NATURAL GAS SERVICES GROUP INC
Form 10-Q
November 07, 2008

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, 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
[Missing Graphic Reference]
NATURAL GAS SERVICES GROUP, INC.
(Exact name of registrant as specified in its charter)

Colorado	75-2811855
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

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 x No o

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.

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

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

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 6, 2008
Common Stock, $.01 par value	12,093,833

NATURAL GAS SERVICES GROUP, INC.

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PART I – FINANCIAL INFORMATION

Item 1. Financial Statements

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

	December 31, 2007	September 30, 2008
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 245	$ 6,701
Short-term investments	18,661	—
Trade accounts receivable, net of doubtful accounts of $110 and $106, respectively	11,322	11,078
Inventory, net of allowance for obsolescence of $273 and $380, respectively	20,769	29,270
Prepaid income taxes	3,584	377
Prepaid expenses and other	641	87
Total current assets	55,222	47,513
Rental equipment, net of accumulated depreciation of $16,810 and $22,374, respectively	76,025	104,539
Property and equipment, net of accumulated depreciation of $4,792 and $5,657, respectively	8,580	9,129
Goodwill, net of accumulated amortization of $325, both periods	10,039	10,039
Intangibles, net of accumulated amortization of $1,145 and $1,374, respectively	3,324	3,095
Other assets	43	17
Total assets	$ 153,233	$ 174,332
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	5,178
Accrued liabilities	3,990	5,922
Current income tax liability	3,525	109
Deferred income	81	51
Total current liabilities	16,646	14,638
Long term debt, less current portion	9,572	7,039
Line of credit, less current portion	—	7,000

Deferred income tax payable		12,635		18,744
Other long term liabilities		—		447
Total liabilities		38,853		47,868
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		83,883
Retained earnings		30,799		42,460
Total stockholders' equity		114,380		126,464
Total liabilities and stockholders' equity	$	153,233	$	174,332

See accompanying notes to these condensed consolidated financial statements.

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

	Three months ended September 30,		Nine months ended September 30,	
	2007	2008	2007	2008
Revenue:				
Sales, net	$10,574	$13,239	$30,239	$32,024
Rental income	7,857	11,414	22,019	30,519
Service and maintenance income	220	293	729	814
Total revenue	18,651	24,946	52,987	63,357
Operating costs and expenses:				
Cost of sales, exclusive of depreciation stated separately below	6,894	9,038	20,856	21,669
Cost of rentals, exclusive of depreciation stated separately below	3,161	4,106	8,885	11,604
Cost of service and maintenance, exclusive of depreciation stated separately below	132	207	456	567
Selling, general, and administrative expense	1,311	1,539	3,773	4,374
Depreciation and amortization	1,921	2,608	5,448	7,097
Total operating costs and expenses	13,419	17,498	39,418	45,311
Operating income	5,232	7,448	13,569	18,046
Other income (expense):				
Interest expense	(281)	(84)	(879)	(518)
Other income	346	21	1,062	395
Total other income (expense)	65	(63)	183	(123)
Income before provision for income taxes	5,297	7,385	13,752	17,923
Provision for income taxes	1,960	2,574	5,088	6,262
Net income	$3,337	$4,811	$8,664	$11,661
Earnings per share:				
Basic	$0.28	$0.40	$0.72	$0.96
Diluted	$0.28	$0.40	$0.72	$0.96
Weighted average shares outstanding:				
Basic	12,072	12,091	12,067	12,088
Diluted	12,091	12,144	12,086	12,153

See accompanying notes to these condensed consolidated financial statements.

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

	Nine months ended September 30,	
	2007	2008
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$8,664	$11,661
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	5,448	7,097
Deferred taxes	2,259	6,262
Employee stock options expensed	292	294
Gain on sale of property and equipment	(1)	(14)
Changes in current assets and liabilities:		
Trade accounts receivables, net	716	244
Inventory, net	(4,179)	(8,501)
Prepaid expenses and other	(209)	554
Accounts payable and accrued liabilities	2,190	3,038
Current income tax liability	(683)	(286)
Deferred income	21	(30)
Other	30	17
NET CASH PROVIDED BY OPERATING ACTIVITIES	14,548	20,336
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of property and equipment	(15,676)	(35,943)
Purchase of short-term investments	(2,347)	(320)
Redemption of short-term investments	4,500	18,981
Proceeds from sale of property and equipment	44	35
NET CASH USED IN INVESTING ACTIVITIES	(13,479)	(17,247)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from line of credit	—	7,500
Proceeds from other long term liabilities	—	447
Repayments of long-term debt	(3,597)	(3,533)
Repayments of line of credit	—	(1,100)
Proceeds from exercise of stock options	159	53
NET CASH (USED IN) PROVIDED BY FINANCING ACTIVITIES	(3,438)	3,367
NET CHANGE IN CASH	(2,369)	6,456
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	4,391	245
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$2,022	$6,701

SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Interest paid	$942	$480
Income taxes paid	$3,546	$287

See accompanying notes to these condensed consolidated financial statements.

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

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

The accompanying unaudited condensed consolidated financial statements present the condensed consolidated 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, 2008 and December 31, 2007 and the results of our operations for the three month and nine month periods ended September 30, 2008 and September 30, 2007 not misleading. As permitted by the rules and regulations of the Securities and Exchange Commission (SEC) the accompanying condensed consolidated financial statements do not include all disclosures normally required by accounting principles generally accepted in the United States of America. These condensed consolidated 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, 2007 on file with the SEC. In our opinion, the condensed consolidated 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 month periods ended September 30, 2008 is not necessarily indicative of the results of operations to be expected for the full fiscal year ending December 31, 2008.

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 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.

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 3 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.

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NATURAL GAS SERVICES GROUP, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED 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) Stock-Based Compensation

A summary of option activity under our 1998 Stock Option plan for the nine month period ended September 30, 2008 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, 2007	167,502	$ 11.25	7.77	$ 1,401
Granted	113,000	18.81		
Exercised	8,833	6.04		
Forfeited or expired	6,335	12.67		
Outstanding, September 30, 2008	265,334	$ 14.61	8.19	$ 760
Exercisable, September 30, 2008	144,084	$ 11.78	7.13	$ 820

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 total intrinsic value, or the difference between the exercise price and the market price on the date of exercise, of options exercised during the nine months ended September 30, 2008, was approximately $149,000. Cash received from stock options exercised during the nine months ended September 30, 2008 was approximately $53,000.

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

The following table summarizes information about the options outstanding at September 30, 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	4.20	$ 4.11	22,000	$ 4.11
5.59 – 9.43	60,000	6.71	9.11	60,000	9.11
9.44 – 15.60	45,334	8.28	14.33	25,834	14.18
15.61 – 20.48	138,000	9.44	18.76	36,250	19.15
$ 0.00 – 20.48	265,334	8.19	$ 14.61	144,084	$ 11.78

The summary of the status of the Company's unvested stock options as of September 30, 2008 and changes during the nine months ended September 30, 2008 is presented below.

Unvested stock options:	Shares	Weighted Average Grant Date Fair Value
Unvested at December 31, 2007	41,000	$ 9.19
Granted	113,000	8.46
Vested	28,416	11.67
Forfeited	4,334	5.35
Unvested at September 30, 2008	121,250	$ 8.06

As of September 30, 2008, there was approximately $823,000 of unrecognized compensation cost related to unvested options. Such cost is expected to be recognized over a weighted-average period of 1.32 years. Total compensation expense for stock options was $99,000 and $113,000 for the three months ended September 30, 2007 and 2008, respectively, and $292,000 and $294,000 for the nine months ended September 30, 2007 and 2008, respectively. An income tax benefit was recognized from the exercise of stock options of approximately $37,000 and $44,000 for the three months ended September 30, 2007 and 2008, respectively, and $108,000 and $75,000 for the nine months ended September 30, 2007 and 2008, respectively.

(3) 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.

All of our short-term investments were converted to cash equivalents as of September 30, 2008.

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

(4) Inventory

Inventory, net of allowance for obsolescence of $273,000 at December 31, 2007 and $380,000 at September 30, 2008 consisted of the following amounts:

	December 31, 2007	September 30, 2008
	(in thousands)	(in thousands)
Raw materials	$ 17,492	$ 25,168
Work in process	3,277	4,102
	$ 20,769	$ 29,270

(5) Long term debt

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.

Revolving Line of Credit Facility. Our revolving line of credit facility allows us to borrow, repay and re-borrow funds drawn under this facility. After entering into the Seventh Amended and Restated Loan Agreement, the total amount that we could borrow and have outstanding at any one time is the lesser of $40.0 million or the amount available for advances under a “borrowing base” calculation established by the bank. As of September 30, 2008, the amount available for revolving line of credit advances under our borrowing base 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 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%) nor higher than eight and three quarter percent (8.75%). We had $7 million outstanding as of September 30, 2008 on this revolving line of credit facility, and the interest rate was 4.50% as of that date.

$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 credit 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 revolving line of credit 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 September 30, 2008 this term loan facility had a principal balance of $10.4

million, and the interest rate was 4.75% as of that date.

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, a consolidated tangible net worth (as defined in the Loan Agreement) of at least $85 million;

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

- At the end of each fiscal quarter, a debt service coverage ratio (as defined in the Loan Agreement) of at least 1.50 to 1.00; and
- At the end of each month, a ratio of consolidated debt to consolidated tangible net worth (as such terms are defined in the Loan Agreement) of less than 2.0 to 1.0.

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

As of September 30, 2008, we were in compliance with all material covenants in our Loan Agreement. A default under our bank credit facility could trigger the acceleration of our bank debt so that it is immediately due and payable. Such default would have a material adverse effect on our liquidity, financial position and operations.

As of September 30, 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 received by the Company 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, 2008 was $297,000.

(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,	
	2007	2008	2007	2008
	(in thousands, except per share amounts)			
Numerator:				
Net income	$3,337	$4,811	$8,664	$11,661
Denominator for basic net income per common share:				
Weighted average common shares outstanding	12,072	12,091	12,067	12,088
Denominator for diluted net income per share:				
Weighted average common shares outstanding	12,072	12,091	12,067	12,088
Dilutive effect of stock options and warrants	19	53	19	65
Diluted weighted average shares	12,091	12,144	12,086	12,153
Earnings per common share:				
Basic	$0.28	$0.40	$0.72	$0.96
Diluted	$0.28	$0.40	$0.72	$0.96

(7) 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.

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

For the three months ended September 30, 2008 (in thousands):

	Sales	Rental	Service & Maintenance	Corporate	Total
Revenue	$ 13,239	$ 11,414	$ 293	$ —	$ 24,946
Operating costs and expenses	9,038	4,106	207	4,147	17,498
Other income/(expense)	—	—	—	(63)	(63)
Income before provision for income taxes	$ 4,201	$ 7,308	$ 86	$ (4,210)	$ 7,385

For the three months ended September 30, 2007 (in thousands):

	Sales	Rental	Service & Maintenance	Corporate	Total
Revenue	$ 10,574	$ 7,857	$ 220	$ —	$ 18,651
Operating costs and expenses	6,894	3,161	132	3,232	13,419
Other income/(expense)	—	—	—	65	65
Income before provision for income taxes	$ 3,680	$ 4,696	$ 88	$ (3,167)	$ 5,297

For the nine months ended September 30, 2008 (in thousands):

	Sales	Rental	Service & Maintenance	Corporate	Total
Revenue	$ 32,024	$ 30,519	$ 814	$ —	$ 63,357
Operating costs and expenses	21,669	11,604	567	11,471	45,311
Other income/(expense)	—	—	—	(123)	(123)
Income before provision for income taxes	$ 10,355	$ 18,915	$ 247	$ (11,594)	$ 17,923

For the nine months ended September 30, 2007 (in thousands):

	Sales	Rental	Service & Maintenance	Corporate	Total
Revenue	$ 30,239	$ 22,019	$ 729	$ —	$ 52,987
Operating costs and expenses	20,856	8,885	456	9,221	39,418
Other income/(expense)	—	—	—	183	183
Income before provision for income taxes	$ 9,383	$ 13,134	$ 273	$ (9,038)	$ 13,752

(8) Legal Proceedings

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 Inc., 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. Due to the early stages of this lawsuit we are unable to accurately predict its outcome, but we have filed an answer denying all of plaintiff's claims and intend to vigorously contest the plaintiff's claims. We have not established a reserve with respect to plaintiff's claims.

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 consolidated financial position, results of operations or cash flow. Except as discussed herein, we are not currently a party to any other legal proceedings and we are not aware of any other threatened litigation.

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NATURAL GAS SERVICES GROUP, INC.

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 consolidated 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, 2007 filed with the SEC. All dollar amounts reported in tables are in thousands of dollars unless otherwise noted.

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, 2008, we had 1,662 natural gas compressor packages in our rental fleet, of which 1,418 compressors totaling 175,740 horsepower were rented to 110 customers, compared to 1,277 natural gas compressor packages in our rental fleet, of which 1,136 compressors totaling 132,147 horsepower rented to 92 customers at September 30, 2007.

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 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, Tulsa, Oklahoma 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. As of September 30, 2008, we had written maintenance agreements with customers relating to 46 compressors. Maintenance agreements typically have terms of nine months to one year and require payment of a monthly fee.

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

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

Demand for our products and services was strong throughout 2007 and the first nine months of 2008. We continue to believe that the long-term outlook for our business remains favorable, although the present macroeconomic factors, e.g., credit tightening and cash conservation, combined with deteriorating natural gas and oil prices may prove to be a negative factor in the near term.

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NATURAL GAS SERVICES GROUP, INC.

For fiscal year 2008, our forecasted capital expenditures are approximately $40 - $45 million, primarily for additions to our compressor rental fleet. We believe that the proceeds from our public offering of common stock in March 2006, together with funds available to us under our bank credit facility and cash flows from operations will be sufficient to satisfy our capital and liquidity requirements through 2008. We may require additional capital to fund any unanticipated expenditures, including any acquisitions of other businesses. Additional capital may not be available to us when we need it or on acceptable terms.

Results of Operations

Three months ended September 30, 2007, compared to the three months ended September 30, 2008.

The table below shows our revenues and percentage of total revenues of each of our segments for the three months ended September 30, 2007 and September 30, 2008.

	Revenue (in thousands) Three months Ended September 30,			
	2007		2008	
Sales	$ 10,574	57%	$ 13,239	53%
Rental	7,857	42%	11,414	46%
Service and Maintenance	220	1%	293	1%
Total	$ 18,651		$ 24,946	

Total revenue increased from $18.7 million to $25.0 million, or 33.8%, for the three months ended September 30, 2008, compared to the same period ended September 30, 2007. This was mainly the result of increased rental revenue. Sales revenue increased 25.2%, rental revenue increased 45.3%, and service and maintenance revenue increased 33.2%.

Sales revenue increased from $10.6 million to $13.2 million, or 25.2%, for the three months ended September 30, 2008, compared to the same period ended September 30, 2007. This increase is mainly the result of additional compressor unit sales to third parties from our Tulsa and Michigan operations. Sales from outside sources included: (1) compressor unit sales, (2) flare sales, (3) parts, (4) compressor rebuilds and (5) rental unit sales.

Rental revenue increased from $7.9 million to $11.4 million, or 45.3%, for the three months ended September 30, 2008, compared to the same period ended September 30, 2007. This increase was the result of additional units added to our rental fleet and rented to third parties. The company ended the period with 1,662 compressor packages in its rental fleet, up from 1,277 units at September 30, 2007. The rental fleet had a utilization of 85.3% as of September 30, 2008 compared to 89.0% utilization as of September 30, 2007. This utilization decrease partially resulted from units being returned by a major customer that performed routine yearly evaluations of their compressor needs. Also the demand for smaller horsepower units has slowed.

Service and maintenance revenue increased from $220,000 to $293,000, or 33.2%, for the three months ended September 30, 2008, compared to the same period ended September 30, 2007.

The overall operating margin percentage increased to 29.9% for the three months ended September 30, 2008, from 28.1% for the same period ended September 30, 2007. This is mainly the result of increased margins on our rental

fleet activity and the increased margin for gas compressor sales activity. The overall margin is affected by the product mix between rental and sales, and since our rental margin is higher and rentals increased during the period, the overall margin moved higher. Because of the larger margins that we obtain from rentals it is generally our focus is to increase our rental business. Rental margins increased from 60% to 64% for the three months ended September 30, 2008, compared to the same period ended September 30, 2007.

Selling, general, and administrative expense increased from $1.3 million to $1.5 million or 17.4% for the three months ended September 30, 2008, as compared to the same period ended September 30, 2007. This increase is mainly due to an increase in sales commissions on rental equipment and additional sales personnel.

Depreciation and amortization expense increased from $1.9 million to $2.6 million or 35.8% for the three months ended September 30, 2008, compared to the same period ended September 30, 2007. This increase was the result of 385 new gas compressor rental units being added to the rental fleet from September 30, 2007 to September 30, 2008, thus increasing the depreciable base.

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Other income net of other expense decreased $325,000 for the three months ended September 30, 2008, compared to the same period ended September 30, 2007. This decrease is mainly the result of decreased balances in our short-term investments.

Interest expense decreased 70.1% for the three months ended September 30, 2008, compared to the same period ended September 30, 2007, mainly due to decreased principal balances owed under our bank loan facility and a reduction in our interest rate on our term loan and bank line of credit.

Provision for income tax increased from $2.0 million to $2.6 million, or 31.3%, and is the result of the increase in taxable income.

Nine months ended September 30, 2007, compared to the nine months ended September 30, 2008.

The table below shows our revenues and percentage of total revenues of each of our segments for the nine months ended September 30, 2007 and September 30, 2008.

	Revenue (in thousands) Nine months ended September 30,			
	2007		2008	
Sales	$ 30,239	57%	$ 32,024	51%
Rental	22,019	42%	30,519	48%
Service and Maintenance	729	1%	814	1%
Total	$ 52,987		$ 63,357	

Total revenue increased from $53.0 million to $63.4 million, or 19.6%, for the nine months ended September 30, 2008, compared to the same period ended September 30, 2007. This was mainly the result of increased rental revenue. Sales revenue increased 5.9%, rental revenue increased 38.6%, and service and maintenance revenue increased 11.7%.

Sales revenue increased from $30.2 million to $32.0 million, or 5.9%, for the nine months ended September 30, 2008, compared to the same period ended September 30, 2007. This increase is mainly the result of additional sales in our Tulsa and Michigan facilities. Sales from outside sources included: (1) compressor unit sales, (2) flare sales, (3) parts sales, (4) compressor rebuilds and (5) rental unit sales.

Rental revenue increased from $22.0 million to $30.5 million, or 38.6%, for the nine months ended September 30, 2008, compared to the same period ended September 30, 2007. This increase was the result of additional units added to our rental fleet and rented to customers. The company ended the period with 1,662 compressor packages in its rental fleet, up from 1,277 units at September 30, 2007. The rental fleet had a utilization of 85.3% as of September 30, 2008 compared to 89.0% utilization as of September 30, 2007. This utilization decrease partially resulted from units being returned by a major customer that performed routine yearly evaluations of their compressor needs. Also the demand for smaller horsepower units has slowed.

Service and maintenance revenue increased from $729,000 to $814,000, or 11.7%, for the nine months ended September 30, 2008, compared to the same period ended September 30, 2007. This increase is due to increased service in New Mexico and Michigan.

The overall operating margin percentage increased to 28.5% for the nine months ended September 30, 2008, from 25.6% for the same period ended September 30, 2007. This is mainly the result of increased margins of our rental fleet activity. The overall margin is also affected by the product mix between rental and sales, since our rental margin is higher and rentals increased during the period the overall margin moved higher. Because of the larger margins that we obtain from rentals it is generally our focus to increase our rental business.

Selling, general, and administrative expense increased from $3.8 million, to $4.4 million or 15.9% for the nine months ended September 30, 2008, as compared to the same period ended September 30, 2007. This increase is mainly due to the increase in commissions on rental equipment, additional sales personnel and an increase in officers' salaries.

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NATURAL GAS SERVICES GROUP, INC.

Depreciation and amortization expense increased from $5.4 million, to $7.1 million or 30.3% for the nine months ended September 30, 2008, compared to the same period ended September 30, 2007. This increase was the result of 385 new gas compressor rental units being added to the rental fleet from September 30, 2007 to September 30, 2008, thus increasing the depreciable base.

Other income net of other expense decreased $667,000 for the nine months ended September 30, 2008, compared to the same period ended September 30, 2007. This decrease is mainly the result of decreased balances in our short-term investments.

Interest expense decreased 41.1% for the nine months ended September 30, 2008, compared to the same period ended September 30, 2007, mainly due to decreased principal balances owed under our bank loan facility and a reduction in our interest rates on our term loan and bank line of credit.

Provision for income tax increased from $5.1 million to $6.3 million, or 23.1%, and is the result of the increase in taxable income.

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, 2007.

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 3 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.

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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.

Liquidity and Capital Resources

The following represents the Company's working capital position as of December 31, 2007 and September 30, 2008.

	December 31, 2007 (in thousands)	September 30, 2008 (in thousands)
Current Assets:		
Cash and cash equivalents	$ 245	$ 6,701
Short-term investments	18,661	—
Trade accounts receivable, net	11,322	11,078
Inventory, net	20,769	29,270
Prepaid income taxes	3,584	377
Prepaid expenses and other	641	87
Total current assets	55,222	47,513
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	5,178
Accrued liabilities	3,990	5,922
Current portion of tax liability	3,525	109
Deferred income	81	51
Total current liabilities	16,646	14,638
Total working capital	$ 38,576	$ 32,875

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 financing 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, 2008, we invested $35.9 million in equipment for our rental fleet and service vehicles. We financed this activity with cash flow from operations, cash on hand and borrowings from our revolving line of credit facility. In addition, we have repaid $4.6 million of our existing debt.

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Cash flows

At September 30, 2008, we had cash, cash equivalents and short-term investments of $6.7 million compared to $18.9 million at December 31 2007. We had working capital of $32.9 million at September 30, 2008 compared to $38.6 million at December 31, 2007. At September 30, 2008, our total debt was $17.4 million of which $3.4 million was classified as current compared to $14.6 million and $4.4 million, respectively at December 31, 2007. We had positive net cash flow from operating activities of $20.3 million during the first nine months of 2008 compared to $14.5 million for the first nine months of 2007. The increase was primarily from net income of $11.7 million, an increase in accounts payable and accrued liabilities of $3.0 million, offset by an increase in inventory of $8.5 million during the nine months ended September 30, 2008.

Accounts receivable decreased $244,000 to $11.1 million at September 30, 2008 as compared to $11.3 million at December 31, 2007. This decrease largely reflects the timing of collections during the first nine months of 2008.

Inventory increased $8.5 million to $29.3 million as of September 30, 2008, as compared to $20.8 million as of the year ended December 31, 2007. This increase is mainly the result of additional inventory to stock the service branches and an increase in raw materials to meet our increased production schedule.

Long-term debt increased $3.4 million to $17.4 million at September 30, 2008, compared to $14.6 million at December 31, 2007. This increase is the result of additional borrowing on our bank line of credit to increase our rental fleet offset by the normal debt amortization. The current portion of long-term debt decreased to $3.4 million at September 30, 2008, compared to $4.4 million at December 31, 2007 due to the final payment of $1.0 million of our subordinated debt on January 3, 2008.

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.

Revolving Line of Credit Facility. Our revolving line of credit facility allows us to borrow, repay and reborrow funds drawn under this facility. After entering into the Seventh Amended and Restated Loan Agreement, the total amount that we could borrow and have outstanding at any one time is the lesser of $40.0 million or the amount available for advances under a “borrowing base” calculation established by the bank. As of September 30, 2008, the amount available for revolving line of credit advances under our borrowing base 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%) nor higher than eight and three quarter percent (8.75%). We had $7 million outstanding as of September 30, 2008 on this revolving line of credit facility, and the interest rate on that date was 4.50%.

$16.9 Million Multiple Advance Term Loan Facility. This multiple advance term loan facility represents the consolidation of our previously existing advancing line of credit and term loan facilities. Reborrowings are not permitted under this facility. Principal under this credit facility is due and payable in 59 monthly installments of $282,000 each, which commenced November 1, 2006 and continuing through September 1, 2011. Since April 1, 2008, our interest rate on the revolving line of credit 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 September 30, 2008 this term loan facility had a principal balance of $10.4 million, and the interest rate on that date was 4.75%.

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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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 such terms are defined in the Loan Agreement) of less than 2.0 to 1.0.

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

As of September 30, 2008, we were in compliance with all material covenants in our Loan Agreement. A default under our bank credit facility could trigger the acceleration of our bank debt so that it is immediately due and payable. Such default would have a material adverse effect on our liquidity, financial position and operations.

Subordinated Debt-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 employees of the Company, 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.

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 of dollars)						
	2008(1)	2009	2010	2011	2012	Thereafter	Total
Term loan facility (secured)	$ 845	$ 3,378	$ 3,378	$ 2,816	$ —	—$	10,417
Interest on term loan facility(2)	114	361	209	58	—	—	742
Line of credit (secured)	—	—	7,000	—	—	—	7,000
Interest on line of credit(3)	83	333	249	—	—	—	665
Purchase agreement	239	956	956	956	956	558	4,621
	—	—	—	—	—	150	150

Other long term debt							
Facilities and office leases	72	288	211	160	168	114	1,013
Total	$ 1,353	$ 5,316	$ 12,003	$ 3,990	$ 1,124	$ 822	$ 24,608

(1) For the three months remaining in 2008.
(2) Assumes an interest rate of 4.50%.
(3) Assumes an interest rate of 4.75%.

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, 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, availability of, or requirements for, capital resources.

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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. The long-term liability remaining as of September 30, 2008 was $297,000.

Special Note Regarding Forward-Looking Statements

Please refer to and read “Special Note Regarding Forward-Looking Statements” in our Annual Report on Form 10-K for the fiscal year ended December 31, 2007.

Item 3. Quantitative and Qualitative Disclosures 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.

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 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, 2008, and were determined based upon interest rates currently available to us for borrowings with similar terms.

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 and seek to minimize exposure to any one customer where other customers are readily available. 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 % for our term loan facility and Prime Rate less 1/4 % for our revolving line of credit 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, 2008, we were not using any derivatives to manage interest rate risk.

Item 4. Controls and Procedures

(a) Evaluation of Disclosure Controls and Procedures.

Under the supervision and with the participation of certain members of Natural Gas Services Group, Inc's management, the chief executive officer and the vice-president of accounting evaluated the effectiveness of the design and operation of the disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as amended (the "Exchange Act")) of Natural Gas Services Group, Inc. as of the end of the period covered by this report. Based on this evaluation, the chief executive officer and vice-president of accounting concluded that, as of the end of the period covered by this report, Natural Gas Services Group, Inc's disclosure controls and procedures were effective to ensure that information required to be disclosed by Natural Gas Services Group, Inc. in the reports that it files under the Exchange Act is collected, processed and disclosed within the time periods specified in the SEC's rules and forms.

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(b) Changes in Internal Controls.

There were no changes in Natural Gas Services Group, Inc's internal controls during the period covered by this report that have materially affected or are reasonably likely to materially affect Natural Gas Services Group, Inc's internal controls over financial reporting. In addition, to the knowledge of the chief executive officer and vice-president of accounting there were no changes in other factors that could significantly affect these controls subsequent to the date of the most recent evaluation made by the chief executive officer and the vice-president of accounting.

PART II – OTHER INFORMATION

Item 1. Legal Proceedings

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 Inc., 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. Due to the early stages of this lawsuit we are unable to accurately predict its outcome, but we have filed an answer denying all of plaintiff's claims and intend to vigorously contest the plaintiff's claims. We have not established a reserve with respect to plaintiff's claims.

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 consolidated financial position, results of operations or cash flow. Except as discussed herein, we are not currently a party to any other 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, 2007 for a discussion of the risk associated with our company and industry.

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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 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 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 Stephen C. Taylor and Natural Gas Services Group, Inc. (Incorporated by reference to Exhibit 10.1 of the Registrant’s Form 8-K Report, dated August 24, 2005, and filed with the Securities and Exchange Commission on August 30, 2005)

10.9 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)

10.10 Promissory Note, dated January 3, 2005, in the original principal amount of $300 thousand made by Natural Gas Services Group, Inc. payable to Jim Hazlett (Incorporated by reference to Exhibit 10.3 of the Registrant's Form 8-K Report, dated September 14, 2005, and filed with the Securities and Exchange Commission on November 14, 2005)

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NATURAL GAS SERVICES GROUP, INC.

10.11 Retirement Agreement, dated December 14, 2005, between Wallace C. Sparkman and Natural Gas Services Group, Inc. (Incorporated by reference to Exhibit 10.1 of the Registrant's Form 8-K Report, dated December 14, 2005, and filed with the Securities and Exchange Commission on December 15, 2005)

10.12 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)

10.13 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

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

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

10.16 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)

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

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

*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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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	/s/ Earl R. Wait
Stephen C. Taylor	Earl R. Wait
President and Chief Executive Officer	Principal Accounting Officer and Treasurer

November 6, 2008

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NATURAL GAS SERVICES GROUP, INC.

INDEX TO 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 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)
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