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Period of Report	12/31/08
Smaller Reporting Company	off
Shell Company	No
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Well-Known Seasoned Issuer	No
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Emails	kim.huckaba@ngsgj.com

Documents

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Module and Segment References

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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549



FORM 10-K

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

For the fiscal year ended December 31, 2008

or

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

For the transition period from _____ to _____

Commission file number: 1-31398

NATURAL GAS SERVICES GROUP, INC.

(Exact Name of Registrant as Specified in its Charter)

Colorado

(State or other jurisdiction of incorporation or organization)

508 W. Wall St, Suite 550 Midland, Texas

(Address of principal executive offices)

75-2811855

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

79701

(Zip Code)

Registrant's telephone number, including area code:

(432) 262-2700

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

Title of each class

Common Stock, \$.01 par value

Name of each exchange on which registered

New York Stock Exchange

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

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

Yes ☐

No ☒

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

Yes ☐

No ☒

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

Yes ☒

No ☐

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated Filer ☐ Accelerated Filer ☒ Non-Accelerated Filer ☐ Smaller Reporting Company ☐

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

Yes ☐

No ☒

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

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

Documents Incorporated by Reference

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

FORM 10-K
NATURAL GAS SERVICES GROUP, INC.
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SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

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

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

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

PART I

ITEM 1. BUSINESS

Unless the context otherwise requires, references in this Annual Report on Form 10-K to "Natural Gas Services Group," the "Company," "we," "us," "our" or "ours" refer to Natural Gas Services Group, Inc. Certain specialized terms used in describing our natural gas compressor business are defined in "Glossary of Industry Terms" on page 6.

The Company

We are a leading provider of small to medium horsepower compression equipment to the natural gas industry. We focus primarily on the non-conventional natural gas production business in the United States (such as coalbed methane, gas shales and tight gas), which, according to data from the Energy Information Administration, is the single largest and fastest growing segment of U.S. gas production. We manufacture, fabricate and rent natural gas compressors that enhance the production of natural gas wells and provide maintenance services for those compressors. In addition, we sell custom fabricated natural gas compressors to meet customer specifications dictated by well pressures, production characteristics and particular applications. We also manufacture and sell flare systems for oil and gas plant and production facilities.

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

We were incorporated in Colorado on December 17, 1998

Historically, the majority of our revenue has been derived from our compressor rental business. In January 2005, we acquired Screw Compression Systems, Inc., or "SCS," which predominantly focused on the custom fabrication sales business. By acquiring SCS, we increased our fabrication facilities by over 91,000 square feet. We have primarily used this additional space for SCS' core business of custom fabrication but have from time to time fabricated a minimal number of rental units. On June 30, 2007, we merged SCS into Natural Gas Services Group, Inc.

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

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

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

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

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

Industry Trends

Natural gas prices historically have been volatile, and this volatility is expected to continue. Uncertainty continues to exist as to the direction of future United States and worldwide natural gas and crude oil price trends. We believe that natural gas is a more environmentally friendly source of energy which is likely to result in increases in demand. Being primarily a provider of services and equipment to natural gas producers, we are more significantly impacted by changes in natural gas prices than by changes in crude oil and condensate prices. Longer term natural gas prices will be determined by the supply and demand for natural gas as well as the prices of competing fuels, such as oil and coal.

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

We believe that there will continue to be a growing demand for natural gas. We expect demand for our products and services to continue to rise as a result of:

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

Our Operating Units

We identify our segments based upon major revenue sources as Gas Compressor Rental, Engineered Equipment Sales, Service and Maintenance and Corporate. Please refer to Footnote 11 on page F-16 of the Notes to Consolidated Financial Statements.

Gas Compressor Rental. Our rental business is primarily focused on non-conventional gas production. We provide rental of small to medium horsepower compression equipment to customers under contracts typically having minimum initial terms of six to 24 months. Historically, in our experience, most customers retain the equipment beyond the expiration of the initial term. By outsourcing their compression needs, we believe our customers are able to increase their revenues by producing a higher volume of natural gas due to greater equipment run-time. Outsourcing also allows our customers to reduce their compressor downtime, operating and maintenance costs and capital investments and more efficiently meet their changing compression needs. As of December 31, 2008, the utilization rate of our rental fleet was 84.9%.

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

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

Engineered Equipment Sales. This segment includes the following components:

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

Parts sales and compressor rebuilds. To provide customer support for our compressor and flare sales businesses, we stock varying levels of replacement parts at our Midland, Texas facility and at field service locations. We also provide an exchange and rebuild program for screw compressors and maintain an inventory of new and used compressors to facilitate this part of our business.

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

Business Strategy

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

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

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

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

Selectively pursue acquisitions. We will continue to evaluate potential acquisitions that would provide us with access to new markets or enhance our current market position.

Competitive Strengths

We believe our competitive strengths include:

Superior customer service. Our emphasis on the small to medium horsepower markets has enabled us to effectively meet the evolving needs of our customers. We believe these markets have been under-served by our larger competitors which, coupled with our personalized services and in-depth knowledge of our customers’ operating needs and growth plans, have allowed us to enhance our relationships with existing customers as well as attract new customers. The size, type and geographic diversity of our rental fleet enable us to provide customers with a range of compression units that can serve a wide variety of applications. We are able to select the correct equipment for the job, rather than the customer trying to fit its application to our equipment.

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

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

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

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

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

Major Customers

Sales and rental income to XTO Energy, Inc. and Energen Resources Corporation in the year ended December 31, 2006 amounted to 39% and 12% of consolidated revenue, respectively. Sales and rental income to XTO Energy, Inc. and Devon Energy, Inc. in the year ended December 31, 2007 amounted to 40% and 12% of consolidated revenue, respectively. Sales and rental income to XTO Energy, Inc. and Devon Energy, Inc. in the year ended December 31, 2008 amounted to 26% and 14% of consolidated revenue, respectively. No other single customer accounted for more than 10% of our revenues in 2006, 2007 or 2008. XTO Energy, Inc. amounted to 64% and 35% of our consolidated accounts receivable as of December 31, 2007 and 2008, respectively, and Equipos y Sistemas Dinamicos amounted to 14% of our consolidated accounts receivable as of December 31, 2008. No other customer amounted to more than 10% of our consolidated accounts receivable as of December 31, 2007 and 2008. The loss of any one or more of the above customers could have a material adverse effect on our business, consolidated financial condition, results of operations and cash flows, depending upon the demand for our compressors at the time of such loss and our ability to attract new customers.

Sales and Marketing

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

Competition

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

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

Backlog

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

Employees

As of December 31, 2008, we had 309 total employees. No employees are represented by a labor union and we believe we have good relations with our employees.

Liability and Other Insurance Coverage

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

Government Regulation

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

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

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

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

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

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

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

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

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

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

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

Patents, Trademarks and Other Intellectual Property

We believe that the success of our business depends more on the technical competence, creativity and marketing abilities of our employees than on any individual patent, trademark, or copyright. Nevertheless, as part of our ongoing research, development and manufacturing activities, we may seek patents when appropriate on inventions concerning new products and product improvements. We currently own one United States patent covering certain flare system technologies, which will expire in January 2010. We do not own any foreign patents. Although we continue to use the patented technology and consider it useful in certain applications, we do not consider this patent to be material to our business as a whole.

Suppliers and Raw Materials

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

Glossary of Industry Terms

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

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

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

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

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

ITEM 1A. RISK FACTORS

You should carefully consider the following risks associated with owning our common stock. If any of the following risks actually occur, our business, financial condition or results of operations would likely suffer. If this occurs, the trading price of our common stock could decline, and you could lose all or part of your investment in our common stock. Although the risks described below are the risks that we believe are material, they are not the only risks relating to our industry, our business and our common stock. Additional risks and uncertainties, including those that are not yet identified or that we currently believe are immaterial, may also adversely affect our business, financial condition or results of operations.

Risks Associated With Our Industry

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

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

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

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

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

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

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

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

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

Due to the short-term nature of most of our rental contracts, changes in market conditions can quickly affect our business. As a result of the cyclicity of our industry, our results of operations may be volatile in the future.

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

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

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

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

Risks Associated With Our Company

We might be unable to employ qualified technical personnel, which could hamper our plans for expansion or increase our costs.

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

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

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

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

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

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

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

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

Historically, we have funded our capital expenditures through internally generated funds, borrowings under bank credit facilities and the proceeds of equity financings. Although we believe that cash flows from our operations will provide us with sufficient cash to fund our planned capital expenditures for 2009, we cannot assure you that these sources will be sufficient. We may require additional capital to fund any unanticipated capital expenditures, including any acquisitions, and to fund our growth beyond 2009, and necessary capital may not be available to us when we need it or on acceptable terms. Our ability to raise additional capital will depend on the results of our operations and the status of various capital and industry markets at the time we seek such capital. Failure to generate sufficient cash flow, together with the absence of alternative sources of capital, could have a material adverse effect on our business, consolidated financial condition, results of operations or cash flows.

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

As of December 31, 2008, we had an aggregate of approximately \$17.0 million of outstanding indebtedness, and accounts payable and accrued expenses of approximately \$12.4 million. As a result of our significant indebtedness, we might not have the ability to incur any substantial additional indebtedness. The level of our indebtedness could have several important effects on our future operations, including:

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

If we are unable to service our debt, we will likely be forced to take remedial steps that are contrary to our business plan.

As of December 31, 2008, our principal payments for our debt service requirements were approximately \$282 thousand on a monthly basis; \$845 thousand on a quarterly basis; and \$3.4 million on an annual basis. It is possible that our business will not generate sufficient cash flow from operations to meet our debt service requirements and the payment of principal when due. If this were to occur, we may be forced to:

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

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

Under the terms of our loan agreement, we must:

- comply with a minimum current ratio;
- maintain minimum levels of tangible net worth;
- not exceed specified levels of debt;
- comply with a debt service coverage ratio; and
- comply with a debt to tangible net worth ratio.

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

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

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

As of December 31, 2008, a significant majority of our compressor rentals were for terms of six months or less which, if terminated or not renewed, would adversely impact our revenue and our ability to recover our initial equipment costs.

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

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

Our business is dependent not only on securing new customers but also on maintaining current customers. We had two customers that accounted for approximately 26% and 14% of our consolidated revenue for the year ended December 31, 2008, and approximately 40% and 12% of our consolidated revenue for the year ended December 31, 2007. Unless we are able to retain our existing customers, or secure new customers if we lose one or more of our significant customers, our revenue and results of operations would be adversely affected.

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

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

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

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

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

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

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

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

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

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

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

We must evaluate our intangible assets annually for impairment.

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

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

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

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

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

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

Risks Associated With Our Common Stock

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

ITEM 1B. UNRESOLVED STAFF COMMENTS

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

ITEM 2.**PROPERTIES**

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

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

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

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

ITEM 3.**LEGAL PROCEEDINGS**

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

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

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

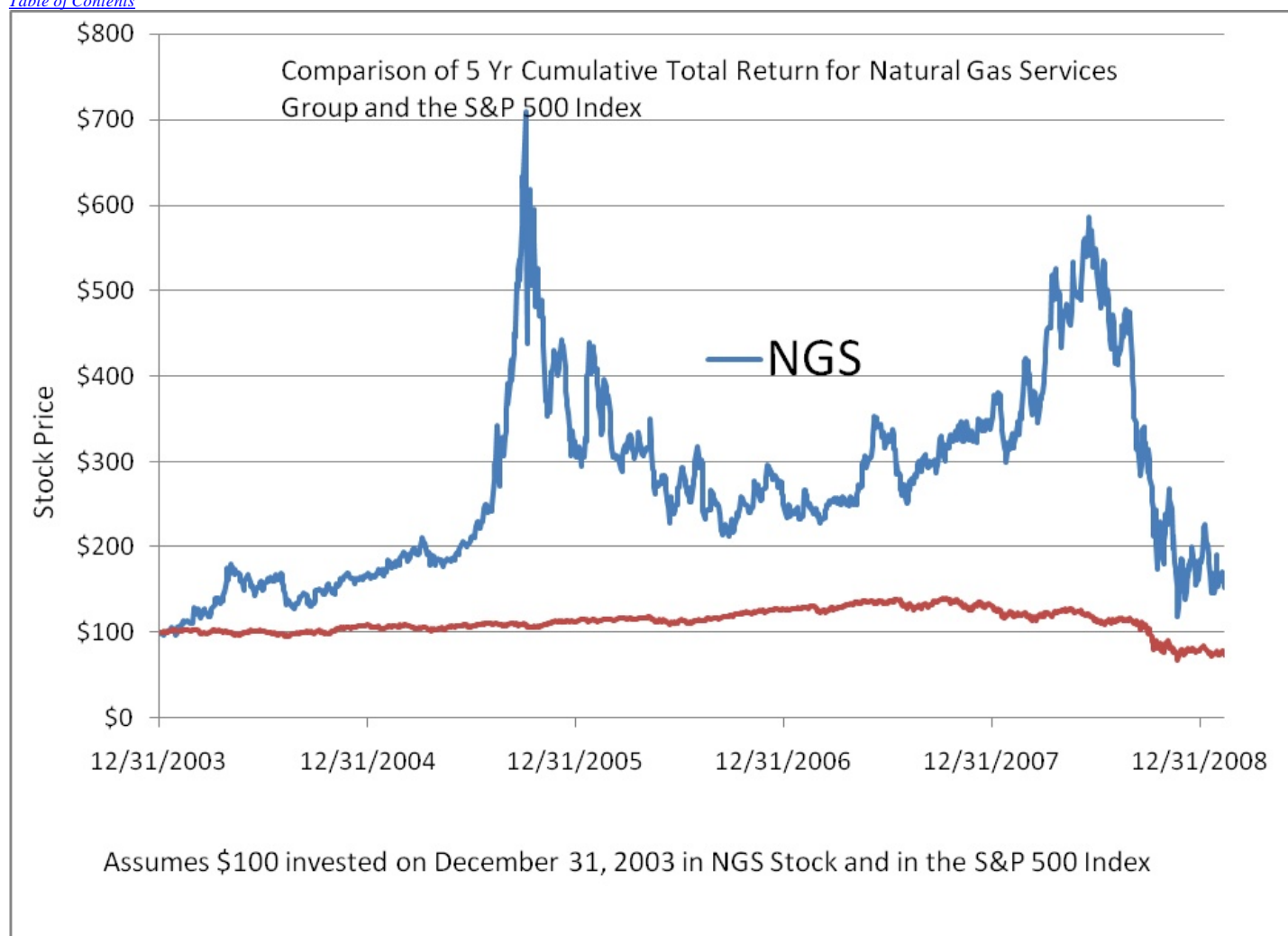
We did not submit any matters to a vote of our stockholders during the fourth quarter of 2008.

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

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

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

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



Dividends

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

Equity Compensation Plans

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

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

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

Repurchase of Equity Securities

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

Sale of Unregistered Securities

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

ITEM 6. SELECTED FINANCIAL DATA

In the table below, we provide you with selected historical financial data. We have derived this information from our audited consolidated financial statements for each of the years in the five-year period ended December 31, 2008. This information is only a summary and it is important that you read this information along with our audited consolidated financial statements and related notes, and “Management’s Discussion and Analysis of Financial Condition and Results of Operations” under Item 7 below, which discusses factors affecting the comparability of the information presented. The selected financial information provided is not necessarily indicative of our future results of operations or financial performance.

	Year Ended December 31,				
	2004	2005(1)	2006	2007	2008
	(in thousands, except per share amounts)				
CONSOLIDATED STATEMENTS OF INCOME AND OTHER INFORMATION:					
Revenues	\$ 15,958	\$ 49,311	\$ 62,729	\$ 72,489	\$ 85,336
Costs of revenue, exclusive of depreciation shown separately below	6,951	31,338	39,308	41,106	44,994
Gross margin(2)	9,007	17,973	23,421	31,383	40,342
Depreciation and amortization	2,444	4,224	6,020	7,470	9,925
Other operating expenses	2,652	4,890	5,270	5,324	5,842
Operating income	3,911	8,859	12,131	18,589	24,575
Total other income (expense)(3)	603	(1,798)	(256)	144	355
Income before income taxes	4,514	7,061	11,875	18,733	24,220
Income tax expense	1,140	2,615	4,287	6,455	8,627
Net income	3,374	4,446	7,588	12,278	15,593
Preferred dividends	53	—	—	—	—
Net income available to common stockholders	\$ 3,321	\$ 4,446	\$ 7,588	\$ 12,278	\$ 15,593
Net income per common share:					
Basic	\$ 0.59	\$ 0.59	\$ 0.67	\$ 1.02	\$ 1.29
Diluted	\$ 0.52	\$ 0.52	\$ 0.66	\$ 1.01	\$ 1.28
Weighted average shares of common stock outstanding:					
Basic	5,591	7,564	11,405	12,071	12,090
Diluted	6,383	8,481	11,472	12,114	12,143
EBITDA(4)	\$ 7,796	\$ 13,282	\$ 19,541	\$ 27,358	\$ 34,887
As of December 31,					
	2004	2005	2006	2007	2008
	(in thousands)				
BALANCE SHEET INFORMATION:					
Current assets	\$ 7,295	\$ 24,642	\$ 55,170	\$ 55,222	\$ 47,032
Total assets	43,255	86,369	135,552	153,233	181,050
Long-term debt (including current portion)	15,017	28,205	18,392	13,950	17,013
Stockholders' equity	22,903	45,690	101,201	114,380	130,450

- (1) The information for the periods presented may not be comparable because of our acquisition of SCS in January 2005. For additional information regarding this acquisition, you should read the information under “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations” in our 2007 10-K and “Item 13. Certain Relationships, and Related Transactions, and Director Independence – Acquisition of Screw Compression Systems, Inc.” in this Annual Report on Form 10-K.
- (2) Gross margin is defined, reconciled to net income and discussed further below under “-- Non-GAAP Financial Measures”.
- (3) Total other income (expense) for the year ended December 31, 2004 includes \$1.5 million in life insurance proceeds paid to us upon the death of our former Chief Executive Officer.
- (4) EBITDA is defined, reconciled to net income and discussed further below under “-- Non-GAAP Financial Measures”.

Non-GAAP Financial Measures

Our definition and use of EBITDA

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

- it is widely used by investors in the energy industry to measure a company’s operating performance without regard to items excluded from the calculation of EBITDA, which can vary substantially from company to company depending upon accounting methods and book value of assets, capital structure and the method by which assets were acquired, among other factors;
- it helps investors to more meaningfully evaluate and compare the results of our operations from period to period by removing the impact of our capital structure and asset base from our operating structure; and
- it is used by our management for various purposes, including as a measure of operating performance, in presentations to our Board of Directors, as a basis for strategic planning and forecasting, and as a component for setting incentive compensation.

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

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

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

Our definition and use of gross margin

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

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

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

Reconciliation

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

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

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

The following discussion is intended to assist you in understanding our financial position and results of operations for each of the years ended December 31, 2006, 2007, and 2008. You should read the following discussion and analysis in conjunction with our audited consolidated financial statements and the related notes.

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

Overview

We fabricate, manufacture, rent and sell natural gas compressors and related equipment. Our primary focus is on the rental of natural gas compressors. Our rental contracts generally provide for initial terms of six to 24 months. After the initial term of our rental contracts, most of our customers have continued to rent our compressors on a month-to-month basis. Rental amounts are paid monthly in advance and include maintenance of the rented compressors. As of December 31, 2008, we had 1,469 natural gas compressors totaling approximately 184,831 horsepower rented to 112 third parties, compared to 1,194 natural gas compressors totaling approximately 140,853 horsepower rented to 94 third parties at December 31, 2007.

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

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

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

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

	Year Ended December 31,		
	2006	2007	2008
		(in thousands)	
Sales	\$ 38,214	\$ 41,088	\$ 41,380
Rental	23,536	30,437	42,864
Service and maintenance	979	964	1,092
Total	<u>\$ 62,729</u>	<u>\$ 72,489</u>	<u>\$ 85,336</u>

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

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

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

Demand for our products and services have been strong throughout 2007 and 2008, but in 2009 demand may decline due to lower oil and natural gas prices and decreased demand for natural gas. We believe the long-term trend in our markets is favorable.

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

Our Performance Trends and Outlook

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

Results of Operations

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Critical Accounting Policies and Practices

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

Our critical accounting policies are as follows:

- revenue recognition;
- estimating the allowance for doubtful accounts receivable;
- accounting for income taxes;
- valuation of long-lived and intangible assets and goodwill; and
- valuation of inventory

Revenue Recognition

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

Allowance for Doubtful Accounts Receivable

We perform ongoing credit evaluations of our customers and adjust credit limits based upon payment history and the customer's current credit worthiness, as determined by our review of their current credit information. We continuously monitor collections and payments from our customers and maintain a provision for estimated credit losses based upon our historical experience and any specific customer collection issues that we have identified. While such credit losses have historically been within our expectations and the provisions established, we cannot guarantee that we will continue to experience the same credit loss rates that we have in the past. At December 31, 2008, two customers accounted for approximately 35% and 14%, respectively, of our consolidated accounts receivable, and at December 31, 2007, one customer accounted for approximately 64% of our consolidated accounts receivable. A significant change in the liquidity or financial position of this customer could have a material adverse impact on the collectability of our accounts receivables and our future operating results.

Accounting for Income Taxes

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

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

Valuation of Long-Lived and Intangible Assets and Goodwill

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

- significant underperformance relative to expected historical or projected future operating results;
- significant changes in the manner of our use of the acquired assets or the strategy for our overall business; and
- significant negative industry or economic trends.

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

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

Inventories

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

Recently Issued Accounting Pronouncements

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

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

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

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

Environmental Regulations

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

Liquidity and Capital Resources

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

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

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

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

Cash flows

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

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

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

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

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

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

Recession strategy

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

Contractual Obligations and Commitments

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

	Obligation Due in Period						
	(in thousands)						
Cash Contractual Obligations	2009	2010	2011	2012	2013	Thereafter	Total
Term loan facility (secured)	\$ 3,378	\$ 3,378	\$ 2,816	\$ —	\$ —	\$ —	\$ 9,572
Interest on term loan facility	321	186	51	—	—	—	558
Line of credit (secured)	—	7,000	—	—	—	—	7,000
Interest on line of credit	280	93	—	—	—	—	373
Purchase obligations	956	956	956	956	814	—	4,638
Other long term debt	—	—	—	—	—	441	441
Facilities and office leases	433	357	259	235	168	13	1,465
Total	\$ 5,368	\$ 11,970	\$ 4,082	\$ 1,191	\$ 982	\$ 454	\$ 24,047

Senior Bank Borrowings

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

Revolving Line of Credit Facility. Our revolving line of credit facility allows us to borrow, repay and re-borrow funds drawn under this facility. The total amount that we can borrow and have outstanding at any one time is the lesser of \$40.0 million or the amount available for advances under a “borrowing base” calculation established by the bank. As of December 31, 2008, the amount available for revolving line of credit advances was \$33.0 million. The amount of the borrowing base is based primarily upon our receivables, equipment and inventory. The borrowing base is re-determined by the bank on a monthly basis. If, as a result of the re-determination of the borrowing base, the aggregate outstanding principal amount of the notes payable to the bank under the Loan Agreement exceeds the borrowing base, we must prepay the principal of the revolving line of credit note in an amount equal to such excess. Interest only on borrowings under our revolving line of credit facility is payable monthly on the first day of each month. All outstanding principal and unpaid interest is due on May 1, 2010. Since April 1, 2008, our interest rate on the revolving line of credit is equal to prime rate minus one quarter of one percent (.25%) but never lower than four percent (4.0%) nor higher than eight and three quarter percent (8.75%). We had \$7.0 million and \$600,000 outstanding as of December 31, 2008 and 2007, respectively, on this revolving line of credit facility. The interest rates were 4.00% and 7.5% as of December 31, 2008 and 2007, respectively.

\$16.9 Million Multiple Advance Term Loan Facility. This multiple advance term loan facility represents the consolidation of our previously existing advancing line of credit and term loan facilities. Re-borrowings are not permitted under this facility. Principal under this term loan facility is due and payable in 59 monthly installments of \$282,000 each which commenced on November 1, 2006 and continuing through September 1, 2011. Since April 1, 2008, our interest rate on the term loan is equal to prime rate minus one half of one percent (.50%) but never lower than four percent (4%) nor higher than eight and three quarter percent (8.75%). Interest on the unpaid principal balance is due and payable on the same dates as principal payments. All outstanding principal and unpaid interest is due on October 1, 2011. As of December 31, 2008 and 2007, respectively, this term loan facility had a principal balance of \$9.6 million and \$13.0 million. The interest rates were 4.0% and 7.5% as of December 31, 2008 and 2007, respectively.

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

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

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

- at the end of each month, a consolidated current ratio (as defined in the Loan Agreement) of at least 1.6 to 1.0;
- at the end of each month, consolidated tangible net worth (as defined in the Loan Agreement) of at least \$85.0 million;
- at the end of each fiscal quarter, a debt service coverage ratio (as defined in the Loan Agreement) of at least 1.50 to 1.00; and
- at the end of each month, a ratio of consolidated debt to consolidated tangible net worth (as defined in the Loan Agreement) of less than 2.0 to 1.0.

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

As of December 31, 2008, we were in compliance with all covenants in our Loan Agreement. A default under our bank credit facility could trigger the acceleration of our bank debt so that it is immediately due and payable. Such default would have a material adverse effect on our liquidity, financial position and operations.

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

Subordinated Debt - Related Parties

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

Components of Our Principal Capital Expenditures

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

Expenditure Category	Actual		
	2006	2007	2008
	<i>(in thousands)</i>		
Rental equipment, vehicles and shop equipment	\$ 27,684	\$ 25,307	\$ 46,271

The level of our expenditures will vary in future periods depending on energy market conditions and other related economic factors. Based upon existing economic and market conditions, we believe that our operating cash flow will be sufficient to fully fund our net investing cash requirements for 2009. We also believe we have significant flexibility with respect to our financing alternatives and adjustment of our expenditure plans if circumstances warrant. When considered in relation to our total financial capacity, we do not have any material continuing commitments associated with expenditure plans related to our current operations.

Off-Balance Sheet Arrangements

From time-to-time, we enter into off-balance sheet arrangements and transactions that can give rise to off-balance sheet obligations. As of December 31, 2008, the off-balance sheet arrangements and transactions that we have entered into include operating lease agreements and purchase agreements. We do not believe that these arrangements are reasonably likely to materially affect our liquidity or availability of, or requirements for, capital resources.

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

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

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

Interest Rate Risk

Our Loan Agreement provides for Prime Rate less 1/2 % for our term loan facility and Prime Rate less 1/4 % for our revolving line of credit facility. Consequently, our exposure to interest rates relates primarily to interest earned on short-term investments and paying above market rates, if such rates are below the fixed rate, on our bank borrowings. As of December 31, 2008, we were not using any derivatives to manage interest rate risk.

Financial Instruments and Debt Maturities

Our financial instruments consist of cash and cash equivalents, short-term investments, accounts receivable, accounts payable, bank borrowings, and notes. The carrying amounts of cash and cash equivalents, accounts receivable, and accounts payable approximate fair value because of the highly liquid nature of these short-term instruments. The fair value of our bank borrowings approximate the carrying amounts as of December 31, 2008 and 2007, and were determined based upon interest rates currently available to us.

Customer Credit Risk

We are exposed to the risk of financial non-performance by our customers. Our ability to collect on sales to our customers is dependent on the liquidity of our customer base. To manage customer credit risk, we monitor credit ratings of our customers. Unless we are able to retain our existing customers, or secure new customers if we lose one or more of our significant customers, our revenue and results of operations would be adversely affected. See “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations – Critical Accounting Policies and Procedures – Allowance For Doubtful Accounts Receivable” on page 23.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

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

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

None.

ITEM 9A. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

An evaluation was carried out under the supervision and with the participation of our management, including our President and Chief Executive Officer and our Principal Accounting Officer And Treasurer, of the effectiveness of the design of our “disclosure controls and procedures” (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended or, the “Exchange Act”) as of December 31, 2008, pursuant to Exchange Act Rule 13a-15. Based upon that evaluation, the President and Chief Executive Officer and our Principal Accounting Officer And Treasurer have concluded that our disclosure controls and procedures as of December 31, 2008, are effective to ensure that information required to be disclosed by us in the reports filed or submitted by us under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the SEC’s rules and forms and include controls and procedures designed to ensure that information required to be disclosed by us in such reports is accumulated and communicated to our management, including our principal executive and financial officers as appropriate to allow timely decisions regarding required disclosures. Due to the inherent limitations of control systems, not all misstatements may be detected. Those inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple errors or mistakes. Additionally, controls could be circumvented by the individual acts of some persons or by collusion of two or more people. Our controls and procedures can only provide reasonable, not absolute, assurance that the above objectives have been met.

Changes in Internal Control Over Financial Reporting

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

Management’s Report on Internal Control Over Financial Reporting

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

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

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

Our management assessed the effectiveness of our internal control over financial reporting as December 31, 2008 using the criteria set forth by the Commission of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control-Integrated Framework*. Based on this assessment, our management concluded that, as of December 31, 2008, our internal control over financial reporting was effective.

Report of Independent Registered Public Accounting Firm

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

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

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

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

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

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

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Natural Gas Services Group, Inc. as of December 31, 2007 and 2008, and the related consolidated statements of income, stockholders' equity and cash flows for each of the three years in the period ended December 31, 2008 of Natural Gas Services Group, Inc. and our report dated March 2, 2009 expressed an unqualified opinion.

/s/ HEIN & ASSOCIATES LLP

Dallas, Texas
March 2, 2009

ITEM 9B. OTHER INFORMATION

None.

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

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

ITEM 11. EXECUTIVE COMPENSATION

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

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

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

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

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

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

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

PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES

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

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

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

(a)(3) Exhibits

See Item 15(b) below.

(b) Exhibits:

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

<u>Exhibit No.</u>	<u>Description</u>
3.1	Articles of Incorporation, as amended (Incorporated by reference to Exhibit 3.1 of the 10QSB filed and dated November 10, 2004)
3.2	Bylaws (Incorporated by reference to Exhibit 3.4 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
4.1	Non-Statutory Stock Option Agreement (Incorporated by reference to Exhibit 10.2 to Form 8-K Report filed with the SEC on August 30, 2005)
10.1	1998 Stock Option Plan, as amended (Incorporated by reference to Exhibit 10.1 of the Registrant's Form 8-K Report dated September 20, 2006 on file with the SEC September 26, 2006)
10.2	Lease Agreement, dated March 1, 2004, between the Registrant and the City of Midland, Texas (Incorporated by reference to Exhibit 10.19 of the Registrant's Form 10-QSB for the fiscal quarter ended September 30, 2004)
10.3	Securities Purchase Agreement, dated July 20, 2004, between the Registrant and CBarney Investments, Ltd. (Incorporated by reference to Exhibit 4.1 of the Registrant's Current Report on Form 8-K dated July 20, 2004 and filed with the Securities and Exchange Commission on July 27, 2004)
10.4	Employment Agreement between Paul D. Hensley and Natural Gas Services Group, Inc. (Incorporated by reference to Exhibit 10.1 of the Registrant's Form 8-K Report, dated January 3, 2005, as filed with the Securities and Exchange Commission on January 7, 2005)
10.5	Promissory Note, dated January 3, 2005, in the original principal amount of \$2.1 million made by Natural Gas Services Group, Inc. payable to Paul D. Hensley (Incorporated by reference to Exhibit 10.26 of the Registrant's Form 10-KSB for the fiscal year ended December 31, 2004, and filed with the Securities and Exchange Commission on March 30, 2005)
10.6	Guaranty Agreement, dated as of January 3, 2005, made by Natural Gas Service Group, Inc., for the benefit of Western National Bank (Incorporated by reference to Exhibit 10.3 of the Registrant's Current Report on Form 8-K, dated January 3, 2005, and filed with the Securities and Exchange Commission on January 7, 2005)
10.7	Guaranty Agreement, dated as of January 3, 2005, made by Screw Compression Systems, Inc., for the benefit of Western National Bank (Incorporated by reference to Exhibit 10.4 of the Registrant's Current Report on Form 8-K, dated January 3, 2005, and filed with the Securities and Exchange Commission on January 7, 2005)
10.8	Employment Agreement between James R. Hazlett and Natural Gas Services Group, Inc. (Incorporated by reference to Exhibit 10.1 of the Registrant's Form 8-K Report, dated September 14, 2005, and filed with the Securities and Exchange Commission on November 14, 2005)

<u>Exhibit No.</u>	<u>Description</u>
10.9	Promissory Note, dated January 3, 2005, in the original principal amount of \$300,000 made by Natural Gas Services Group, Inc. payable to Jim Hazlett (Incorporated by reference to Exhibit 10.3 of the Registrant's Form 8-K Report, dated September 14, 2005, and filed with the Securities and Exchange Commission on November 14, 2005)
10.10	Guaranty Agreement dated as of January 3, 2006, and made by Screw Compression Systems, Inc. for the benefit of Western National Bank (Incorporated by reference to Exhibit 10.4 of the Registrant's Current Report on Form 8-K, dated January 3, 2006, and filed with the Securities and Exchange Commission on January 6, 2006)
10.11	Seventh Amended and Restated Loan Agreement (Incorporated by reference to Exhibit 10.1 of the Registrant's Form 8-K dated October 26, 2006 and filed with the Securities and Exchange Commission on November 1, 2006
10.12	Eighth Amended and Restated Loan Agreement between Natural Gas Services Group, Inc. and Western National Bank.
10.13	Revolving Line of Credit Promissory Note issued to Western National Bank.
10.14	Employment Agreement between Natural Gas Services Group, Inc. and Stephen C. Taylor dated October 25, 2008 (Incorporated by reference to Exhibit 10.1 of the Registrant's Current Report on Form 8-K filed with the Securities and Exchange Commission on October 30, 2008)
*10.15	Lease Agreement, dated March 26, 2008, between WNB Tower, LTD (as landlord) and Natural Gas Services Group, Inc. (as tenant) in connection with the lease of the Company's principal offices in Midland, Texas.
14.0	Code of Ethics (Incorporated by reference to Exhibit 14.0 of the Registrant's Form 10-KSB for the fiscal year ended December 31, 2004, and filed with the Securities and Exchange Commission on March 30, 2005)
*23.1	Consent of Hein & Associates LLP
*31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
*31.2	Certification of Principal Accounting Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
*32.1	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
*32.2	Certification of Principal Accounting Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

* Filed herewith.

SIGNATURES

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

NATURAL GAS SERVICES GROUP, INC.

Date: March 2, 2009

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

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

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

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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

We have audited the accompanying consolidated balance sheets of Natural Gas Services Group, Inc. (the “Company”) as of December 31, 2007 and 2008, and the related consolidated statements of income, stockholders' equity and cash flows for each of the three years in the period ended December 31, 2008. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2007 and 2008, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2008, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Natural Gas Services Group, Inc.'s, internal control over financial reporting as of December 31, 2008, based on *criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)*, and our report dated March 2, 2009 expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

/s/ HEIN & ASSOCIATES LLP

Dallas, Texas
March 2, 2009

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

	December 31,	
	2007	2008
ASSETS		
Current Assets:		
Cash and cash equivalents	\$ 245	\$ 1,149
Short-term investments	18,661	2,300
Trade accounts receivable, net of doubtful accounts of \$110 and \$177, respectively	11,322	11,321
Inventory, net of allowance for obsolescence of \$273 and \$500, respectively	20,769	31,931
Prepaid income taxes	3,584	244
Prepaid expenses and other	641	87
Total current assets	<u>55,222</u>	<u>47,032</u>
Rental equipment, net of accumulated depreciation of \$16,810 and \$24,624, respectively	76,025	111,967
Property and equipment, net of accumulated depreciation of \$4,792 and \$6,065, respectively	8,580	8,973
Goodwill, net of accumulated amortization of \$325, both periods	10,039	10,039
Intangibles, net of accumulated amortization of \$1,145 and \$1,198, respectively	3,324	3,020
Other assets	43	19
Total assets	<u>\$ 153,233</u>	<u>\$ 181,050</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Current portion of long-term debt and subordinated notes	\$ 4,378	\$ 3,378
Current portion of line of credit	600	—
Accounts payable	4,072	8,410
Accrued liabilities	3,990	3,987
Current income tax liability	3,525	110
Deferred income	81	38
Total current liabilities	<u>16,646</u>	<u>15,923</u>
Long term debt, less current portion	9,572	6,194
Line of credit, less current portion	—	7,000
Deferred income tax payable	12,635	21,042
Other long term liabilities	—	441
Total liabilities	<u>38,853</u>	<u>50,600</u>
Commitments and contingencies (Notes 4, 5, 10 and 13)		
Stockholders' equity:		
Preferred stock, 5,000 shares authorized, no shares issued or outstanding	—	—
Common stock, 30,000 shares authorized, par value \$0.01; 12,085 and 12,094 shares issued and outstanding, respectively	121	121
Additional paid-in capital	83,460	83,937
Retained earnings	30,799	46,392
Total stockholders' equity	<u>114,380</u>	<u>130,450</u>
Total liabilities and stockholders' equity	<u>\$ 153,233</u>	<u>\$ 181,050</u>

See accompanying notes to these consolidated financial statements.

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

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

See accompanying notes to these consolidated financial statements.

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

	<u>Preferred Stock</u>		<u>Common Stock</u>		<u>Additional</u>	<u>Retained</u>	<u>Total</u>
	<u>Shares</u>	<u>Amount</u>	<u>Shares</u>	<u>Amount</u>	<u>Paid-In</u>	<u>Earnings</u>	<u>Stockholders'</u>
					<u>Capital</u>		<u>Equity</u>
BALANCES, January 1, 2006	—	\$ —	9,022	\$ 90	\$ 34,667	\$ 10,933	\$ 45,690
Exercise of common stock options and warrants	—	—	129	1	356	—	357
Compensation expense on issuance of common stock options	—	—	—	—	376	—	376
Income tax benefit realized from the exercise of stock options	—	—	—	—	27	—	27
Issuance of common stock, net of offering costs	—	—	2,895	29	47,134	—	47,163
Net income	—	—	—	—	—	7,588	7,588
BALANCES, December 31, 2006	—	\$ —	12,046	\$ 120	\$ 82,560	\$ 18,521	\$ 101,201
Exercise of common stock options and warrants	—	—	39	1	247	—	248
Compensation expense on issuance of common stock options	—	—	—	—	541	—	541
Income tax benefit realized from the exercise of stock options	—	—	—	—	112	—	112
Net income	—	—	—	—	—	12,278	12,278
BALANCES, December 31, 2007	—	\$ —	12,085	\$ 121	\$ 83,460	\$ 30,799	\$ 114,380
Exercise of common stock options	—	—	9	—	54	—	54
Compensation expense on issuance of common stock options	—	—	—	—	423	—	423
Net income	—	—	—	—	—	15,593	15,593
BALANCES, December 31, 2008	—	\$ —	12,094	\$ 121	\$ 83,937	\$ 46,392	\$ 130,450

See accompanying notes to these consolidated financial statements.

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

	For the Years Ended December 31,		
	2006	2007	2008
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income	\$ 7,588	\$ 12,278	\$ 15,593
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	6,020	7,470	9,925
Deferred taxes	2,544	2,930	8,407
Employee stock options expense	376	541	423
Loss (gain) on disposal of assets	13	(1)	7
Changes in current assets:			
Trade accounts receivables, net	(2,271)	(2,859)	1
Inventory, net	749	(3,826)	(11,162)
Prepaid expenses and other	135	(3,904)	3,894
Changes in current liabilities:			
Accounts payable and accrued liabilities	(3)	3,228	4,335
Current income tax liability	849	2,581	(3,415)
Deferred income	122	(144)	(43)
Other	(46)	(25)	285
NET CASH PROVIDED BY OPERATING ACTIVITIES	16,076	18,269	28,250
CASH FLOWS FROM INVESTING ACTIVITIES:			
Purchase of property and equipment	(27,684)	(25,307)	(46,271)
Purchase of short-term investments	(38,252)	(2,609)	(2,620)
Redemption of short-term investments	13,200	9,000	18,981
Proceeds from sale of property and equipment	73	95	47
NET CASH USED IN INVESTING ACTIVITIES	(52,663)	(18,821)	(29,863)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Proceeds from line of credit	1,375	600	7,500
Proceeds from long-term debt	68	—	—
Proceeds from other long term liabilities, net	—	—	441
Repayments of long-term debt	(9,581)	(4,442)	(4,378)
Repayment of line of credit	(1,675)	—	(1,100)
Proceeds from exercise of stock options and warrants	357	248	54
Proceeds from sale of stock, net of transaction costs	47,163	—	—
NET CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES	37,707	(3,594)	2,517
NET CHANGE IN CASH	1,120	(4,146)	904
CASH AT BEGINNING OF PERIOD	3,271	4,391	245
CASH AT END OF PERIOD	\$ 4,391	\$ 245	\$ 1,149
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:			
Interest paid	\$ 1,692	\$ 1,191	\$ 802
Income taxes paid	\$ 894	\$ 4,620	\$ 294

See accompanying notes to these consolidated financial statements.

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

1. Summary of Significant Accounting Policies

Organization and Principles of Consolidation

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

On January 3, 2005, we purchased all of the outstanding shares of capital stock of Screw Compression System, Inc. ("SCS") a manufacturer of natural gas compressors, with its principal offices located in Tulsa, Oklahoma for the purpose of expanding the product line, production capacity and customer base. SCS operated as a wholly owned subsidiary until June 30, 2007, when it was merged into Natural Gas Services Group, Inc.

All significant intercompany accounts and transactions were eliminated in consolidation.

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

Nature of Operations

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

Use of Estimates

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

Cash Equivalents

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

Short-term Investments

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

Accounts Receivable

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

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

Revenue Recognition

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

Description of Rental Arrangements

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

Major Customers and Concentration of Credit Risk

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

Inventory

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

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

Property and Equipment

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

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

Goodwill

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

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS***Intangibles***

At December 31, 2008, NGS has intangible assets (excluding patents) with a gross carrying value of \$4.2 million, which relate to developed technology, acquired customer contracts, distribution agreements and non-compete agreements. The carrying amount net of accumulated amortization at December 31, 2008 was \$3.0 million. Intangible assets (excluding patents) are amortized on a straight-line basis with useful lives ranging from 5 to 20 years with a weighted average life remaining of approximately fourteen years as of December 31, 2008. Amortization expense recognized in each of the years ending December 31, 2006, 2007, and 2008 was \$299,000. In addition, NGS has an intangible asset with a gross carrying value of \$654,000 at December 31, 2008 related to the trade name of SCS. This asset is not being amortized as it has been deemed to have an indefinite life.

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

2009	\$ 299
2010	260
2011	179
2012	125
2013	125
Thereafter	1,378
	<u>\$ 2,366</u>

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

Patents

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

Other Assets

Included in other assets are debt issuance costs, net of accumulated amortization, and deposits totaling approximately \$43,000 and \$19,000 at December 31, 2007 and 2008, respectively. Such costs are amortized over the period of the respective debt agreements on a straight-line method, which approximates the effective interest method.

Warranty

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

Financial Instruments and Concentrations of Credit Risk

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

Advertising Costs

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

Other Income

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

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

Per Share Data

Basic earnings per common share is computed using the weighted average number of common shares outstanding during the period. Diluted earnings per common share is computed using the weighted average number of common stock and common stock equivalent shares outstanding during the period. There was an anti-dilutive effect of 10,000 and 25,000 common stock options for the years ended December 31, 2006 and 2007, respectively, and none in 2008.

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

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

Income Taxes

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

Fair Value Measurement

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

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

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

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

Reclassification

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

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

Recently Issued Accounting Pronouncements

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

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

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

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

2. Rental Activity

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

Years Ending December 31,	
2009	\$ 3,813
2010	264
Total	<u>\$ 4,077</u>

NATURAL GAS SERVICES GROUP, INC.
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3. Property and Equipment

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

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

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

4. Credit Facility

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

Line of Credit

Our revolving line of credit facility allows us to borrow, repay and reborrow funds drawn under this facility, as amended. The total amount that we can borrow and have outstanding at any one time is the lesser of \$40.0 million or the amount available for advances under a "borrowing base" calculation established by the bank. As of December 31, 2008, the amount available for revolving line of credit advances was \$33.0 million. The amount of the borrowing base is based primarily upon our receivables, equipment and inventory. The borrowing base is redetermined by the bank on a monthly basis. If, as a result of the redetermination of the borrowing base, the aggregate outstanding principal amount of the notes payable to the bank under the Loan Agreement exceeds the borrowing base, we must prepay the principal of the revolving line of credit note in an amount equal to such excess. Interest only on borrowings under our revolving line of credit facility is payable monthly on the first day of each month. All outstanding principal and unpaid interest is due on May 1, 2010. Since April 1, 2008, our interest rate on the revolving line of credit is equal to prime rate minus one quarter of one percent (.25%) but never lower than four percent (4.0%) nor higher than eight and three quarter percent (8.75%). We had \$7.0 million and \$600,000 outstanding as of December 31, 2008 and 2007, respectively, on this revolving line of credit facility. The interest rates were 4.0% and 7.5% as of December 31, 2008 and 2007, respectively.

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

Term Loan Facility

This multiple advance term loan facility represents the consolidation of our previously existing advancing line of credit and term loan facilities. Reborrowings are not permitted under this facility. Principal under this term loan facility is due and payable in 59 monthly installments of \$282,000 each, which commenced November 1, 2006 and continuing through September 1, 2011. Since April 1, 2008, our interest rate on the term loan is equal to prime rate minus one half of one percent (.50%) but never lower than four percent (4%) nor higher than eight and three quarter percent (8.75%) and seven and one half percent (7.5%) and four percent (4.0%) at December 31, 2008 and 2007, respectively. Interest on the unpaid principal balance is due and payable on the same dates as principal payments. All outstanding principal and unpaid interest is due on October 1, 2011. As of December 31, 2008 and 2007, respectively, this term loan facility had a principal balance of \$9.6 million and \$13.0 million. The interest rates were 4.0% and 7.5% as of December 31, 2008 and 2007, respectively.

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

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

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

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

- At the end of each month, a consolidated current ratio (as defined in the Loan Agreement) of at least 1.6 to 1.0;
- At the end of each month, a consolidated tangible net worth (as defined in the Loan Agreement) of at least \$85 million;
- At the end of each fiscal quarter, a debt service coverage ratio (as defined in the Loan Agreement) of at least 1.50 to 1.00; and
- At the end of each month, a ratio of consolidated debt to consolidated tangible net worth (as defined in the Loan Agreement) of less than 2.0 to 1.0.

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

As of December 31, 2008 and 2007, we were in compliance with all covenants in our Loan Agreement. A default under our bank credit facility could trigger the acceleration of our bank debt so that it is immediately due and payable. Such default would have a material adverse effect on our liquidity, financial position and operations.

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

2009	\$ 3,378
2010	3,378
2011	2,816
Total	<u>\$ 9,572</u>

5. Other Long-term Liabilities

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

6. Subordinated Notes – Related Parties

On January 3, 2005, we issued subordinated promissory notes to Paul D. Hensley, James R. Hazlett and Tony Vohjesus, the owners of SCS, as part of the consideration for the acquisition of Screw Compression Systems, Inc. As of January 3, 2005, Screw Compression Systems, Inc. became a wholly owned subsidiary of NGSG. Mr. Hensley is currently the Senior Vice President of Technical Services and a Director of Natural Gas Services Group, Inc. Mr. Hazlett is the Vice President of Technical Services. Mr. Vohjesus is a Manager of Product Services. The aggregate principal amount was \$3.0 million bearing interest at the rate of 4.00% per annum. Beginning January 3, 2006, a principal payment of \$1.0 million is due and payable each year until maturity on January 3, 2008 plus the current outstanding interest. The subordinated promissory notes are secured by a letter of credit in the face amount of \$2.0 million. As of December 31, 2007, \$1.0 million was outstanding on these notes. We repaid these notes in full at maturity in January 2008.

7. Income Taxes

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

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

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

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

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

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

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

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

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

8. Stockholders' Equity

Initial Public Offering

In October, 2002, we closed an initial public offering in which we sold 1.5 million shares of common stock and warrants to purchase 1.5 million shares of common stock for a total of \$7.9 million. Costs and commissions associated with the offering totaled \$1.3 million. The warrants were exercisable anytime through October 21, 2006 at \$6.25 per share. In connection with this offering, the underwriter received options to purchase 150,000 shares of common stock at \$6.25 per share and warrants at \$0.3125 per share. The warrants, when purchased by the underwriter, contained an exercise price of \$7.81 per share. The underwriter's warrants were exercised or expired in October 2007. The underwriter's options expired in October 2007. As of December 31, 2008, there were no underwriter options or warrants outstanding.

Secondary Public Offering

On March 8, 2006, we sold 2.5 million shares of our common stock pursuant to a public offering at a price of \$17.50 per share, resulting in net proceeds to us of \$40.7 million. We did not receive any proceeds from sales by certain selling stockholders. We granted the underwriter an option for a period of 30 days to purchase up to an additional 428,000 shares to cover over-allotments, if any. On March 27, 2006, the underwriter exercised its over-allotment option and on March 30, 2006, we sold an additional 428,000 shares resulting in proceeds to NGSG of \$7.1 million in addition to the net proceeds of \$40.7 million from the sale of the 2.5 million shares of common stock on March 8, 2006. The net proceeds after offering costs to us were \$47.1 million and a portion was used to reduce our bank debt by \$5.0 million.

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

Preferred Stock

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

9. Stock-Based Compensation

Stock Option Plan

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

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

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

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

	<u>Number of Stock Options</u>	<u>Weighted Average Exercise Price</u>	<u>Weighted Average Remaining Contractual Life (years)</u>	<u>Aggregate Intrinsic Value (in thousands)</u>
Outstanding at December 31, 2007	167,502	\$ 11.25	7.77	\$ 1,401
Granted	113,000	18.81		
Exercised	(8,833)	6.04		
Forfeited or expired	<u>(7,168)</u>	<u>12.85</u>		
Outstanding at December 31, 2008	<u>264,501</u>	<u>\$ 14.61</u>	<u>7.94</u>	<u>*</u>
Exercisable at December 31, 2008	<u>158,333</u>	<u>\$ 12.15</u>	<u>7.00</u>	<u>*</u>

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

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

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

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

The following table summarizes information about the options outstanding at December 31, 2008:

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

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

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

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

10. Commitments

401(k) Plan

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

Rented Facilities

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

2009	\$ 433
2010	357
2011	259
2012	235
2013	168
Thereafter	13
Total	<u>\$ 1,465</u>

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

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

11. Segment Information

SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*, establishes standards for public companies relating to the reporting of financial and descriptive information about their operating segments in financial statements. Operating segments are components of an enterprise about which separate financial information is available that is evaluated regularly by chief operating decision makers in the allocation of resources and the assessment of performance. Our management identifies segments based upon major revenue sources as shown in the tables below. However, management does not track assets by segment.

For the Year Ended December 31, 2006

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

For the Year Ended December 31, 2007

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

For the Year Ended December 31, 2008

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

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

2006	Q1	Q2	Q3	Q4	Total
Total revenue	\$ 13,578	\$ 15,458	\$ 17,130	\$ 16,563	\$ 62,729
Operating income	3,053	1,912	3,690	3,476	12,131
Net income applicable to common shares	1,696	1,208	2,364	2,320	7,588
Net income per share - Basic	0.18	0.10	0.20	0.19	0.67
Net income per share - Diluted	0.17	0.10	0.20	0.19	0.66
2007	Q1	Q2	Q3	Q4	Total
Total revenue	\$ 16,712	\$ 17,624	\$ 18,651	\$ 19,502	\$ 72,489
Operating income	4,203	4,134	5,232	5,020	18,589
Net income applicable to common shares	2,681	2,646	3,337	3,614	12,278
Net income per share - Basic	0.22	0.22	0.28	0.30	1.02
Net income per share - Diluted	0.22	0.22	0.28	0.30	1.01

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

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

13. Legal Proceedings

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

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

INDEX TO EXHIBITS

(a) Exhibits

<u>Exhibit No.</u>	<u>Description</u>
3.1	Articles of Incorporation, as amended (Incorporated by reference to Exhibit 3.1 of the 10QSB filed and dated November 10, 2004)
3.2	Bylaws (Incorporated by reference to Exhibit 3.4 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
4.1	Non-Statutory Stock Option Agreement (Incorporated by reference to Exhibit 10.2 to Form 8-K Report filed with the SEC on August 30, 2005)
10.1	1998 Stock Option Plan, as amended (Incorporated by reference to Exhibit 10.1 of the Registrant's Form 8-K Report dated September 20, 2006 on file with the SEC September 26, 2006)
10.2	Lease Agreement, dated March 1, 2004, between the Registrant and the City of Midland, Texas (Incorporated by reference to Exhibit 10.19 of the Registrant's Form 10-QSB for the fiscal quarter ended September 30, 2004)
10.3	Securities Purchase Agreement, dated July 20, 2004, between the Registrant and CBarney Investments, Ltd. (Incorporated by reference to Exhibit 4.1 of the Registrant's Current Report on Form 8-K dated July 20, 2004 and filed with the Securities and Exchange Commission on July 27, 2004)
10.4	Employment Agreement between Paul D. Hensley and Natural Gas Services Group, Inc. (Incorporated by reference to Exhibit 10.1 of the Registrant's Form 8-K Report, dated January 3, 2005, as filed with the Securities and Exchange Commission on January 7, 2005)
10.5	Promissory Note, dated January 3, 2005, in the original principal amount of \$2.1 million made by Natural Gas Services Group, Inc. payable to Paul D. Hensley (Incorporated by reference to Exhibit 10.26 of the Registrant's Form 10-KSB for the fiscal year ended December 31, 2004, and filed with the Securities and Exchange Commission on March 30, 2005)
10.6	Guaranty Agreement, dated as of January 3, 2005, made by Natural Gas Service Group, Inc., for the benefit of Western National Bank (Incorporated by reference to Exhibit 10.3 of the Registrant's Current Report on Form 8-K, dated January 3, 2005, and filed with the Securities and Exchange Commission on January 7, 2005)
10.7	Guaranty Agreement, dated as of January 3, 2005, made by Screw Compression Systems, Inc., for the benefit of Western National Bank (Incorporated by reference to Exhibit 10.4 of the Registrant's Current Report on Form 8-K, dated January 3, 2005, and filed with the Securities and Exchange Commission on January 7, 2005)
10.8	Employment Agreement between James R. Hazlett and Natural Gas Services Group, Inc. (Incorporated by reference to Exhibit 10.1 of the Registrant's Form 8-K Report, dated September 14, 2005, and filed with the Securities and Exchange Commission on November 14, 2005)
10.9	Promissory Note, dated January 3, 2005, in the original principal amount of \$300,000 made by Natural Gas Services Group, Inc. payable to Jim Hazlett (Incorporated by reference to Exhibit 10.3 of the Registrant's Form 8-K Report, dated September 14, 2005, and filed with the Securities and Exchange Commission on November 14, 2005)
10.10	Guaranty Agreement, dated as of January 3, 2006, and made by Screw Compression Systems, Inc. for the benefit of Western National Bank (Incorporated by reference to Exhibit 10.4 of the Registrant's Current Report on Form 8-K, dated January 3, 2006, and filed with the Securities and Exchange Commission on January 6, 2006)
10.11	Seventh Amended and Restated Loan Agreement (Incorporated by reference to Exhibit 10.1 of the Registrant's Form 8-K dated October 26, 2006 and filed with the Securities and Exchange Commission on November 1, 2006)
10.12	Eighth Amended and Restated Loan Agreement between Natural Gas Services Group, Inc. and Western National Bank.
10.13	Revolving Line of Credit Promissory Note issued to Western National Bank.

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

* Filed herewith.

Consent of Independent Registered Public Accounting Firm

The Board of Directors
Natural Gas Services Group, Inc.
Midland, Texas

We consent to the incorporation by reference in the registration statements on Form S-8 (No. 333-147311 and No. 333-110954) and the registration statements (No. 333-119502 and No. 333-122687) on Form S-3, of Natural Gas Services Group, Inc. of our report dated March 2, 2009, relating to our audits of the consolidated financial statements and internal control over financial reporting, which appear in this Annual Report on Form 10-K of Natural Gas Services Group, Inc for the year ended December 31, 2008.

/s/ HEIN & ASSOCIATES LLP

Dallas, Texas
March 2, 2009

Certifications

I, Stephen C. Taylor, certify that:

1. I have reviewed this Annual Report on Form 10-K of Natural Gas Services Group, Inc;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 2, 2009

Natural Gas Services Group, Inc.

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

Certifications

I, Earl R. Wait, certify that:

1. I have reviewed this Annual Report on Form 10-K of Natural Gas Services Group, Inc;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 2, 2009

Natural Gas Services Group, Inc.

By: /s/ Earl R. Wait
Earl R. Wait
Vice President of Accounting
(Principal Accounting Officer) and Treasurer

**CERTIFICATION PURSUANT TO
18 U.S.C. §1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Annual Report of Natural Gas Services Group, Inc. (the "Company") on Form 10-K for the year ended December 31, 2008 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Stephen C. Taylor, Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. §1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: March 2, 2009

By: Natural Gas Services Group, Inc.
/s/ Stephen C. Taylor
Stephen C. Taylor
Chairman of the Board of Director, President
and Chief Executive Officer
(Principal Executive Officer)

**CERTIFICATION PURSUANT TO
18 U.S.C. §1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Annual Report of Natural Gas Services Group, Inc. (the "Company") on Form 10-K for the year ended December 31, 2008, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Earl R. Wait, Vice President - Accounting (Principal Accounting Officer) of the Company, certify, pursuant to 18 U.S.C. §1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: March 2, 2009

Natural Gas Services Group, Inc.

By: /s/ Earl R. Wait
Earl R. Wait
Vice President of Accounting
(Principal Accounting Officer) and Treasurer

LEASE AGREEMENT

STATE OF TEXAS

COUNTY OF MIDLAND

THIS LEASE AGREEMENT made and entered into this the 26th day of March, 2008, between WNB Tower, LTD, (hereinafter called "Landlord"), whose address for purposes hereof 508 West Wall Street, Suite 1000, Midland, Texas 79701, and Natural Gas Services Group, Inc., (hereinafter called "Tenant").

WITNESSETH:

Section 1. Premises

Subject to and upon the terms, provisions, and conditions hereinafter set forth, and each in consideration of the duties, covenants, and obligations of the other hereunder, Landlord does hereby lease, demise, and let to Tenant, and the Tenant does hereby lease from Landlord, those certain premises being approximately 13,135 square feet of net rentable area including (CAM) Common Area Maintenance (the "Leased Premises") on the 5th floor of the building known as WNB Tower Building, 508 W. Wall Street, (The "Building"), located on real property more particularly described on Exhibit "A" attached hereto and made a part hereof for all purposes.

Section 2. Term

This Lease shall be for a term of 60 months beginning on the 14th day of June, 2008, (hereinafter referred to as the "Commencement Date"), and shall expire on the 14th day of June, 2013.

Section 3. Rent

- a. Annual Period: Tenant covenants and agrees to pay Landlord, at its office in Midland, Texas, as rent, the following:

	1 st Yr	2 nd Yr.	3 rd Yr	4 th Yr	5 th Yr
Annual Rental:	\$ 108,363.75	\$ 118,215.00	\$ 128,066.25	\$ 134,633.75	\$ 141,201.25
Monthly Rental	\$ 9,030.32	\$ 9,851.25	\$ 10,672.19	\$ 11,219.48	\$ 11,766.77

Such rent shall be paid to Landlord in advance and without demand, counterclaim or offset, on or before the first day of each calendar month.

- b. Second and Succeeding Annual Periods: To provide an equitable adjustment of rental to allow for increases in operating expenses incurred through the operation of the Building, the rental shall be adjusted in accordance with the following procedures:

The Landlord shall prepare annually prior to the end of each calendar year an estimate of total operating expenses for the upcoming calendar year.

Commencing June 1st, 2009 Tenant shall pay monthly additional rental consisting of one twelfth (1/12) of the difference between the "Base Year" actual operating expense costs and the upcoming year's estimated operating expense costs allocated to the Leased Premises. For purposes of this Lease Agreement the "Base Year" shall be the calendar year of 2008. This additional rent allocation shall be based on the proportion of the Leased Premises' net rentable area to the Building's total net rentable area. Tenant's proportionate share for purposes defined herein shall be 7.3898 % of the total estimated operating expense increase.

After the first annual period (first lease year), Landlord may from time to time throughout the calendar year adjust the amount Tenant pays to Landlord monthly for increases *or decreases* in operating expenses, should Landlord reasonably determine that the actual costs for operating expenses are significantly above or below the estimated costs for operating expenses.

In no event shall Landlord include costs for capital replacement items, capital expenditures, leasing commissions, or any expenditure that would be capitalized in accordance with generally accepted accounting principles in the actual or estimated operating expense calculations.

Within ninety (90) days after the conclusion of each calendar year of the Lease Term, or as soon thereafter as possible, Landlord shall provide Tenant a detailed statement of actual operating expenses for the previous calendar year. The actual operating expenses shall be compared to the estimated operating expenses, and Tenant's account shall be adjusted **annually upon completion of audited financials** by an increase or decrease based on Tenant's proportionate share, to reflect actual cost incurred. The Tenant shall then be credited or billed accordingly to reflect this adjustment. The operating expense adjustment shall in no event cause the initial base rent to decrease.

For purposes of calculating Tenant's initial escalation amount, Landlord shall estimate the 2009 calendar year's operating expenses prior to June, 2009 and compare the estimated amount to the actual operating expenses incurred in calendar year 2008. Tenant shall commence paying the prorated calendar year difference between the amounts in monthly increments beginning June, 2009.

During the last year of the term of this Lease Agreement, Tenant's share of increases in operating expenses shall be calculated on a proportionate basis so Tenant is charged only for increases in operating expenses applicable to those months which this Lease Agreement is in effect.

All sums or amounts which Tenant shall be or become obligated to pay under this Lease shall be deemed Rent, whether referred to as "Rental or Rent or Additional Rent" or otherwise, and Landlord shall have all of the remedies provided by Law for the collection thereof. Additionally, Tenant's obligation to pay its share of actual costs found to be excess of estimated costs shall survive any termination of this Lease, whether by lapse of time or otherwise.

- c. Past Due Rent: Any installments of rent not received by Landlord by the fifth day of each month, shall be assessed a late charge equal to 10% of the total rental amount due. Rental payments not received by the last day of any given month shall be assessed an additional 10% late charge on the total delinquent balance. It is agreed that the late payment charge shall constitute liquidated damages to reimburse Landlord for the damages to Landlord in connection with the handling and processing of late rent installments.

Section 4. Security Deposit

None

Section 5. Services to be Furnished by Landlord

Landlord shall furnish (at Landlord's cost) to Tenant while occupying the Leased Premises the following services:

- (A) Hot and cold water at those points of supply provided for general use of the tenants in the Building;
- (B) Heat and air conditioning in season, during normal business hours for the Building at such temperatures and in such amounts as are considered by Landlord to be standard. Normal business hours are 7:00 A.M. to 6:00 P.M., Monday through Friday and 7:00 A.M. to 1:00 P.M. on Saturdays. Such service at times other than normal business hours shall be optional on the part of Landlord, provided that upon reasonable prior notice such service will be provided to Tenant at Tenant's expense, at an hourly charge of \$250.00.
- (C) Elevator service in common with other tenants for ingress and egress to and from the Building;
- (D) Janitorial service on a five (5) day week basis provided that Tenant's floor covering or other improvements are building standard. If Tenant's improvements require other than standard janitorial services, Tenant may contract directly with a janitor, approved by Landlord, to clean those above standard improvements at Tenant's cost.
- (E) Electric current (110 volts) for normal office usage in the Leased Premises and electric lighting service or all public areas and special service areas of the Building, plus replacement fluorescent light bulbs for the ceiling fixtures in the Leased Premises.

Failure by Landlord to any extent to furnish, or any stoppage of, these defined services, resulting from causes beyond the control of Landlord, or from any other cause, shall not render Landlord liable in any respect for damages to either person or property, nor shall be construed as an eviction of Tenant, nor work as an abatement of rent, nor relieve Tenant from fulfillment of any covenant or agreement hereof. Should any equipment or machinery break down, or for any cause cease to function properly, Landlord shall use reasonable diligence to repair the same promptly. Tenant shall have no claim for rebate of rent or damages on account of any interruptions in service occasioned thereby or resulting therefrom.

Notwithstanding the above, if there is an interruption in electricity, heating, ventilating and air conditioning or water service to the Leased Premises and such interruption continues for a period of seven (7) consecutive business days after receipt by Landlord of written notice from Tenant of such interruption, the Tenant shall be entitled to an abatement of the **full current Monthly Base** Rental Amount effective from the time of interruption, which abatement shall continue until such services are restored.

Section 6. Keys and Locks

Landlord shall furnish Tenant (2) keys for each corridor door entering the Leased Premises. Additional keys will be furnished at a charge of \$2.00 each by Landlord on receipt of an order signed by Tenant or Tenant's authorized representative. All such keys shall remain the property of Landlord. No additional locks shall be allowed on any door of the Leased Premises without Landlord's written permission, and Tenant shall not make or permit to be made any duplicate keys, except those furnished by Landlord. Upon termination of this Lease, Tenant shall surrender to Landlord all keys to the Leased Premises. Landlord shall not be liable to Tenant for losses due to theft or burglary or for damages done by unauthorized persons on the Leased Premises.

Section 7. Signage

No signs, advertisements or notices shall be painted or affixed on or to any window or doors or other parts of the Building except of such color, size and style and in such places as shall be first approved in writing by Landlord. No nails, hooks or screws shall be driven or inserted in any part of the Building other than the Leased Premises except by the building maintenance personnel, nor shall any part be defaced by tenants. Landlord will provide and maintain an alphabetical directory board in the ground floor lobby of the Building and allot three (3) name strips for Tenant.

Section 8. Name of Building

Landlord reserves the right to change the name of the Building at any time and from time to time.

Section 9. Improvements to be Made by Landlord

None

Section 10. Maintenance and Repairs by Landlord

Unless otherwise stipulated herein, Landlord shall be required to maintain and repair only the structural portions of the Building, both exterior and interior, including the heating, ventilating, and air conditioning systems and equipment, public foyers, atriums and lobbies, corridors, parking areas, elevators, stairwells, restrooms and all other areas serving more than one tenant of the Building; provided however the maintenance and repair of interior partitioning wall, carpeting and other portions of the Leased Premises which might otherwise be considered building standard finish shall not be the obligation of Landlord.

Section 11. Repairs by Tenant

Tenant covenants and agrees with Landlord, at Tenant's own cost and expense, to repair or replace any damage or injury done to the Leased Premises, Building, or any part thereof, caused by Tenant or Tenant's agents and employees, along with any such damages done by Tenant's employees, agents, invitees or visitors in the leased Premises, and such repairs shall restore the Building to the same or as good a condition as it was in prior to such injury or damage, and shall be effected in compliance with all building and fire codes and other applicable laws and regulations; provided, however, if Tenant fails to make such repairs or replacements promptly, Landlord may, at its option, make such repairs or replacements, and Tenant shall repay the cost thereof, plus an additional 15% charge to cover overhead, to Landlord on demand.

Section 12. Care of the Premises

Tenant covenants and agrees with Landlord to take good care of the Leased Premises and the fixtures and appurtenances therein and, at Tenant's expense, to make all non-structural repairs thereto as and when needed to preserve them in good order and condition except for reasonable wear and tear. Tenant shall not commit or allow any waste or damage to be committed on any portion of the Leased Premises, and at the termination of the Lease, by lapse of time or otherwise, to deliver up the Leased Premises to Landlord in as good a condition as at the date of the commencement of the term of this Lease, ordinary wear and tear excepted, and upon any termination of this Lease, Landlord shall have the right to re-enter and resume possession of the Leased Premises.

Section 13. Parking

Landlord agrees to provide 6 indoor covered parking space(s) in the garage and 25 outdoor parking space(s) in the adjacent lots at no cost. First Right of Refusal on one (1) space in Breezeway.

Section 14. Common Areas

All entrances and exits thereto, and other facilities furnished by Landlord, including all stairways, and other areas and improvements provided by Landlord for the general use, in common, of tenants, their officers, agents, employees, invitees, licensees, visitors and customers shall be at all times subject to the exclusive control and management of Landlord, and Landlord shall have the right from time to time to establish, modify and enforce reasonable rules and regulations with respect to all facilities and areas mentioned in this paragraph.

Section 15. Peaceful Enjoyment

Tenant shall, and may peacefully have, hold, and enjoy the Leased Premises, subject to all other terms hereof, provided that Tenant pays the rent and other sums herein recited to be paid by Tenant and performs all of Tenant's covenants and agreements herein contained. It is understood and agreed that this covenant and any and all other covenants of Landlord contained in the Lease shall be binding upon Landlord and its successors only with respect to breaches occurring during its or their respective periods of ownership of Landlord's interest hereunder, provided that any change of ownership of the Building will not in and of itself discharge Landlord of any liability to Tenant incurred prior to such ownership change.

Section 16. Holding Over

In the event of holding over the Leased Premises by Tenant without the written consent of Landlord after the expiration or other termination of the Lease, Tenant shall, throughout the entire holdover period, pay rent equal to one and one-half the Base Rental and Additional Rent which would have been applicable had the term of this Lease continued throughout the period of such holding over by Tenant. No holding over by Tenant after the expiration of the term of this Lease shall be construed to extend the term of this Lease; and in the event of any unauthorized holding over, Tenant shall indemnify Landlord against all claims for damages by any other tenant or prospective tenant to whom Landlord may have leased all or any part of the Leased Premise effective before or after the expiration of the term of this Lease, resulting from delay by Tenant in delivering possession of all or any part of the Leased Premises. Any holding over with the written consent of Landlord shall thereafter constitute a lease from month-to-month, under the terms and provisions of this Lease to the extent applicable to a tenancy from month-to-month. Landlord shall have the right at all times during such holding over period and ~~without~~ **with reasonable** notice to enter and show the Leased Premises to prospective tenants and real estate representatives.

Section 17. Alterations, Additions and Improvements

Tenant covenants and agrees with Landlord not to make any material alterations or physical additions in or to the Leased Premises without first obtaining the written consent of Landlord in each such instance. Landlord shall have the sole right to refuse Tenant's request for improvements if these improvements are not appropriate for the Building or Leased Premises. All such improvements or additions made to the Leased Premises shall at once become the property of Landlord and shall be surrendered to Landlord upon Lease termination. Tenant shall be responsible for any lien filed against the Leased Premise or any portion of the Building for work claimed to have been done for, or materials claimed to have been furnished to Tenant. Any and all such alterations, physical additions, or improvements, when made to the Leased Premises by Tenant, shall be at the Tenant's expense and shall at once become the property of the Landlord and shall be surrendered to Landlord upon termination of this Lease by lapse of time or otherwise; provided, however, this clause shall not apply to movable fixtures, office equipment, and other personal property owned by Tenant.

Section 18. Use of Premises

The Leased Premises are to be used and occupied by Tenant solely for office purposes and for no other purposes or use. By execution of this Lease, Tenant agrees to accept the Leased Premises.

Section 19. Laws and Regulations, Building Rules

Tenant covenants and agrees with Landlord to reasonably comply with all laws, ordinances, rules, and regulations of any state, federal, municipal or other government or governmental agency having jurisdiction over the Leased Premises and with all those rules and regulations established by Landlord, attached hereto as Exhibit "D" and made a part hereof, and as may be altered by Landlord from time to time for the proper operation, safety, care, and cleanliness of the Leased Premises and Building and for the preservation of good order therein, all changes to which will be sent by Landlord to Tenant in writing and shall be thereafter carried out and observed by Tenant. In the event of a conflict or inconsistency between the provisions of this Lease and the provisions of the Rules and Regulations, this Lease shall control.

Section 20. Nuisance

Tenant covenants and agrees with Landlord to conduct its business and to control its agents, employees, invitees, and visitors in such manner as not to create any nuisance, or interfere with, annoy, or disturb any other tenant or Landlord in its operation of the Building.

Section 21. Entry by Landlord

Tenant covenants and agrees upon receipt of reasonable notice from Landlord to permit Landlord or its agents or representatives to enter into and upon any part of the Leased Premises during normal business hours, unless otherwise agreed with Tenant, with prospective purchasers, prospective tenants of the Building, mortgagees, or insurers, to clean or make repairs, alterations, or additions thereto, as Landlord may deem necessary or desirable, and Tenant shall not be entitled to any abatement or reduction of rent by reasons thereof.

Section 22. Assignment and Subletting

(I) Tenant shall not, without the prior written consent of Landlord, (A) assign or in any manner transfer this Lease or any estate or interest therein, or (B) permit any assignment or transfer of this Lease, or (C) sublease the Leased Premises or any part thereof, or (D) grant any license, concession, or other right of occupancy of any portion of the Leased Premises. Consent by Landlord to one or more assignments or sublettings shall not operate as a waiver of Landlord's right as to any subsequent assignments and sublettings. Notwithstanding any approved assignment or subletting, Tenant shall at all times remain fully responsible and liable for the payment of the rent herein specified and for compliance with all of Tenant's other obligations under this Lease and in the event of any assignment, by operation of law, merger, consolidation or otherwise, any assignee shall assume and agree to perform all obligations of Tenant hereunder. If an event of default, as hereinafter defined, should occur while the Leased Premises or any part thereof are then assigned or sublet, Landlord, in addition to any other remedies herein provided or provided by law, may at its option, collect directly from such assignee or sub-tenant, and apply such rent against any sums due to Landlord by Tenant hereunder and Tenant hereby authorized any such assignee or sub-tenant to make such payments of rent directly to Landlord upon receipt of notice from Landlord. No direct collection by Landlord from any such assignee or sub-tenant shall be construed to constitute a novation or a release of Tenant from the further performance of its obligations hereunder. Receipt by Landlord of rent from any assignee, sub-tenant, or occupant of the Leased Premises shall not be deemed a waiver of the covenant contained in this Lease against assignment and subletting or a release of Tenant under this Lease. Tenant shall not mortgage, pledge, or otherwise encumber its interest in this Lease or in the Leased Premises. Any attempted assignment or sublease by Tenant in violation of the terms and covenants of this paragraph shall be void. If Tenant is a corporation, partnership or other entity and if at any time during the primary term of this Lease or any renewal or extension thereof the person or persons who own a majority of either the outstanding voting rights or the outstanding ownership interests of Tenant at the time of the execution of this Lease cease to own a majority of such voting rights of ownership interests (except as a result of transferees by rights or ownership interests), such shall be deemed an assignment of this Lease by Tenant and, therefore, subject in all respects to the provisions of this Section 22. (I). The previous sentence shall not apply however, if at the time of the execution of this Lease, Tenant is a corporation and the outstanding voting shares of capital stock of Tenant are listed on a recognized security exchange or over the counter market.

(II) In the event Tenant desires Landlord's consent to an assignment of the Leases or subletting of all or a part of the Leased Premises and as a condition to the granting of such consent, Tenant shall submit to Landlord in writing the name of the proposed assignee or sub-tenant, the proposed commencement date of such assignment or subletting, the nature and character of the business of the assignee or sub-tenant and such financial information as shall be reasonably necessary for Landlord to determine the credit worthiness of such proposed assignee or sub-tenant, Landlord shall have the option (to be exercised within thirty (30) days from submission of Tenant's written request), (A) to refuse to consent to Tenant's assignment or subleasing of such space and to compel Tenant to continue this Lease in full force and effect as to the entire Leased Premises; or (B) to permit Tenant to assign or sublet such space; subject, however, to provisions satisfactory to Landlord for payment to Landlord of any consideration to be paid by such proposed assignee or sub-tenant in connection with such assignment or subletting in excess of Base Rental otherwise payable by Tenant and for payment to Landlord of any lump sum payment in connection with such assignment or subletting. If Landlord should fail to notify Tenant in writing of its election as described above within such thirty (30) day period, Landlord shall be deemed to have elected option (B) above.

Section 23. Transfers of Landlord

Landlord shall have the right to transfer and assign, in whole or in part, all its rights and obligations hereunder and in the Building and property referred to herein, and provided Landlord's transferee assumes the duties and obligations of Landlord arising from and after the date of any such transfer or assignment, upon such transfer or assignment Landlord shall be released from any further obligations hereunder, and Tenant agrees to look solely to such successor-in-interest of Landlord for the performance of such obligations. Landlord shall advise Tenant in writing of its assignee and all requisite contact names, addresses and phone numbers prior to the effective date of assignment. Notwithstanding the above, no such assignment will relieve Landlord of any obligation to the Lease existing prior to such assignment and/or transfer.

Section 24. Subordination to Mortgage

This Lease shall be subject and subordinate to any mortgage or deed of trust which may hereafter encumber the Building, and to all renewals, modifications, consolidations, replacements, and extensions thereof, which contain (or which are included in a separate agreement) provisions to the effect that if there should be a foreclosure or sale under power under such mortgage or deed of trust, Tenant shall not be made a party defendant thereto, nor shall such foreclosure or sale under power disturb Tenant's possession under this Lease, provided always Tenant shall not be in default under this Lease. This clause shall be self-operative and no further instrument of subordination need be required by any mortgagee. In confirmation of such subordination, however, Tenant shall at Landlord's request, execute promptly any certificate or instrument evidencing such subordination that Landlord may *reasonably* request.

Tenant hereby constitutes and appoints Landlord the Tenant's attorney-in-fact to execute any such certificate or instrument for and on behalf of Tenant. In the event of the enforcement by the trustee or the beneficiary under any such mortgage or deed of trust of the remedies provided for by law or by such mortgage or deed of trust, Tenant will, upon request of any person or party succeeding to the interest of Landlord as a result of such enforcement, automatically become the Tenant of such successor-in-interest without change in the terms of other provisions of this Lease; provided, however, that such successor in interest shall not be bound by any amendment or modification of this Lease made without the written consent of such trustee or such beneficiary or such successor in interest. Upon request by such successor-in-interest, Tenant shall execute and deliver an instrument or instruments confirming the attornment provided for herein.

Section 25. Mechanics Liens

Tenant will not permit any mechanic's lien or liens to be placed upon the Leased Premises or improvements thereon or the Building during the term hereof caused by or resulting from any work performed, materials furnished, or obligation incurred by or at the request of Tenant, and nothing contained in this Lease shall be deemed or construed in any way as constituting the consent or request of Landlord, express or implied, by inference or otherwise, to any contractor, sub-contractor, laborer, or materialman for performance of any labor or the furnishing of any materials for specific improvement, alteration, or repair of or to the Leased Premises, or any part thereof, nor as giving Tenant any right, power, or authority to contract for or permit the rendering of any services or the furnishing of any materials that would give rise to the filing of any mechanic's or other liens against the interest of Landlord in the Leased Premises. In the case of the filing of any lien on the interest of Landlord or Tenant in the Leased Premises, Tenant shall cause the same to be discharged of record within ten (10) days after the filing of same by procuring the discharge of such lien. If Tenant shall fail to discharge such mechanic's lien within such period, then, in addition to any other right or remedy of Landlord, Landlord may, but shall not be obligated to, discharge the same, either by paying the amount claimed to be due, or by procuring the discharge of such lien by deposit in court or bonding. Any amount paid by Landlord shall be repaid by Tenant to Landlord on demand, including interest thereon at the rate of ten per cent (10%) per annum or the highest lawful rate, whichever is the less.

Section 26. Estoppel Certificates

Tenant will, from time to time, upon not less than ten (10) days prior request by Landlord, and at Landlord's reasonable request, execute, acknowledge, and deliver to Landlord a statement in writing executed by Tenant certifying that Tenant is in possession of the Leased Premises under the terms of the Lease, that this Lease is unmodified and in full effect (or, if there have been modifications, that this Lease is in full effect as modified, and setting forth such modifications), and that as of such date the rent has been paid, and either stating that to the knowledge of Tenant no default exists hereunder, or specifying each such default of which Tenant may have knowledge, and such other matters as may be reasonably requested by Landlord; it being intended that any such statement by Tenant may be relied upon by any prospective purchaser or mortgagee of the Building.

Section 27. Events of Default

(I) The following events shall be deemed to be "Events of Default" by Tenant under this Lease:

(A) Failure to pay any installment of the Base Rental or other sums of money payable hereunder when due and continuance of such failure for fifteen (15) days';

(B) Failure to comply with any term, provision, or covenant of this Lease, other than the payment of rent, and not curing such failure within a ten (10) day grace period after written notice thereof to Tenant, or, if such failure cannot reasonably be cured within such ten (10) day period, Tenant shall commence such actions as are necessary to cure such defect within such ten (10) day period and thereafter diligently prosecute such curative action.

(C) Tenant shall become insolvent, or shall make a transfer in fraud of creditors, or shall commit any act of bankruptcy, or shall make an assignment for the benefit of creditors or admission in writing of its inability to pay its debts as they become due.

(D) Tenant shall file a petition with any bankruptcy court under any section or chapter of the United States Bankruptcy Code, as amended, or under any similar law or statute of the United States Bankruptcy Code, as amended, or under any similar law or statute, or Tenant shall have filed any petition or answer seeking any reorganization, arrangement, composition, readjustment, liquidation, dissolution, or similar relief under any present or future federal or state act or law relating to bankruptcy, insolvency or other relief of debtors, or Tenant shall be the subject of any order, judgement or decree entered into by a court of competent jurisdiction approving a petition filed against Tenant for any reorganization, arrangement, composition, readjustment, liquidation, dissolution or similar relief under any present or future federal or state act relating to bankruptcy, insolvency or other relief for debtors.

(E) A receiver, conservator or trustee shall be appointed for all or substantially all of the assets of Tenant or of the Leased Premises or any of Tenant's property located thereon in any proceeding brought by Tenant, or any such receiver or trustee shall be appointed in any proceeding brought against Tenant and shall not be discharged within sixty (60) days after such appointment, or tenant shall consent or acquiesce in such appointment.

(F) The Leased Premises hereunder shall be taken on execution or other process of law in any action against Tenant.

(II) If an Event of Default shall have occurred, Landlord shall have the right at its election, then or at any time thereafter (and upon the expiration of any applicable grace period, Tenant shall not be entitled to cure same and be reinstated as "Tenant" in good standing hereunder), to pursue any one or more of the following remedies in addition to all other rights or remedies provided herein or at law or in equity:

(A) Landlord may terminate this Lease and forthwith repossess the Leased Premises and shall be entitled to recover forthwith as damages a sum of money equal to the total of (1) the cost of recovering the Premises, (2) the unpaid rent earned at the time of termination, plus interest thereon at the rate of ten percent (10%) per annum or the maximum legal rate, whichever is lesser, from the due date, (3) the balance of the rent for the remainder of the term less the fair market value of the Leased Premises for such period, and (4) any other sum of money and damages owed by Tenant to Landlord in accordance herewith.

(B) Landlord may terminate Tenant's right of possession (but not the Lease) and may repossess the Leased Premises by legal means or detainer suit, without demand or notice of any kind to Tenant and without terminating this Lease, in which event Landlord may, but shall be under no obligation to do so, relet the same for the account of Tenant for such rent and upon such terms as shall be satisfactory to Landlord. For the purpose of such reletting, Landlord is authorized to decorate or to make any reasonable repairs, changes, alterations, or additions in or to the Leased Premises and to incur leasing commissions that may be necessary or convenient and reasonable, and (1) if Landlord shall fail or refuse to relet the Leased Premises or (2) if the same are relet and a sum equal to the rent that would have otherwise been paid by Tenant over time, discounted to obtain present value shall not be realized from such reletting after paying the unpaid Base Rental Amount and Additional Rent due hereunder earned, but unpaid at the time of reletting, plus ten percent (10%) interest thereon or the highest lawful rate, whichever is lesser, the cost of recovering possession, and all of the reasonable costs and expenses of such decorations, repairs, changes, alterations and additions, and leasing commissions and the expense of such reletting and of the collection of the rent accruing therefrom to satisfy the rent provided for in this Lease to be paid, then Tenant shall pay to Landlord as damages a sum equal to the amount of the rent reserved in this Lease for such period or periods, or if the Leased Premises have been relet Tenant shall satisfy and pay any such deficiency upon demand therefor from time to time, and Tenant agrees that Landlord may file suit to recover any sums falling due under the terms of this Section 27 from time to time; and that no delivery or recovery of any portion due Landlord hereunder shall be any defense in any time; and that no delivery or recovery of any portion due Landlord hereunder shall be any defense in any action to recover any amount not theretofore reduced to judgement in favor of Landlord, nor shall such reletting be construed as an election on the part of Landlord to terminate this Lease unless a written notice of such intention be given to Tenant by Landlord. Notwithstanding any such reletting without termination, Landlord may at any time thereafter elect to terminate this Lease for such previous breach.

Section 28. Landlord's Right to Relet

In the event of default by Tenant in any of the terms or covenants of this Lease or in the event the Leased Premises are abandoned by Tenant, Landlord shall have the right, but not the obligation to relet same for the remainder of the term provided for herein, and if the rent received through reletting does not at least equal the rent that would have otherwise been paid by Tenant over time, discounted to obtain present value, Tenant shall pay and satisfy the deficiency between the amount of the rent so provided for and that received through reletting, including, but not limited to, the reasonable cost of renovating, altering and decorating for a new occupant as well as any reasonable leasing commissions incurred in connection therewith. Nothing herein shall be construed as in any way denying Landlord the right, in the event of abandonment of the Leased Premises or other breach of this Lease by Tenant, to treat the same as an entire breach of this Lease and any and all damages which Landlord suffers thereby.

Section 29. Lien for Rent

None.

Section 30. Attorney's Fees

If on account of any breach or default by Tenant in its obligations hereunder, Landlord shall employ an attorney to present, enforce or defend any of Landlord's rights or remedies hereunder, Tenant agrees to pay any reasonable attorney's fees incurred by Landlord in such connection.

Section 31. No Implied Waiver

The failure of Landlord to insist at any time upon the strict performance of any covenant or agreement or to exercise any option, right, power, or remedy contained in this Lease shall not be construed as a waiver or a relinquishment thereof for the future. The waiver of or redress for any violation of any term, covenant, agreement, or condition contained in the Lease shall not prevent a subsequent act, which would have originally constituted a violation, from having all the force and effect of an original violation. No express waiver shall affect any condition other than the one specified in such waiver and that one only for the time and in the manner specifically stated. A receipt by Landlord of any rent with knowledge of the breach of any covenant or agreement contained in this Lease shall not be deemed a waiver of such breach, and no waiver by Landlord of any provision of this Lease shall be deemed to have been made unless expressed in writing and signed by Landlord.

No payment by Tenant or receipt by Landlord of a lesser amount than the monthly installment of rent due under this Lease shall be deemed to be other than on account of the earliest rent due hereunder, nor shall any endorsement or statement on any check or any letter accompanying any check or payment as rent be deemed an accord and satisfaction, and Landlord may accept such check or payment without prejudice to Landlord's right to recover the balance of such rent or pursue any other remedy in this Lease provided.

Section 32. Insurance

PROPERTY: Landlord shall maintain fire and extended coverage insurance on the Building. Such insurance shall be maintained with an insurance company authorized to do business in Texas, in amounts desired by Landlord and at the expense of Landlord (as a part of the Operating Expenses), and payments for losses thereunder shall be made solely to Landlord. If the annual premiums to be paid by Landlord shall exceed the standard rates because Tenant's operations, contents of the Leased Premises, or improvements with respect to the Leased Premises are beyond building standard, Tenant shall pay the excess amount of the premium within ten (10) days of receipt of written request by Landlord. Tenant acknowledges and agrees that insurance coverage carried by Landlord will not cover Tenant's property within the Leased Premises or the Building and that Tenant shall be responsible, at Tenant's sole cost and expense, for providing insurance coverage for Tenant's movable equipment, furnishing, trade fixtures and other personal property in or upon the Leased Premises or the Building, and for any alteration, additions or improvements to or of the Leased Premises or any part thereof made by Tenant, in the event of damage or loss thereto from any cause whatsoever. Tenant shall procure and maintain throughout the term of this Lease a policy or policies of insurance, at its sole cost and expense, insuring Tenant and Landlord against any and all liability for injury to or death of a person or persons' occasioned by or arising out of or in connection with the use or occupancy of the Leased Premises, the limits of such policy or policies to be in an amount not less than \$1,000,000 with respect to injuries to or death of any person and in an amount of not less than \$1,000,000 with respect to any one accident or disaster, and shall furnish evidence satisfactory to Landlord of the maintenance of such insurance. Tenant shall obtain a written obligation on the part of such insurance company to notify Landlord at least 10 days prior to cancellation of such insurance. It is recommended that Tenant carry fire and extended coverage insurance on its personal property, as Landlord shall in no event be required to rebuild, repair or replace any part of the furniture, equipment, fixtures and other improvements which may have been placed by Tenant on or within the Leased Premises.

Section 33. Legal Use and Violations of Insurance Coverage

Tenant covenants and agrees with Landlord not to occupy or use, or permit any portion of the Leased Premises to be occupied or used, for any business or purpose which is unlawful, disreputable, or deemed to be extra-hazardous on account of fire, or permit anything to be done which would in any way increase the rate of fire, liability, or any other insurance coverage on the Building and/or its contents.

Section 34. Indemnity

Each party to this agreement agrees to indemnify the other for and defend and hold the other harmless from and against all fines, suits, claims, demands, liabilities and actions [including reasonable costs and expenses of defending against such claims) resulting or alleged to result from any breach, violation or non-performance of any covenant or condition hereof, or from the use or occupancy of the Leased Premises, by said party or its agents, employees, licensees, or invitees, for any damage to person or property resulting from any act or omission or negligence of any co-tenant, visitor or other occupancy of the Leased Premises except as the party's own negligence may contribute thereto.

Section 35. Waiver of Subrogation Rights

Anything in this Lease to the contrary notwithstanding, Landlord and Tenant each hereby waives any and all rights of recovery, claim, action, or cause of action, against the other, its agents, officers, or employees, for any loss or damage that may occur to the Leased Premises, or any improvements thereto, or any personal property of such party therein, by reason of fire, the elements, or any other cause which are insured against under the terms of standard fire and extended coverage of policies, regardless of cause or origin, including negligence of the other party hereto, its agents, officers, or employees, and covenants that no insurer shall hold any right of subrogation against such other party.

Section 36. Casualty Damage

If the Leased Premises or any part thereof shall be damaged by fire or other casualty, Tenant shall give prompt written notice thereof to Landlord. In case the Building shall be damaged by fire or other casualty, but shall not be rendered untenable in whole or in part, Landlord shall, at its sole expense, cause such damage to be repaired with reasonable diligence to substantially the same condition in which it was immediately prior to the happening of the casualty, and the Base Rental Amount hereunder shall not be abated; however, in case the Building shall be so damaged by fire or other casualty that substantial alteration or reconstruction of the Building shall, in the agreement of Landlord and Tenant, or if they cannot agree, in the opinion of an independent third party architect, be required (whether or not the Leased Premises shall have been damaged by such fire or other casualty), or in the event any mortgagee under a mortgage or deed of trust covering the Building should require that the insurance proceeds payable as a result of said fire or other casualty be used to retire the Mortgage debt,

Landlord may, at its option, terminate this Lease and the term and estate hereby granted by notifying Tenant in writing of such termination within sixty (60) days after the date of such damage. If Landlord does not thus elect to terminate this Lease, Landlord shall within seventy-five (75) days after the date of such damage commence to repair and restore the Building and shall proceed with reasonable diligence to restore the Building which restoration shall be completed no later than 120 days from the date of such damage to substantially the same condition in which it was immediately prior to the happening of the casualty, except that Landlord shall not be required to rebuild, repair, or replace any part of Tenant's fixtures, equipment or other personal property removable by Tenant under the provisions of this Lease, and Landlord shall not in any event be required to spend for such work an amount in excess of the insurance proceeds actually received by Landlord as a result of the fire or other casualty. Landlord shall not be liable for any inconvenience or annoyance to Tenant or injury to the business of tenant resulting in any way from such damage or the repair thereof, except that, subject to the provisions of the next sentence, Landlord shall allow Tenant a proportionate diminution of rent based on the percentage of the Leased Premises that is affected during the time and to the extent the Leased Premises, or any portion thereof, are unfit for occupancy. If the Premises or any other portion of the Building shall be damaged by fire or other casualty resulting from the *willful* fault or negligence of Tenant or any of Tenant's agents, employees, or invitees in the Leased Premises, the rent hereunder shall not be diminished during the repair of such damage, and Tenant shall be liable to Landlord for the cost and expense of the repair of such damage, and Tenant shall be liable to Landlord for the cost and expense of the repair and restoration of the Building caused thereby to the extent such cost and expense is not covered by insurance proceeds. Any insurance which may be carried by Landlord or Tenant against loss or damage to the Building or to the Leased Premises shall be for the sole benefit of the party carrying such insurance and under its sole control.

Section 37. Condemnation

If the whole or substantially the whole of the Leased Premises should be taken for any public or quasi-public use under any governmental law, ordinance, or regulation or by right of eminent domain, or should be sold to the condemning authority in lieu of condemnation, then this Lease shall terminate as of the date when physical possession of the Leased Premises is taken by the condemning authority. If less than the whole or substantially the whole Building or the Leased Premises is thus taken or sold, Landlord (whether or not the Leased Premises are affected thereby) may terminate this Lease by giving written notice thereof to Tenant *immediately* after the right of election accrues, in which event this Lease shall terminate as of the date when physical possession of such portion of the Building or Leased Premises is taken by the condemning authority. If upon any such taking or sale of less than the whole or substantially less than the whole of the Building or the Leased Premises, this Lease shall not be thus terminated, the Base Rental Amount and ***Additional Rental*** payable thereunder shall be diminished by an amount representing that part of the Base Rental Amount *and Additional Rental* as shall be allocable to the portion of the Leased Premises which was so taken or sold or affected, and Landlord shall, at Landlord's sole expense, restore and reconstruct the Parking Area, Building or the Leased Premises, as the case may be, to substantially their former condition to the extent that the same, in Landlord's judgement, may be feasible; Landlord shall not in any event be required to spend for such work an amount in excess of the amount received by Landlord as compensation awarded upon a taking of any part or all of the Parking Area, Building or the Leased Premises, and Tenant shall not be entitled to and expressly waives all claim to any such compensation.

Section 38. Notices and Cure

In the event of any act or omission by Landlord which would give Tenant the right to damages from Landlord or the right to terminate this Lease by reason of the constructive or actual eviction from all or part of the Leased Premises or otherwise, Tenant shall not sue for such damages or exercise any such right to terminate until it shall have given written notice of such act or omission to Landlord and a reasonable period of time for remedying such act or omission shall have elapsed following the giving of such notice, during which time Landlord, their agents or employees, shall be entitled to enter upon the Leased Premises and do therein whatever may be necessary to remedy such act or omission. During the period after the giving of such notice and during the remedying of such act or omission, the Base Rental Amount *and Additional Amount* payable by Tenant for such period as provided in this Lease shall be abated and apportioned only to the extent that all or any part of the Leased Premises shall be untenable.

Section 39. Personal Liability

The liability of Landlord for any default by Landlord under the terms of this Lease shall be limited to the interest of Landlord in the building and the land on which the building is situated, and Tenant agrees to look solely to Landlord's interest in the Building and the land on which the Building is situated for the recovery of any judgment from Landlord, it being intended that Landlord shall not be personally liable for any judgment of deficiency. This clause shall not be deemed to limit or deny any remedies which Tenant may have in the event of a default by Landlord hereunder which do not involve the personal liability of Landlord.

Section 40. Notice

Any notice, communication, request, reply, or advice (hereinafter severally and collectively called "notice") in this Lease provided for or permitted to be given, made, or accepted by either party to the other must be in writing, and may, unless otherwise in this Lease expressly provided, be given or be served by depositing the same in the United States Mail, postpaid and certified and addressed to the party to be notified, with return receipt requested, or by delivering the same in person to any office of such party, or by prepaid telegram, when appropriate, addressed to the party to be notified. Notice deposited in the mail in the manner herein above described shall be effective, unless otherwise stated in this Lease, from and after the expiration of three (3) days after it is so deposited. Notice given in any other manner shall be effective only if and when received by the party to be notified. For purposes of notice, the addresses of the parties shall, until changed as herein provided, be as follows:

For Landlord:

WNB Tower, Ltd.
508 West Wall Street, Suite 1000
Midland, Texas 79701

For Tenant:

Natural Gas Services Group, Inc.
508 West Wall, Suite 550
Midland, Texas 79701

The parties hereto and their respective heirs, successors, legal representatives, and assigns shall have the right at any time to change their respective addresses and each shall have the right to specify as its address any other address by at least fifteen (15) days written notice to the other party delivered in compliance with this Section 40.

Section 41. Surrender

On the last day of the term of this Lease or upon the earlier termination of this Lease, Tenant shall peaceably surrender the Leased Premises to Landlord in good order, repair, and condition at least equal to the condition when delivered to Tenant, excepting only reasonable wear and tear resulting from normal use, the damage by fire or other casualty covered by the insurance carried by Landlord. All movable fixtures, office equipment, and other personal property of Tenant shall remain the property of Tenant, and upon the expiration date or earlier termination of this Lease may be removed from the Leased Premises by Tenant, subject, however, that Tenant shall repair and restore in a good and workmanlike manner (reasonable wear and tear excepted) any damage to the Leased Premises or Building caused by such removal. Any of such movable fixtures, office equipment and other personal property not so removed by Tenant at or prior to the expiration date or earlier termination of this Lease shall ***unless otherwise agreed*** become the property of Landlord. All other property as a part of the Leased Premises attached or affixed to the floor, wall or ceiling of the Leased Premises (including wall-to-wall carpeting, paneling or other wall covering) are the property of Landlord and shall remain upon and be surrendered with the Leased Premises as a part thereof at the termination of this Lease by lapse of time or otherwise, Tenant hereby waiving all rights to any payment or compensation therefor. Notwithstanding anything herein to the contrary, Tenant's surrender of the Leased Premises shall in no way affect Tenant's obligation to pay rent to the date of expiration of this Lease, whether or not the amount of such obligation has been ascertained either as of the date Tenant surrenders the Leased Premises or as of the date of expiration of this Lease.

Section 42. Relocation

If Landlord determines it necessary to utilize the Leased Premises for other purposes during the term of this lease, Tenant agrees to relocate to other space in the Leased Property designated by Landlord, provided such other space is of equal or larger size and ***approximate in elevation and exposure*** than the Leased Premises ***or rental may be negotiated***.

Section 43. Captions

The captions of each section of this Lease are inserted and included solely for convenience and shall never be considered or given any effect in construing this Lease, or any provisions hereof, or in connection with the duties, obligations, or liabilities of the respective parties hereto, or in ascertaining intent, if any questions of intent exists.

Section 44. Entirety and Amendments

This Lease embodies the entire contract between the parties hereto relative to the subject matter hereof. No variations, modifications, changes or amendments herein or hereof shall be binding upon any party hereto unless in writing, executed by a duly authorized officer or a duly authorized agent of the particular party. All exhibits referred to in this Lease and attached hereto are incorporated herein for all purposes.

Section 45. Severability

If any terms or provision of this Lease, or the application thereof to any person or circumstance, shall, to any extent, be invalid or unenforceable, the remainder of this Lease, or the application of such term or provision to person or circumstances other than those as to which it is held invalid or unenforceable, shall not be affected thereby, and each term and provision of this Lease shall be valid and enforced to the fullest extent permitted by law.

Section 46. Binding Effect

Subject to Section 22, all covenants and obligations as contained within this Lease shall bind, extend, and inure to the benefit of Landlord, its successors and assigns, and shall be binding upon Tenant, its permitted successors and assigns.

Section 47. Number and Gender of Words

All personal pronouns used in this Lease shall include the other gender, whether used in the masculine, feminine, or neuter gender, and singular shall include the plural whenever and as often as may be appropriate.

Section 48. Recordation

Tenant agrees not to record this Lease, but no request of Landlord, will execute a short form lease in a form recordable and complying with applicable Texas laws. In no event shall such document set forth the rental or other charges payable by Tenant under this Lease; and any such document shall expressly state that it is executed pursuant to the provisions contained in this Lease and is not intended to vary the terms and conditions of this Lease.

Section 49. Governing Law

This Lease and rights and obligations of the parties hereto shall be interpreted, construed, and enforced in accordance with the laws of the State of Texas.

Section 50. Force Majeure

Whenever a period of time is herein prescribed for the taking of any action by Landlord, Landlord shall not be liable or responsible for, and there shall be excluded from the computation of such period of time, any delays due to strikes, riots, acts of God, shortages of labor or materials, war, governmental laws, regulations or restrictions, or any act, omission, delay or neglect of Tenant or any of Tenant's employees or agents, or any other cause whatsoever beyond the control of Landlord. Furthermore, the foregoing shall in no manner release, relieve or affect the independent obligation of Tenant to pay rent hereunder.

Section 51. Relationship of Parties

Nothing contained herein shall create any relationship between the parties hereto other than that of Landlord and Tenant, and it is acknowledged and agreed that Landlord does not in any way or for any purpose intend, nor shall this Lease be construed to create as between Landlord and Tenant the relation of partner, joint venturer or member of a joint or common enterprise with Tenant.

Section 52. Termination by Landlord

Notwithstanding any provision hereof, Landlord may, in Landlord's reasonable discretion, determine that the continued operation of the building in which the Leased Premises are located is no longer economic. Upon any such reasonable determination by Landlord, Landlord shall notify Tenant of such determination, and provide Tenant with 90 days notice of Landlord's intention to terminate this Lease and close such building. Such determination may not be made on a lease-by-lease basis, but must be made as to all tenants of the building.

Section 53. Special Provisions

None

IN WITNESS WHEREOF, Landlord and Tenant have executed this Lease in multiple original counterparts as of the date and year first above written.

Signed at Midland, Texas, this 5th day of May, 2008.

LANDLORD:

WNB Tower, Ltd. /s/ John M. Morgan
By:
Name: Jon M. Morgan
Title: Agent

TENANT:

Natural Gas Services Group, Inc.
By: /s/ Stephen C. Taylor
Name: Stephen C. Taylor
Title: President/CEO

EXHIBIT "A"

WNB Tower, Ltd.
508 West Wall Street
Midland Texas 79701

Legal Description

COMPLETE PROPERTY DESCRIPTION:

TRACT ONE: Situated in Midland County, Texas and being all of LOTS SEVEN (7), EIGHT (8) and NINE (9) in BLOCK FIFTY EIGHT (58) of ORIGINAL TOWN of Midland, Midland County, Texas, according to the map or plat thereof recorded in Volume 3, Page 232 of the Deed Records of Midland County, Texas and being more particularly described by metes and bounds as follows:

BEGINNING at a point on the north boundary of Wall Avenue, at the platted southwestern corner of Lot 7, Block 58, Original Town of Midland, Texas, according to the plat of record in Volume 3, Page 232, Midland, County Deed Records; THENCE Northeasterly, along the north boundary of Wall Avenue, 140.0 feet to a point on the west boundary of a north-south alley, for the southeast corner of Lot 7;

THENCE Northwesterly, along the west boundary of alley, at 50 feet pass the southeast corner of Lot 8, at 100 feet pass the southeast corner of Lot 9, in all 150.0 feet to the northeast corner of Lot 9 and southeast corner of Lot 10, said Block 58;

THENCE Southwesterly, along the common line between Lot 9 and Lot 10, a distance of 140.0 feet to a point on the east boundary of Pecos Street, at the platted southwest corner of Lot 10 and northwest corner of Lot 9;

THENCE Southwesterly, along the east boundary of Pecos Street and west boundary of Lots 9, 8 and 7, a distance of 150 feet to the PLACE OF BEGINNING, said real property containing 21,000 square feet.

EXHIBIT "B"

EXHIBIT "B"

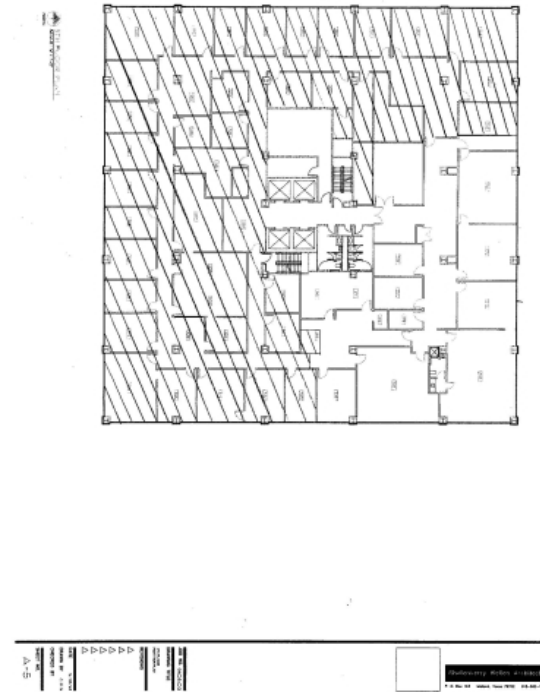


EXHIBIT "C"

RENEWAL OPTION

Provided no Event of Default exists and Tenant is occupying the entire Leased Premises at the time of such election, Tenant may elect to exercise one additional 5 year term at a fifty cent rate increase per year, under the same terms and conditions of the current lease subject to Tenant delivering written notice of its intent to exercise the option no later than 90 days before the expiration of the lease term.

EXHIBIT "D"

BUILDING RULES
LAWS AND REGULATIONS

1. Landlord agrees to furnish Tenant with adequate cards and keys to access the Building and the Leased Premises. Additional keys will be furnished at a normal charge.
2. Tenant will refer all contractors, contractor's representatives and installation technicians, rendering any service on or to the Leased Premises for Tenant, to Landlord for Landlord's approval, and supervision before performance of any contractual service, such approval shall not be unreasonably withheld. This provision shall apply to all work performed in the Building including installation of telephones, telegraph equipment, electrical devices and attachments and installations of any nature affecting floors, walls, woodwork, trim, windows, ceilings, equipment of any other physical portion of the Building.
3. Tenant shall at no time occupy part of the Building as sleeping or lodging quarters.
4. Tenant shall not place, install or operate on the Leased Premises or in any part of the Building, any engine, stove or machinery, or conduct mechanical operations or cook thereon or therein, or place or use in or about the Leased Premises any explosives, gasoline, kerosene, oil, acids, caustics, or any inflammable, explosive, or hazardous material without written consent of Landlord.
5. Landlord will not be responsible except in the event of Landlord's willful or gross negligence for lost or stolen personal property, equipment, money, or jewelry from Tenant's area or public rooms regardless of whether such loss occurs when area is locked against entry or not.
6. No birds, fowl or animals shall be brought into or kept in or about the Building, with the exception of seeing-eye dogs.
7. Employees of Landlord shall not receive or carry messages for or to any Tenant or other person, nor contract with or render free or paid services to any Tenant or Tenant's agents, employees or invitees.
8. Landlord will not permit entrance to Tenant's offices by use of pass key controlled by Landlord to any person at any time without written permission by Tenant, except employees, contractors or service personnel directly supervised by Landlord.
9. None of the entries, passages, doors, elevators, hallways or stairways shall be blocked or obstructed, or any rubbish, litter, trash, or material of any nature placed, emptied or thrown into these areas, nor any such areas be used at any time except for ingress and egress by Tenant, Tenant's agents, employees or invitees.
10. The water closets and other water fixtures shall not be used for any purpose other than those for which they were constructed, and any damage resulting to them from misuse or by the defacing or injury of any part of the Building shall be borne by the person who shall occasion it. No person shall waste water by interfering with the faucets of otherwise.
11. Nothing shall be thrown out of the windows of the Building or down the stairways or other passages.
12. Tenant agrees to reasonable parking control measures, which may be placed into effect from time to time by Landlord through the use of signs, identifying decals, or other instructions.
13. Movement in or out of the Building of furniture or office supplies and equipment, or dispatch or receipt by Tenant of any merchandise or materials, which requires use of elevators or stairways, or movement through the building entrances, or lobby, shall be restricted to hours designated by Landlord. All such movement shall be under supervision of Landlord and carried out in the manner agreed between Tenant and Landlord by prearrangement before performance. Such prearrangement will include determination by Landlord of time, method, and routing of movement and limitations imposed by safety or other concerns which may prohibit any article, equipment or any other item from being brought into the Building. Tenant assumes, and shall indemnify Landlord against all risks and claims of damage to persons and properties arising in connection with any said movement.
14. The building is designated as non-smoking.
15. The Landlord shall not be liable for damages from stoppage of elevators for necessary or desirable repairs or improvements, or delays of any sort of duration in connection with the elevator service.
16. All deliveries of any and all furniture, supplies, etc., will be made at the back entrance of the Building. Tenant will instruct the supplier of this delivery location.

The Landlord reserves the right to make such other and further reasonable rules and regulations as in its judgement may from time to time be needful, for the safety, care and cleanliness of the Building and Leased Premises, and for the preservation of good order therein; subject only to the terms and conditions of the attached Lease.

/s/Stephen Taylor
Tenant
