|--------|-----|
| | Nine months ended September 30, 2009 | | | 2010 | | |
| | | | | | | |
| Sales | \$ | 16,813 | 32% | \$ | 6,936 | 18% |
| Rental | | 35,597 | 67% | | 30,103 | 80% |
| Service and Maintenance | | 752 | 1% | | 656 | 2% |
| Total | \$ | 53,162 | | \$ | 37,695 | |

Total revenue decreased from \$53.2 million to \$37.7 million, or 29.1%, for the nine months ended September 30, 2010, compared to the same period ended September 30, 2009. This was mainly the result of a 58.8% decrease in sales revenue, a decrease in rental revenue of 15.4%, and service and maintenance revenue decreased 12.8%.

Sales revenue decreased from \$16.8 million to \$6.9 million, or 58.8%, for the nine months ended September 30, 2010, compared to the same period ended September 30, 2009. This decrease is the result of lower demand for our products due to an industry slowdown which resulted in fewer compressor unit sales to third parties from our Tulsa and Michigan operations. Sales included: (1) compressor unit sale, (2) flare sales, (3) parts sales, (4) compressor rebuilds and (5) rental unit sales.

Rental revenue decreased from \$35.6 million to \$30.1 million, or 15.4%, for the nine months ended September 30, 2010, compared to the same period ended September 30, 2009. This decrease was the result of rental price

concessions to our customers and returned rental units. We ended the quarter with 1,849 compressor packages in our rental fleet, up from 1,772 units at September 30, 2009. The rental fleet had a utilization of 68.5% as of September 30, 2010 compared to 69.9% utilization as of September 30, 2009. This utilization decrease is mainly the result of compressor rental units returned by our customers and that have not yet returned to service.

The overall operating margin percentage decreased to 21.2% for the nine months ended September 30, 2010, from 28.0% for the same period ended September 30, 2009. This is mainly the result of decreased margins of our rental fleet activity and the fact that the decline in total revenue means that SG&A and depreciation, which are mainly fixed, become a larger percentage of our total cost. The overall margin is also affected by the product mix between rentals and sales since our rental margin is higher it is generally our focus to increase our rentals business.

Selling, general, and administrative expense decreased from \$4.8 million, to \$4.4 million, or 9.0%, for the nine months ended September 30, 2010, as compared to the same period ended September 30, 2009. This decrease is mainly due to lower commissions, administrative salaries, legal fees and accounting compliance expenses.

NATURAL GAS SERVICES GROUP, INC.

Depreciation and amortization expense remained flat at \$8.8 million for the nine months ended September 30, 2010 and for the same period ended September 30, 2009. Normally we would experience an increase but with fewer new gas compressor rental units being added to the rental fleet in the current year and continuing depreciation the expense was flat during the period of 2010 compared to the same period in 2009.

Interest expense decreased 63.6% for the nine months ended September 30, 2010, compared to the same period ended September 30, 2009, mainly due to decreased principal balance owed under our bank loan facility and pay off of the outstanding balance on our line of credit which expired in July 2010.

Income tax expense decreased from \$5.0 million to \$2.9 million, or 43.3%, and is the result of the decrease in taxable income.

Liquidity and Capital Resources

Our working capital positions as of December 31, 2009 and September 30, 2010 are set forth below:

| | December 31, 2009 | | September 30, 2010 |
|-----------------------------------|----------------------|----|-----------------------|
| | (in thousands) | | |
| Current Assets: | | | |
| Cash and cash equivalents | \$ 23,017 | \$ | 22,863 |
| Trade accounts receivable, net | 7,314 | | 5,139 |
| Inventory, net | 24,037 | | 22,825 |
| Prepaid income taxes | 1,556 | | 1,937 |
| Prepaid expenses and other | 279 | | 361 |
| Total current assets | 56,203 | | 53,125 |
| Current Liabilities: | | | |
| Current portion of long-term debt | 3,378 | | 3,378 |
| Line of credit | 7,000 | | — |
| Accounts payable | 2,239 | | 3,143 |
| Accrued liabilities | 1,485 | | 2,539 |
| Current portion of tax liability | 1,708 | | 546 |
| Deferred income | 90 | | 1,650 |
| Total current liabilities | 15,900 | | 11,256 |
| Total working capital | \$ 40,303 | \$ | 41,869 |

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 from these sources were primarily used to pay debt and to fund the manufacture and fabrication of additional units for our rental fleet of natural gas compressors.

For the nine months ended September 30, 2010, we invested \$13.0 million in equipment for our rental fleet and service vehicles. Even though we have rental equipment idle we often do not have the specific type of equipment that our customers require, therefore we have to build new equipment to satisfy their needs. We financed this activity with cash flow from operations and cash on hand. In addition, we repaid \$9.5 million of our existing debt during the nine months ended September 30, 2010.

Cash flows

At September 30, 2010, we had cash and cash equivalents of \$22.9 million compared to \$23.0 million at December 31, 2009. Our cash flow from operations of \$22.2 million was offset by a repayment of approximately \$7.0 million on our line of credit and capital expenditures of \$13.0 million during the nine months ended September 30, 2010. We had working capital of \$41.9 million at September 30, 2010 compared to \$40.3 million at December 31, 2009. At September 30, 2010, our total debt was \$3.7 million of which \$3.4 million was classified as current compared to \$13.2 million and \$10.4 million, respectively at December 31, 2009. We had positive net cash flow from operating activities of \$22.2 million during the first nine months of 2010 compared to \$24.4 million for the first nine months of 2009. The cash flow from operations of \$22.2 million was primarily the result of the net income of \$5.1 million and the non cash items of depreciation and taxes of \$10.9 million, a reduction in accounts receivable of \$2.2 million, an increase in deferred income of \$1.6 million and an increase in accounts payable of \$2.0 million.

NATURAL GAS SERVICES GROUP, INC.

Accounts receivable decreased \$2.2 million to \$5.1 million September 30, 2010 compared to \$7.3 million at December 31, 2009. This decrease largely reflects the timing of collections and a slowdown in compressor unit sales during the first nine months of 2010.

Inventory decreased \$1.2 million to \$22.8 million at September 30, 2010 compared to \$24.0 million at December 31, 2009. This decrease is mainly the result of utilizing existing stock for the manufacturing activity during the third quarter of 2010.

Long-term debt decreased \$9.5 million to \$3.7 million at September 30, 2010, compared to \$13.2 million at December 2009. This decrease is mainly the result of the normal debt amortization and a repayment of \$7.0 million of our line of credit.

Recession strategy

For the remainder of the fiscal year 2010, 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 limit bank borrowing. Capital expenditures for the year ended December 31, 2010 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 2010. We may require additional capital to fund any unanticipated expenditures, including any acquisitions of other businesses.

Senior Bank Borrowings

Revolving Line of Credit Facility. Our \$40 million line of credit expired on July 1, 2010 and was paid in full at the time. The line of credit was not renewed and we are currently negotiating with another bank to replace our line of credit. Our expectation is to replace this line of credit; however, in the event this line of credit is not replaced, we anticipate this event will have little to no affect on our operations as a whole.

\$16.9 Million Multiple Advance Term Loan Facility. As of September 30, 2010, this term loan facility had a principal balance of \$3.7 million and the interest rate is 4.0%. As of September 30, 2010, we were in compliance with all covenants in our Loan Agreement.

Other

As of September 30, 2010, we had a long-term liability of \$275,000 to Midland Development Corporation. This amount is to be recognized as income contingent upon certain staffing requirements in the future. The staffing requirements related to our agreement will remain in effect until April 9, 2016. Failure to comply with the terms of the agreement could result in the repayment of the entire \$275,000 economic stimulus incentive payment. 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. This long-term liability remaining as of September 30, 2010 was \$261,000.

NATURAL GAS SERVICES GROUP, INC.

Contractual Obligations and Commitments

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

| Cash Contractual Obligations | Obligation Due in Period (in thousands of dollars) | | | | | | Total |
|-----------------------------------|-------------------------------------------------------|----------|----------|----------|----------|------------|----------|
| | 2010(1) | 2011 | 2012 | 2013 | 2014 | Thereafter | |
| Term loan facility (secured) | \$ 844 | \$ 2,817 | \$ — | \$ — | \$ — | \$ — | \$ 3,661 |
| Interest on term loan facility(2) | 34 | 51 | — | — | — | — | 85 |
| Purchase obligations | 170 | 956 | 956 | 956 | 956 | 436 | 4,430 |
| Other long term debt | — | — | — | — | 558 | — | 558 |
| Facilities and office leases | 91 | 294 | 244 | 167 | 17 | — | 813 |
| Total | \$ 1,139 | \$ 4,118 | \$ 1,200 | \$ 1,123 | \$ 1,531 | \$ 436 | \$ 9,547 |

(1) For the three months remaining in 2010.

(2) Assumes an interest rate of 4.0%.

Critical Accounting Policies and Practices

A discussion of our critical accounting policies is included in the Company's Form 10-K for the year ended December 31, 2009.

Recently Issued Accounting Pronouncements

In April 2009, the FASB issued ASC 810, Amendments to FASB Interpretation No. 46(R) (SFAS 167). ASC 810 requires a qualitative approach to identifying a controlling financial interest in a variable interest entity (VIE), and requires ongoing assessment of whether an entity is a VIE and whether an interest in a VIE makes the holder the primary beneficiary of the VIE. SFAS 167 is effective for annual reporting periods beginning after November 15, 2009. The adoption of ASC 810 is not expected to have a material impact on our financial statements.

In September 2009, the FASB issued guidance to change financial reporting by enterprises involved with VIEs. The standard replaces the quantitative-based risks and rewards calculation for determining which enterprise has a controlling financial interest in a VIE with an approach focused on identifying which enterprise has the power to direct the activities of a VIE and the obligation to absorb losses of the entity or the right to receive the entity's residual returns. This standard was effective for us on January 1, 2010. We do not have any interests in variable interest entities; therefore, this standard did not have any impact on our financial statements.

In January 2010, the FASB issued authoritative guidance intended to improve disclosures about fair value measurements. The guidance requires entities to disclose significant transfers in and out of fair value hierarchy levels and the reasons for the transfers and to present information about purchases, sales, issuances and settlements separately in the reconciliation of fair value measurements using significant unobservable inputs (Level 3). Additionally, the guidance clarifies that a reporting entity should provide fair value measurements for each class of assets and liabilities and disclose the inputs and valuation techniques used for fair value measurements using significant other observable inputs (Level 2) and significant unobservable inputs (Level 3). This guidance was effective for us on January 1, 2010 except for the disclosures about purchases, sales, issuances and settlements in the Level 3 reconciliation, which will be effective for interim and annual periods beginning after December 15, 2010. As this guidance provides only disclosure requirements, the adoption of this standard did not impact our results of operations, cash flows or financial position.

NATURAL GAS SERVICES GROUP, INC.

In March 2010, the FASB issued authoritative guidance intended to clarify the scope exception related to embedded credit derivative features related to the transfer of credit risk in the form of subordination of one financial instrument to another. The guidance addresses how to determine which embedded credit derivative features, including those in collateralized debt obligations and synthetic collateralized debt obligations, are considered to be embedded derivatives that should not be analyzed under Accounting Standards Codification Topic 815, "Derivatives and Hedging" Subtopic 15-25 for potential bifurcation and separate accounting. This guidance is effective for each reporting entity at the beginning of its fiscal quarter beginning after September 15, 2010. We do not have any embedded credit derivative features with respect to our financial instruments; therefore, this standard is not expected to have any impact on our financial statements.

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 September 30, 2010, the off-balance sheet arrangements and transactions that we have entered into include operating lease agreements and purchase agreements. We do not believe that these arrangements are reasonably likely to materially affect our liquidity, 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 received by the Company is recorded as a long-term liability and will decrease as the purchase commitment is fulfilled. This long-term liability remaining as of September 30, 2010 was \$261,000.

Special Note Regarding Forward-Looking Statements

Except for historical information contained herein, the statements in this report are forward-looking and made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements involve known and unknown risks and uncertainties, which may cause NGS's actual results in future periods to differ materially from forecasted results. Those risks include, among other things, the loss of market share through competition or otherwise; the introduction of competing technologies by other companies; a prolonged, substantial reduction in oil and natural gas prices which could cause a decline in the demand for NGS's products and services; and new governmental safety, health and environmental regulations which could require NGS to make significant capital expenditures. The forward-looking statements included in this Form 10-Q are only made as of the date of this report, and NGS undertakes no obligation to publicly update such forward-looking statements to reflect subsequent events or circumstances. A discussion of these risk factors is included in our Annual Report on Form 10-K for the year ended December 31, 2009 filed with the Securities and Exchange Commission.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Commodity Risk

Our commodity risk exposure is primarily the pricing applicable to natural gas production, and oil to a lesser extent. Realized commodity prices received for such production are primarily driven by the spot prices applicable to natural gas and the prevailing worldwide price for crude oil. 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.

Financial Instruments and Debt Maturities

Our financial instruments consist of cash and cash equivalents, accounts receivable, accounts payable, bank borrowings, and notes. The carrying amounts of cash and cash equivalents, accounts receivable and accounts payable approximate fair value due to the highly liquid nature of these short-term instruments. The fair value of the bank borrowings approximate the carrying amounts as of September 30, 2010 and were determined based upon interest rates currently available to us.

NATURAL GAS SERVICES GROUP, INC.

Customer Credit Risk

We are exposed to the risk of financial non-performance by 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 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.

Interest Rate Risk

Our Loan Agreement provides for Prime Rate less 1/2 % (but never lower than 4% or higher than 8.75%) for our term loan facility. Consequently, our exposure to interest rates relate 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 September 30, 2010, we were not using any derivatives to manage interest rate risk.

Item 4. Controls and Procedures

(a) 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 and of our “disclosure controls and procedures” (as such term is defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as amended or, the “Exchange Act”) as of the end of the period covered by this report 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 the end of the period covered by this report were 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. These 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 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.

(b) Changes in Internal Controls.

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.

NATURAL GAS SERVICES GROUP, INC.

PART II – OTHER INFORMATION

Item 1. Legal Proceedings

From time to time, we are a party to various other 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 adverse effect on our financial position, results of operations or cash flow. We are not currently a party to any legal proceedings and we are not aware of any other threatened litigation.

Item 1A. Risk Factors

Please refer to and read “Risk Factors” in our Annual Report on Form 10-K for the fiscal year ended December 31, 2009 for a discussion of the risk associated with our company and industry.

NATURAL GAS SERVICES GROUP, INC.

Item 6. Exhibits

The following exhibits are filed herewith or incorporated herein by reference, as indicated:

| Exhibit No. | Description |
|-------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 3.1 | Articles of Incorporation, as amended (Incorporated by reference to Exhibit 3.1 of the 10-QSB filed and dated November 10, 2004) |
| 3.2 | Bylaws (Incorporated by reference to Exhibit 3.4 of the Registrant's Registration Statement on Form SB-2, No. 333-88314) |
| 4.1 | Non-Statutory Stock Option Agreement (Incorporated by reference to Exhibit 10.2 to Form 8-K filed with the SEC on August 30, 2005) |
| 4.2 | Form of Senior Indenture (Incorporated by reference to Exhibit 4.1 of the Registrant's Registration Statement on Form S-3 (No. 333-161346) and filed on August 14, 2009) |
| 4.3 | Form of Senior Note (Incorporated by reference to Exhibit 4.2 of the Registrant's Registration Statement on Form S-3 (No. 333-161346) and filed on August 14, 2009) |
| 4.4 | Form of Subordinated Indenture (Incorporated by reference to Exhibit 4.3 of the Registrant's Registration Statement on Form S-3 (No. 333-161346) and filed on August 14, 2009) |
| 4.4 | Form of Subordinated Note (Incorporated by reference to Exhibit 4.4 of the Registrant's Registration Statement on Form S-3 (No. 333-161346) and filed on August 14, 2009) |
| 4.6 | Form of Deposit Agreement, including Form of Depositary Share (Incorporated by reference to Exhibit 4.5 of the Registrant's Registration Statement on Form S-3 (No. 333-161346) and filed on August 14, 2009) |
| 4.7 | Form of Warrant Agreement, including Form of Warrant Certificate (Incorporated by reference to Exhibit 4.6 of the Registrant's Registration Statement on Form S-3 (No. 333-161346) and filed on August 14, 2009) |
| 4.8 | Form of Unit Agreement (Incorporated by reference to Exhibit 4.7 of the Registrant's Registration Statement on Form S-3 (No. 333-161346) and filed on August 14, 2009) |
| 4.9 | Form of Preferred Stock Certificate (Incorporated by reference to Exhibit 4.8 of the Registrant's Registration Statement on Form S-3 (No. 333-161346) and filed on August 14, 2009) |
| 4.10 | Form of Certificate of Designation with respect to Preferred Stock (Incorporated by reference to Exhibit 4.9 of the Registrant's Registration Statement on Form S-3 (No. 333-161346) and filed on August 14, 2009) |

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

NATURAL GAS SERVICES GROUP, INC.

- 10.1 Lease Agreement, dated March 1, 2004, between the Registrant and the City of Midland, Texas (Incorporated by reference to Exhibit 10.19 of the Registrant's Form 10-QSB for the fiscal quarter ended March 31, 2004)
- 10.2 Amended and Restated Loan Agreement (Incorporated by reference to Exhibit 10.1 of the Registrant's Form 8-K dated October 26, 2006 and filed with the Securities and Exchange Commission on November 1, 2006)
- 10.3 Eighth Amended and Restated Loan Agreement between Natural Gas Services Group, Inc. and Western National Bank. (Incorporated by reference to Exhibit 10.14 of the registrants Quarterly Report on Form 10-Q for the fiscal quarter ended June 30, 2008 and filed with the Securities Exchange Commission on August 7, 2008.)
 - 10.4 Revolving Line of Credit Promissory Note issued to Western National Bank. (Incorporated by reference to Exhibit 10.15 of the registrants Quarterly Report on Form 10-Q for the fiscal quarter ended June 30, 2008 and filed with the Securities and Exchange Commission on August 7, 2008.)
- 10.5 Employment Agreement between Natural Gas Services Group, Inc. and Stephen C. Taylor dated October 25, 2008 (Incorporated by reference to Exhibit 10.1 of the Registrant's Current Report on Form 8-K filed with the Securities and Exchange Commission on October 30, 2008)
- 10.6 Lease Agreement, dated March 26, 2008, between WNB Tower, LTD and Natural Gas Services Group, Inc. (Incorporated by reference to Exhibit 10.15 of the Registrant's Form 10-K for the fiscal year ended December 31, 2008 and filed with the Securities and Exchange Commission on March 9, 2009)
- 10.7 2009 Restricted Stock/Unit Plan (Incorporated by reference to Exhibit 10.1 of the Registrant's Current Report on Form 8-K dated September 18, 2009 and filed with the Securities and Exchange Commission on September 18, 2009.)
- 10.8 1998 Stock Option Plan, as amended (Incorporated by reference to Exhibit 10.2 of the Registrant's Current Report on Form 8-K dated September 18, 2009 and filed with the Securities and Exchange Commission on September 18, 2009.)
- 10.9 Lease Agreement, dated December 11, 2008, between Klement-Wes Partnership, LTD and Natural Gas Services Group, Inc. and commencing on January 1, 2009
- 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)
- *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.

NATURAL GAS SERVICES GROUP, INC.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

NATURAL GAS SERVICES GROUP, INC.

/s/ Stephen C. Taylor
Stephen C. Taylor
President and Chief Executive
Officer

/s/ Earl R. Wait
Earl R. Wait
Principal Accounting Officer and
Treasurer

November 3, 2010

NATURAL GAS SERVICES GROUP, INC.

INDEX TO EXHIBITS

The following exhibits are filed herewith or incorporated herein by reference, as indicated:

| Exhibit No. | Description |
|-------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 3.1 | Articles of Incorporation, as amended (Incorporated by reference to Exhibit 3.1 of the 10-QSB filed and dated November 10, 2004) |
| 3.2 | Bylaws (Incorporated by reference to Exhibit 3.4 of the Registrant's Registration Statement on Form SB-2, No. 333-88314) |
| 4.1 | Non-Statutory Stock Option Agreement (Incorporated by reference to Exhibit 10.2 to Form 8-K filed with the SEC on August 30, 2005) |
| 4.2 | Form of Senior Indenture (Incorporated by reference to Exhibit 4.1 of the Registrant's Registration Statement on Form S-3 (No. 333-161346) and filed on August 14, 2009) |
| 4.3 | Form of Senior Note (Incorporated by reference to Exhibit 4.2 of the Registrant's Registration Statement on Form S-3 (No. 333-161346) and filed on August 14, 2009) |
| 4.4 | Form of Subordinated Indenture (Incorporated by reference to Exhibit 4.3 of the Registrant's Registration Statement on Form S-3 (No. 333-161346) and filed on August 14, 2009) |
| 4.4 | Form of Subordinated Note (Incorporated by reference to Exhibit 4.4 of the Registrant's Registration Statement on Form S-3 (No. 333-161346) and filed on August 14, 2009) |
| 4.6 | Form of Deposit Agreement, including Form of Depositary Share (Incorporated by reference to Exhibit 4.5 of the Registrant's Registration Statement on Form S-3 (No. 333-161346) and filed on August 14, 2009) |
| 4.7 | Form of Warrant Agreement, including Form of Warrant Certificate (Incorporated by reference to Exhibit 4.6 of the Registrant's Registration Statement on Form S-3 (No. 333-161346) and filed on August 14, 2009) |
| 4.8 | Form of Unit Agreement (Incorporated by reference to Exhibit 4.7 of the Registrant's Registration Statement on Form S-3 (No. 333-161346) and filed on August 14, 2009) |
| 4.9 | Form of Preferred Stock Certificate (Incorporated by reference to Exhibit 4.8 of the Registrant's Registration Statement on Form S-3 (No. 333-161346) and filed on August 14, 2009) |
| 4.10 | Form of Certificate of Designation with respect to Preferred Stock (Incorporated by reference to Exhibit 4.9 of the Registrant's Registration Statement on Form S-3 (No. 333-161346) and filed on August 14, 2009) |

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

NATURAL GAS SERVICES GROUP, INC.

- 10.1 Lease Agreement, dated March 1, 2004, between the Registrant and the City of Midland, Texas (Incorporated by reference to Exhibit 10.19 of the Registrant's Form 10-QSB for the fiscal quarter ended March 31, 2004)
- 10.2 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
- 10.3 Eighth Amended and Restated Loan Agreement between Natural Gas Services Group, Inc. and Western National Bank. (Incorporated by reference to Exhibit 10.14 of the registrants Quarterly Report on Form 10-Q for the fiscal quarter ended June 30, 2008 and filed with the Securities Exchange Commission on August 7, 2008.)
- 10.4 Revolving Line of Credit Promissory Note issued to Western National Bank. (Incorporated by reference to Exhibit 10.15 of the registrants Quarterly Report on Form 10-Q for the fiscal quarter ended June 30, 2008 and filed with the Securities Exchange Commission on August 7, 2008.)
- 10.5 Employment Agreement between Natural Gas Services Group, Inc. and Stephen C. Taylor dated October 25, 2008 (Incorporated by reference to Exhibit 10.1 of the Registrant's Current Report on Form 8-K filed with the Securities and Exchange Commission on October 30, 2008)
- 10.6 Lease Agreement, dated March 26, 2008, between WNB Tower, LTD and Natural Gas Services Group, Inc. (Incorporated by reference to Exhibit 10.15 of the Registrant's Form 10-K for the fiscal year ended December 31, 2008 and filed with the Securities and Exchange Commission on March 9, 2009)
- 10.7 2009 Restricted Stock/Unit Plan (Incorporated by reference to Exhibit 10.1 of the Registrant's Current Report on Form 8-K dated September 18, 2009 and filed with the Securities and Exchange Commission on September 18, 2009.)
- 10.8 1998 Stock Option Plan, as amended (Incorporated by reference to Exhibit 10.2 of the Registrant's Current Report on Form 8-K dated September 18, 2009 and filed with the Securities and Exchange Commission on September 18, 2009.)
- 10.9 Lease Agreement, dated December 11, 2008, between Klement-Wes Partnership, LTD and Natural Gas Services Group, Inc. and commencing on January 1, 2009
- 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)
- *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.

22
