

NATURAL GAS SERVICES GROUP INC

Form 10-Q

November 09, 2006

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
FORM 10-Q**

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

For the quarterly period ended September 30, 2006

**OR**

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

**Commission File Number 1-31398  
NATURAL GAS SERVICES GROUP, INC.  
(Exact name of registrant as specified in its charter)**

**Colorado**  
(State or other jurisdiction of  
incorporation or organization)

**75-2811855**  
(I.R.S. Employer  
Identification No.)

**2911 SCR 1260  
Midland, Texas 79706**  
(Address of principal executive offices)

**(432) 563-3974**  
(Issuer's telephone number, including area code)

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

Yes  No

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

Large Accelerated Filer  Accelerated Filer  Non-Accelerated Filer

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

Yes  No

**APPLICABLE ONLY TO CORPORATE ISSUERS**

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

<b>Class</b>	<b>Outstanding at September 30, 2006</b>
Common Stock, \$.01 par value	11,968,444

**NATURAL GAS SERVICES GROUP, INC.**

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Certification of CEO Pursuant to Section 302

Certification of CFO Pursuant to Section 302

Certification Required by Section 906

Certification Required by Section 906

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

	December 31, 2005	September 30, 2006 <i>(unaudited)</i>
<b>ASSETS</b>		
<b>Current Assets:</b>		
Cash and cash equivalents	\$ 3,271	\$ 2,195
Short-term investments		29,205
Trade accounts receivable, net of doubtful accounts	6,192	8,015
Inventory, net of allowance	14,723	17,943
Prepaid expenses and other	456	350
 Total current assets	 24,642	 57,708
 Rental equipment, net of accumulated depreciation of \$7,598 and \$10,139, respectively	 41,201	 55,695
Property and equipment, net of accumulated depreciation of \$2,458 and \$3,424, respectively	6,424	6,699
Goodwill, net of accumulated amortization \$325	10,039	10,039
Intangibles, net of accumulated amortization of \$492 and \$737, respectively	3,978	3,732
Other assets	85	166
 Total assets	 \$ 86,369	 \$ 134,039
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
<b>Current Liabilities:</b>		
Current portion of long-term debt	\$ 5,680	\$ 4,844
Line of credit	300	
Accounts payable and accrued liabilities	5,124	6,991
Deferred income	103	136
 Total current liabilities	 11,207	 11,971
 Long-term debt, less current portion	 20,225	 13,434
Subordinated notes, less current portion	2,000	1,000
Deferred income tax payable	7,247	9,069
 Total liabilities	 40,679	 35,474
 <b>Stockholders Equity:</b>		
Common stock; 9,022 and 11,968 shares issued and outstanding, respectively	90	120
Additional paid-in capital	34,667	82,244
Retained earnings	10,933	16,201

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Total stockholders' equity	45,690	98,565
Total liabilities and stockholders' equity	\$ 86,369	\$ 134,039

See accompanying notes to these condensed consolidated financial statements.

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**NATURAL GAS SERVICES GROUP, INC.**  
**CONDENSED CONSOLIDATED INCOME STATEMENTS**

*(in thousands, except earnings per share)*

*(unaudited)*

	Three months ended September 30,		Nine Months ended September 30,	
	2005	2006	2005	2006
<b>Revenue:</b>				
Sales, net	\$ 7,479	\$ 10,880	\$ 22,066	\$ 28,509
Service and maintenance income	610	209	1,770	749
Rental income	4,371	6,041	11,696	16,908
<b>Total revenue</b>	<b>12,460</b>	<b>17,130</b>	<b>35,532</b>	<b>46,166</b>
<b>Operating costs and expenses:</b>				
Cost of sales, exclusive of depreciation stated separately below	5,778	8,351	16,977	22,472
Cost of service and maintenance, exclusive of depreciation stated separately below	341	170	1,145	567
Cost of rentals, exclusive of depreciation stated separately below	1,782	2,240	4,539	6,513
Selling expense	269	331	750	958
General and administrative expense	1,007	851	2,850	2,866
Depreciation and amortization	1,076	1,497	3,026	4,135
<b>Total operating costs and expenses</b>	<b>10,253</b>	<b>13,440</b>	<b>29,287</b>	<b>37,511</b>
<b>Operating income</b>	<b>2,207</b>	<b>3,690</b>	<b>6,245</b>	<b>8,655</b>
<b>Other income (expense):</b>				
Interest expense	(508)	(385)	(1,439)	(1,308)
Other income (expense)	33	447	51	1,015
<b>Total other income (expense)</b>	<b>(475)</b>	<b>62</b>	<b>(1,388)</b>	<b>(293)</b>
<b>Income before provision for income taxes</b>	<b>1,732</b>	<b>3,752</b>	<b>4,857</b>	<b>8,362</b>
Provision for income taxes	641	1,388	1,797	3,094
<b>Net income</b>	<b>\$ 1,091</b>	<b>\$ 2,364</b>	<b>\$ 3,060</b>	<b>\$ 5,268</b>
<b>Earnings per share:</b>				
Basic	\$ 0.14	\$ 0.20	\$ 0.43	\$ 0.47
Diluted	\$ 0.12	\$ 0.20	\$ 0.37	\$ 0.47
<b>Weighted average shares outstanding:</b>				
Basic	7,606	11,960	7,078	11,199

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Diluted	8,771	12,046	8,213	11,264
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See accompanying notes to these condensed consolidated financial statements.

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

	Nine Months Ended September	
	2005	30, 2006
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$ 3,060	\$ 5,268
<b>Adjustments to reconcile net income to net cash provided by operating activities:</b>		
Depreciation and amortization	3,026	4,135
Deferred taxes	1,700	3,094
Income taxes paid		(879)
Employee stock options expensed		218
Amortization of debt issuance costs	49	
Gain on sale of property and equipment		(17)
Gross profit from sale of rental equipment	(47)	(1,233)
<b>Changes in current assets and liabilities:</b>		
Trade and other receivables	(2,057)	(1,823)
Inventory and work in progress	(5,345)	(3,220)
Prepaid expenses and other	(32)	106
Accounts payable and accrued liabilities	4,180	1,475
Deferred income	(723)	33
Other assets	323	(94)
<b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>	<b>4,134</b>	<b>7,063</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchase of property and equipment	(13,107)	(21,583)
Purchase of short-term investments		(37,905)
Redemption of short-term investments		8,700
Assets acquired, net of cash	(7,584)	
Proceeds from sale of property and equipment		32
Proceeds from sale of rental equipment	239	4,155
<b>NET CASH USED IN INVESTING ACTIVITIES</b>	<b>(20,452)</b>	<b>(46,601)</b>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Proceeds from long-term debt	20,517	68
Proceeds from line of credit	300	1,375
Repayments of long-term debt	(12,268)	(8,695)
Repayments of line of credit		(1,675)
Proceeds from exercise of stock options and warrants		226
Proceeds from sale of stock, net of transaction costs	12,813	47,163



<b>NET CASH PROVIDED BY FINANCING ACTIVITIES</b>	21,362	38,462
<b>NET CHANGE IN CASH</b>	5,044	(1,076)
<b>CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD</b>	685	3,271
<b>CASH AND CASH EQUIVALENTS AT END OF PERIOD</b>	\$ 5,729	\$ 2,195
<b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:</b>		
Interest paid	\$ 1,396	\$ 1,146
Income taxes paid	\$	\$ 879
<b>SUPPLEMENTAL DISCLOSURE OF NON-CASH INVESTING AND FINANCING ACTIVITIES:</b>		
Assets acquired for issuance of subordinated debt	\$ 3,000	\$
Assets acquired for issuance of common stock	\$ 5,120	\$

See accompanying notes to these condensed consolidated financial statements.

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

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

The accompanying unaudited condensed consolidated financial statements present the condensed consolidated results of our company taken from our books and records. In our opinion, such information includes all adjustments, consisting of only normal recurring adjustments, which are necessary to make our financial position at September 30, 2006 and September 30, 2005 and the results of our operations for the three and nine month periods ended September 30, 2006 and September 30, 2005 not misleading. As permitted by the rules and regulations of the Securities and Exchange Commission (SEC) the accompanying condensed consolidated financial statements do not include all disclosures normally required by accounting principles generally accepted in the United States of America. These condensed consolidated financial statements should be read in conjunction with the financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2005 on file with the SEC. In our opinion, the condensed consolidated financial statements are a fair presentation of the financial position, results of operations and cash flows for the periods presented.

The results of operations for the nine month period ended September 30, 2006 are not necessarily indicative of the results of operations to be expected for the full fiscal year ending December 31, 2006.

Unless otherwise noted, amounts reported in tables are in thousands, except per share data and stock option data.  
*Short-Term investments*

Short-term investments consist primarily of government and corporate bonds with original maturities of ninety days to one year.

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

*Intangibles*

At September 30, 2006 the Company has intangible assets (excluding patents) with a gross carrying value of \$4.2 million, which relate to developed technology, acquired customer contracts, distribution agreements and non-compete agreements. The carrying amount net of accumulated amortization at September 30, 2006 was \$3.7 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 of approximately 16 years. In addition, the Company had an intangible asset with a gross carrying value of \$654 thousand at September 30, 2006 related to the trade name of SCS. This asset is not being amortized as it has been deemed to have an indefinite life.

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

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

2006	\$ 75
2007	299
2008	299
2009	299
2010	260
Thereafter	1,808
	\$ 3,040

The Company's policy is to periodically review the net realizable value of its intangibles, other than goodwill and patents, through an assessment of the estimated future cash flows related to such assets. In the event that assets are found to be carried at amounts in excess of estimated undiscounted future cash flows, then the assets will be adjusted for impairment to a level commensurate with a discounted cash flow analysis of the underlying assets. Based upon its most recent analysis, the Company believes no impairment of intangible assets exists at September 30, 2006.

**(2) Recently Issued Accounting Pronouncements**

On December 16, 2004, the FASB published FASB Statement No. 123 (revised 2004), *Share-Based Payment* (Statement 123R), requiring that the compensation cost relating to share-based payment transactions be recognized in financial statements. That cost will be measured based on the fair value of the equity or liability instruments issued. We adopted Statement 123 (R) as of January 1, 2006. See Note 4 for discussion of the impact of the adoption of Statement No. 123 (R).

**(3) Acquisition**

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

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

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

\$8 million in cash;

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

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

**Table of Contents****NATURAL GAS SERVICES GROUP, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

This transaction was completed January 3, 2005 and Natural Gas Services Group, Inc. began reporting combined financial information with SCS in January 2005. The total purchase price was \$16.1 million and the Company recorded goodwill of approximately \$5.0 million and intangible assets of approximately \$4.2 million, reflecting the additional value to our previously existing operations achieved with this acquisition's ability to expand production capacity and product line.

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

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

	Twelve Months Ended December 31, 2004
Revenue	\$ 37,382
Net income available to common stockholders	4,148
Net income per common share, basic	0.67
Net income per common share, diluted	0.59
Summary of net assets acquired is as follows:	
Current assets	\$ 8,274
Other assets	3,047
Intangibles	4,218
Goodwill	7,468
Total assets	23,007
Current liabilities	3,180
Notes payable	1,403
Other liabilities	1,884
Total liabilities	6,467
Net assets	16,540
Acquisition expenses	(418)
Purchase price	\$ 16,122

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

**(4) Stock-Based Compensation**

*Adoption of SFAS No. 123(R)*

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

*Share-Based Payment* ( SAB 107 ) in March, 2005, which provides supplemental SFAS 123(R) application guidance based on the views of the SEC. Under the modified prospective transition method, compensation cost recognized in the quarterly period ended September 30, 2006 includes: (a) compensation cost for all share-based payments granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123, and (b) compensation cost for all share-based payments granted beginning January 1, 2006, based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R). In accordance with the modified prospective transition method, results for prior periods have not been restated. The adoption of SFAS 123(R) resulted in stock compensation expense for the three and nine months ended September 30, 2006 of \$73 thousand and \$218 thousand, respectively, to income before income taxes.

The Black-Scholes option-pricing model was used to estimate the option fair values. The option-pricing model requires a number of assumptions, of which the most significant are expected stock price volatility, the expected pre-vesting forfeiture rate and the expected option term (the amount of time from the grant date until the options are exercised or expire). Expected volatility was calculated based upon actual historical stock price movements over the most recent periods ending September 30, 2006. The expected option term was calculated using the simplified method permitted by SAB 107. The expected forfeiture rate is based on historical experience and expectations about future forfeitures.

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

*Pro-Forma Stock Compensation Expense for the Quarterly Period Ended September 30, 2005*

For the three and nine month periods ended September 30, 2005, the Company applied the intrinsic value method of accounting for stock options as prescribed by APB 25. Since all options granted during the three and nine month periods ended September 30, 2005 had an exercise price equal to the closing market price of the underlying common stock on the grant date, no compensation expense was recognized. If compensation expense had been recognized based on the estimated fair value of each option granted in accordance with the provisions of SFAS 123 as amended by Statement of Financial Accounting Standard 148, our net income and net income per share would have been reduced to the following pro-forma amounts (in thousands, except per share amounts):

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

	Three Months Ended September 30 2005	Nine Months Ended September 30 2005
<b>Pro forma impact of fair value method</b>		
Income applicable to common shares, as reported	\$ 1,091	\$ 3,060
Compensation expenses regained under Opinion 25	21	21
Pro-forma stock-based compensation costs under the fair value method, net of related tax	(47)	(106)
Pro-forma income applicable to common shares under the fair-value method	\$ 1,065	\$ 2,975
<b>Earnings per common share</b>		
Basic earnings per share reported	\$ 0.14	\$ 0.43
Diluted earnings per share reported	\$ 0.12	\$ 0.37
Pro-forma basic earnings per share under the fair value method	\$ 0.14	\$ 0.42
Pro-forma diluted earnings per share under the fair value method	\$ 0.12	\$ 0.36

Pro-forma compensation expense under SFAS 123, among other computational differences, does not consider potential pre-vesting forfeitures. Because of these differences, the pro-forma stock compensation expense presented above for the prior three and nine month periods ended September 30, 2005 under SFAS 123 and the stock compensation expense recognized during the current three and nine month periods ended September 30, 2006 under SFAS 123(R) are not directly comparable. In accordance with the modified prospective transition method of SFAS 123(R), the prior comparative quarterly results have not been restated.

**Stock Option Plan**

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

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

**Table of Contents****NATURAL GAS SERVICES GROUP, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

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

	Three months Ended September 30,		Nine months Ended September 30,	
	2005	2006	2005	2006
Weighted average fair value assumptions:				
Risk free rate	6.75%-7.25%	4.0%-7.25%	6.75%-7.25%	4.0%-7.25%
Expected life	10 yrs	10 yrs	10 yrs	10 yrs
Expected volatility	39.0%	39.0-47.0%	39.0%	39.0-47.0%
Expected dividend yield	0.0%	0.0%	0.0%	0.0%

A summary of option activity under the plan as of September 30, 2006 is presented below. For the three and nine months ended September 30, 2006, the Company did not grant any options under the 1998 Stock Option Plan.

	Number of Stock Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (years)	Aggregate Intrinsic Value (in thousands)
Outstanding, January 1, 2006	146,668	\$ 7.69		
Granted				
Exercised	(8,332)	6.35		
Forfeited or expired	(9,000)	6.86		
Outstanding, September 30, 2006	129,336	\$ 7.83	7.79	\$ 655
Exercisable, September 30, 2006	86,998	\$ 7.45	7.41	\$ 474

No options were granted during the three and nine months ended September 30, 2006. 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 three and nine months ended September 30, 2006, was approximately \$50 thousand and \$74 thousand, respectively. Cash received from stock options exercised during the three and nine months ended September 30, 2006 was \$35 thousand and \$53 thousand, respectively.

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

The following table summarizes information about the options outstanding at September 30, 2006:

Range of	Options Outstanding			Options Exercisable	
	Shares	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Exercise Prices					
\$0.00 5.58	42,000	6.08	\$ 3.98	40,000	\$ 3.90
5.59 9.43	77,336	8.53	8.75	36,998	8.72
9.44 16.96	10,000	9.25	16.96	10,000	16.96
\$0.00-16.96	129,336	7.79	\$ 7.83	86,998	\$ 7.45

The summary of the status of the Company's unvested stock options as of September 30, 2006 and changes during the nine months ended September 30, 2006 is presented below.

	Shares	Weighted Average Grant Date Fair Value
Unvested stock options:		
Unvested at January 1, 2006	75,333	\$ 10.34
Granted		
Vested	25,328	10.37
Forfeited	7,667	4.09
Unvested at September 30, 2006	42,338	\$ 11.45

As of September 30, 2006, there was approximately \$329 thousand of unrecognized compensation cost related to unvested options. Such cost is expected to be recognized over a weighted-average period of 1.25 years. Total compensation expense for stock options was \$73 thousand and \$218 thousand for the three and nine months ended September 30, 2006, respectively. An income tax benefit was recognized of approximately \$27 thousand and \$81 thousand for the three and nine months ended September 30, 2006, respectively.

**(5) Inventory**

Inventory, net of reserves, consisted of the following amounts:

	December 31, 2005	September 30, 2006 <i>(unaudited)</i>
Raw materials	\$ 11,771	\$ 13,275
Finished Goods		774
Work in process	2,952	3,894



\$ 14,723 \$ 17,943

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

**(6) Long Term Debt**

On March 24, 2006, we entered into a Modification Agreement with Western National Bank, Midland, Texas. This Modification Agreement reduced the rate per annum from prime rate plus 0.5%, to the prime rate. This Modification Agreement was effective April 1, 2006.

On August 28, 2006, we entered into another Modification Agreement with Western National Bank, Midland, Texas. This Modification Agreement reduced the rate per annum from prime to 7.5%

On October 26, 2006, we entered into a Seventh Amended and Restated Loan Agreement with Western National Bank for the purpose of consolidating our existing Term Loan and Advancing Line of Credit Facilities into one term loan facility and extending, renewing and increasing our Revolving Line of Credit Facility. The loan facilities provided for under the Seventh Amended and Restated Loan Agreement are evidenced by a Multiple Advance Term Promissory Note, in the original principal amount of \$16.9 million made by Natural Gas Services Group, Inc., bearing interest at a fixed rate of 7.5% per annum and maturing on October 1, 2011, and a Revolving Line of Credit Promissory Note, in the original principal amount of \$40 Million, made by Natural Gas Services Group, Inc., bearing interest at a fixed rate of 7.5% per annum and maturing on October 1, 2008.

The amounts available for borrowing under our Revolving Line of Credit Promissory Note are subject to a borrowing base limitation equal to the lesser of: (a) the face amount of such Note and (b) a borrowing base amount. The borrowing base amount is based on a percentage of the value of our accounts receivable, lease receivables, equipment, work in process and inventory, less the aggregate outstanding principal balances of our Revolving Line of Credit Note and Multiple Advance Term Promissory Note. At the end of each month, we provide a borrowing base report to Western National Bank setting forth our calculation of the borrowing base amount. The bank may, but is not obligated to, re-determine the borrowing base in its sole discretion. If the bank does not re-determine the borrowing base, the amount of the borrowing base set forth in the borrowing base report furnished by us to the bank at the end of each month is deemed to be the re-determined borrowing base, until the bank gives notice to us of a new borrowing base. At October 26, 2006, the borrowing base was \$32.0 million.

If the outstanding principal balance of our Revolving Line of Credit Promissory Note at any time exceeds the then applicable borrowing base, we must, within fifteen business days after notice from the bank, first prepay the principal amount outstanding under such Note in an aggregate amount at least equal to such excess, together with accrued interest on the amount prepaid to the date of such prepayment and, to the extent the excess is not eliminated by the prepayment of such Note, we must next prepay the outstanding principal of our Multiple Advance Term Promissory Note, in an amount equal to the remaining unpaid excess amount.

**Table of Contents****NATURAL GAS SERVICES GROUP, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

*Revolving Line of Credit Facility.* Our revolving line of credit facility allows us to borrow, repay and re-borrow funds drawn under this facility. After entering into the Sixth Amended and Restated Loan Agreement, the total amount that we could borrow and have outstanding at any one time was limited to the lesser of \$10.0 million or the amount available for advances under a borrowing base calculation established by the bank. As of September 30, 2006, the amount available for revolving line of credit advances under our borrowing base was \$10.0 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 first prepay the principal of the revolving line of credit note in an amount equal to such excess, and if the excess is not eliminated by the prepayment, we must then prepay the principal of the other notes payable under the Loan Agreement until the excess is eliminated. Interest only on borrowings under our revolving line of credit facility is payable monthly on the first day of each month. Loans made to us under the revolving line of credit accrued interest at the prime rate until August 28, 2006, at which time such loans began to accrue interest at a rate of 7.5%. Upon entering into the Sixth Amended and Restated Loan Agreement, the revolving line of credit was renewed; the maturity was extended from January 1, 2006 to December 1, 2006.

*\$10.0 Million Multiple Advance Term Loan Facility.* This multiple advance term loan facility allowed us to request advances from time to time through March 14, 2006 in an aggregate amount not to exceed the lesser of \$10.0 million or the amount available for advances under the borrowing base established by the bank. Re-borrowings are not permitted under this facility. As of September 30, 2006, no additional amounts were available for advances under this facility, and the principal amount outstanding under this multiple term advance loan facility at September 30, 2006 was \$9.2 million. Loans made to us under this facility accrued interest at the prime rate until August 28, 2006, at which time such loans began to accrue interest at a rate of 7.5%. Interest only under this credit facility was due and payable on the first day of each month commencing May 1, 2005 and continuing through April 1, 2006. Principal under this credit facility is due and payable in 59 monthly installments in an amount equal to 1/60<sup>th</sup> of the outstanding principal balance on May 1, 2006 with a like installment due on the first day of each succeeding month through March 1, 2011, with interest on the unpaid principal balance being due and payable on the same dates as principal payments. All outstanding principal and unpaid interest is due on April 1, 2011.

*Advancing Line of Credit Facility.* This advancing line of credit facility allowed us to request advances in an aggregate amount not to exceed the lesser of \$10.0 million or the amount available for advances under the borrowing base established by the bank. Re-borrowings are not permitted under this facility. As of September 30, 2006, additional advances under this facility were not permitted. The principal amount outstanding under this facility at September 30, 2006 was \$1.9 million. Loans made to us under this facility accrued interest at the prime rate until August 28, 2006, at which time such loans began to accrue interest at a rate of 7.5%. Interest only under this credit facility was due and payable on the 15<sup>th</sup> day of each month commencing December 15, 2003 and continuing through November 15, 2004. Principal under this credit facility is due and payable in 59 monthly installments of \$167 thousand each, commencing December 15, 2004 through April 15, 2006, and installments of \$57 thousand each from May 15, 2006 and continuing through October 15, 2009. Principal payments also include payments of 1/60<sup>th</sup> of the sum of all advances made between December 15, 2004 and December 15, 2005, such amounts calculated quarterly. 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 November 15, 2009.

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**NATURAL GAS SERVICES GROUP, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

*\$8.0 Million Term Loan.* This term loan is a traditional term loan facility. We may not request additional advances under this facility and re-borrowings are not permitted. As of September 30, 2006, the principal amount outstanding under this term loan was \$6.1 million. Loans made to us under this credit facility accrued interest at the prime rate until August 28, 2006, at which time such loans began to accrue interest at a rate of 7.5%. Principal under this credit facility is due and payable in 84 monthly installments of \$95 thousand each, commencing February 1, 2005 and continuing through December 1, 2011. Interest on the unpaid principal balance is due and payable on the same dates as principal payments. All outstanding principal and unpaid interest is due on January 1, 2012.

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.

**(7) Common Stock Warrants and Options**

In 2001, the Company completed an offering of units consisting of subordinated debt and warrants. Each unit consisted of a \$25,000 10% subordinated note due December 31, 2006 and a five-year warrant to purchase 10,000 shares of the Company's common stock at \$3.25 per share. On August 26, 2005, we prepaid all of the outstanding 10% subordinated notes that were due December 31, 2006. As of September 30, 2006, 50,000 of these warrants are outstanding.

In March 2001 and April 2002, warrants to purchase 68,524 thousand shares of common stock at \$2.50 per share and 16,472 shares at \$3.25 per share, respectively, were issued to certain board members and stockholders as compensation for their debt guarantees. As of September 30, 2006, warrants to purchase 30,832 shares at \$2.50 per share and 5,318 shares at \$3.25 per share remained outstanding.

In October 2002, the Company closed an initial public offering in which it sold 1,500,000 shares of common stock and warrants to purchase 1,500,000 shares of common stock for a total of \$7.9 million. The warrants were exercisable anytime through October 21, 2006 at \$6.25 per share. In connection with the 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, if purchased by the underwriter, will contain an exercise price of \$7.81 per share. The underwriter's options expire in October 2007 and include a cashless exercise provision utilizing the Company's common stock. As of September 30, 2006, there were 14,000 of these warrants outstanding.

On August 26, 2005, we entered into a non-statutory Stock Option Agreement with Mr. Steve C. Taylor, our CEO and President. The Stock Option Agreement grants to Mr. Taylor a ten-year option to purchase 45,000 shares of our common stock at an exercise price equal to \$9.22 (the fair market value of our common stock on January 13, 2005, the date we initially hired Mr. Taylor), with 15,000 shares vesting on each of January 13, 2006, 2007 and 2008. The options expire ten years from the date of grant.

Compensation expense of \$73 thousand and \$218 thousand was recognized related to options that vested in the three and nine month periods ended September 30, 2006, respectively.

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

**(8) Sale of Common Stock**

On March 8, 2006, we sold 2,468,000 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 427,500 shares to cover over-allotments, if any. On March 27, 2006, the underwriter exercised its over-allotment option and on March 30, 2006, the Company sold an additional 427,500 shares, resulting in proceeds to the Company of \$7.1 million, in addition to the net proceeds of \$40.7 million from the sale of the 2,468,000 shares of common stock on March 8, 2006. The net proceeds after offering costs to us were \$47.1 million and a portion has been used to reduce our bank debt by \$5.0 million.

**(9) Earnings per Share**

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

	Three months Ended September 30,		Nine months Ended September 30,	
	2005	2006	2005	2006
Numerator:				
Net income	\$ 1,091	\$ 2,364	\$ 3,060	\$ 5,268
Denominator for basic net income per common share:				
Weighted average common shares outstanding	7,606	11,960	7,077	11,199
Denominator for diluted net income per share:				
Weighted average common shares outstanding	7,606	11,960	7,077	11,199
Dilutive effect of stock options and warrants	1,165	86	1,136	65
Diluted weighted average shares	8,771	12,046	8,213	11,264
Earnings per common share:				
Basic	\$ 0.14	\$ 0.20	\$ 0.43	\$ 0.47
Diluted	\$ 0.12	\$ 0.20	\$ 0.37	\$ 0.47

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

**(10) Segment Information**

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

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

**For the three months ended September 30, 2006:**

	Sales	Service & Maintenance	Rental	Corporate	Total
Revenue	\$10,880	\$ 209	\$6,041		\$ 17,130
Operating costs and expenses	8,351	170	2,240	2,679	13,440
Operating income	\$ 2,529	\$ 39	\$3,801	\$ (2,679)	\$ 3,690
*Segment Assets	\$	\$	\$	\$134,039	\$134,039

**For the three months ended September 30, 2005:**

	Sales	Service & Maintenance	Rental	Corporate	Total
Revenue	\$7,479	\$ 610	\$4,371		\$12,460
Operating costs and expenses	5,778	341	1,782	2,352	10,253
Operating income	\$1,701	\$ 269	\$2,589	\$ (2,352)	\$ 2,207
*Segment Assets	\$	\$	\$	\$85,583	\$85,583

**For the nine months ended September 30, 2006:**

	Sales	Service & Maintenance	Rental	Corporate	Total
Revenue	\$28,509	\$ 749	\$16,908		\$ 46,166
Operating costs and expenses	22,472	567	6,513	7,959	37,511
Operating income	\$ 6,037	\$ 182	\$10,395	\$ (7,959)	\$ 8,655
*Segment Assets	\$	\$	\$	\$134,039	\$134,039

**For the nine months ended September 30, 2005:**

	Sales	Service & Maintenance	Rental	Corporate	Total
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Revenue	\$22,066	\$1,770	\$11,696		\$35,532
Operating costs and expenses	16,977	1,145	4,539	6,626	29,287
Operating income	\$ 5,089	\$ 625	\$ 7,157	\$ (6,626)	\$ 6,245
*Segment Assets	\$	\$	\$	\$85,583	\$85,583

\* Management does not track assets by segment

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

**(11) Legal Proceedings**

We are a party to one lawsuit arising in the ordinary course of our business. While management is unable to predict the ultimate outcome of this action, management believes that any ultimate liability arising from this action will not have a material adverse effect on our consolidated financial position, results of operations or cash flow. Except as discussed herein, we are not currently a party to any other legal proceedings and we are not aware of any other threatened litigation.

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**NATURAL GAS SERVICES GROUP, INC.**

**Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

*The discussion and analysis of our financial condition and results of operations are based on, and should be read in conjunction with, our condensed consolidated financial statements and the related notes included elsewhere in this report and in our December 31, 2005 Form 10-K on file with the SEC. All amounts reported in tables are in thousands of dollars unless otherwise noted.*

**Overview**

We fabricate, manufacture, rent and sell natural gas compressors and related equipment. Our primary focus is on the rental of natural gas compressors. Our rental contracts generally provide for initial terms of six to 24 months. After the initial term of our rental contracts, most of our customers have continued to rent our compressors on a month-to-month basis. Rental amounts are paid monthly in advance and include maintenance of the rented compressors. As of September 30, 2006, we had 909 natural gas compressors totaling 105,213 horsepower rented to 85 third parties, compared to 756 natural gas compressors totaling 83,702 horsepower rented to 76 third parties at September 30, 2005. Of the 909 natural gas compressors, 95 were rented to Dominion Exploration & Production, Inc. and its affiliates.

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. As of September 30, 2006, we had written maintenance agreements with third parties relating to 47 compressors, the majority of which were owned by Dominion Exploration. Maintenance agreements typically have terms of nine months to one year and require payment of a monthly fee.

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

	Three months Ended		Nine months Ended	
	September 30,		September 30,	
	2005	2006	2005	2006
Sales	\$ 7,479	\$ 10,880	\$ 22,066	\$ 28,509
Service and maintenance	610	209	1,770	749
Rental	4,371	6,041	11,696	16,908
Total	\$ 12,460	\$ 17,130	\$ 35,532	\$ 46,166

On January 3, 2005, we completed the acquisition of Screw Compression Systems, Inc., or SCS, for consideration consisting of \$8.0 million in cash, subordinated promissory notes payable by us to the former stockholders of SCS in the aggregate principal amount of \$3.0 million, and 609,756 shares of our common stock. As a result of this acquisition, our results of operations for periods before and after the completion of the acquisition may not be comparable.

Historically, the majority of our revenues and income from operations has come from our compressor rental business. The acquisition of SCS, which is engaged primarily in the business of custom fabrication of compressors for sale to third parties, significantly altered the mix of our revenues, with compressor sales now contributing the largest percentage of our revenues. Margins, exclusive of depreciation, for our rental business have recently averaged 60% to 65%, while margins for the compressor sales business have recently averaged 20%. As a result of the SCS acquisition, our overall margins have declined in 2005 compared to prior periods because of the difference in our product mix. Our strategy for growth is focused on our compressor rental business, and we intend to use the additional fabrication capacity now available through SCS to expand our rental fleet while continuing SCS's core custom fabrication business. As our rental business grows and contributes a larger percentage of our total revenues, we expect our overall margins to improve from those experienced in 2005.

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

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

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Demand for our products and services was strong throughout 2004 and 2005. We believe demand will remain strong throughout 2006 due to high oil and natural gas prices and increased demand for natural gas. Because of these market fundamentals for natural gas, we believe the long-term trend of activity in our markets is favorable. However, these factors could be more than offset by other developments affecting the worldwide supply and demand for natural gas.

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

**Results of Operations*****Three months ended September 30, 2005, compared to the three months ended September 30, 2006.***

The table below shows our revenues, percentage of total revenues, gross profit, exclusive of depreciation, and gross profit margin of each of our segments for the three months ended September 30, 2005 and September 30, 2006. The gross profit margin is the ratio, expressed as a percentage, of gross profit, exclusive of depreciation, to total revenue.

	Revenue				Gross Profit, exclusive of depreciation			
	Three months Ended September 30, 2005		Three months Ended September 30, 2006		Three months Ended September 30, 2005		Three months Ended September 30, 2006	
Sales	\$ 7,479	60%	\$ 10,880	64%	\$ 1,701	23%	\$ 2,529	23%
Service and Maintenance	610	5%	209	1%	269	44%	39	19%
Rental	4,371	35%	6,041	35%	2,589	59%	3,801	63%
Total	\$ 12,460		\$ 17,130		\$ 4,559	37%	\$ 6,369	37%

Total revenue increased from \$12.5 million to \$17.1 million, or 37.5%, for the three months ended September 30, 2006, compared to the same period ended September 30, 2005. This was mainly the result of increased rental revenue and additional compressor sales. Rental revenue increased 38.2% and sales revenue increased 45.5% and these were offset by a decrease in service and maintenance revenue of 65.7%.

Rental revenue increased from \$4.4 million to \$6.0 million, or 38.2%, for the three months ended September 30, 2006, compared to the same period ended September 30, 2005. This increase was the result of additional units added to our rental fleet and rented to third parties. The company ended the period with 1052 compressor packages in its rental fleet, up from 805 units at September 30, 2005. The rental fleet has a utilization of 86.4% as of September 30, 2006.

Sales revenue increased from \$7.5 million to \$10.9 million, or 45.5%, for the three months ended September 30, 2006, compared to the same period ended September 30, 2005. The sales revenue during the three months ended September 30, 2006, included \$1.5 million for the sale of rental equipment to an existing customer. Sales from outside sources included: (1) compressor unit sales (including used rental equipment), (2) flare sales, (3) parts sales and (4) compressor rebuilds.

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**NATURAL GAS SERVICES GROUP, INC.**

Service and maintenance revenue decreased from \$610 thousand to \$209 thousand, or 65.7%, for the three months ended September 30, 2006, compared to the same period ended September 30, 2005. This decrease was mainly the result of the change in our maintenance contract in Michigan with Dominion Resources beginning January 1, 2006.

The overall gross margin percentage, exclusive of depreciation, increased to 37.2% for the three months ended September 30, 2006, from 36.6% for the same period ended September 30, 2005. This is mainly the result of increased margin on our fleet rental activity.

Selling expense increased from \$269 thousand, to \$331 thousand or 23.0% for the three months ended September 30, 2006, as compared to the same period ended September 30, 2005. This increase is the result of increased commissions as a result of increased sales and additional salaries for sales people added to our sales force.

General and administrative expenses decreased from \$1.0 million, to \$851 thousand or 15.5% for the three months ended September 30, 2006, as compared to the same period ended September 30, 2005. This decrease is mainly due to a reduction in the legal expense, officer salaries. The decrease in officer salaries from 2005 to current year was the result of the retirement of former CEO and also the resignation of the Vice President of the Michigan Area.

Depreciation and amortization expense increased from \$1.1 million, to \$1.5 million or 39.1% for the three months ended September 30, 2006, compared to the same period ended September 30, 2005. This increase was the result of 247 new gas compressor rental units being added to the rental fleet from September 30, 2005 to September 30, 2006, thus increasing the depreciable base.

Other income net of other expense increased \$414 thousand for the three months ended September 30, 2006, compared to the same period ended September 30, 2005. This increase is mainly the result of additional interest income from our short-term investment account.

Interest expense decreased 24.2% for the three months ended September 30, 2006, compared to the same period ended September 30, 2005, mainly due to decreased loan balances financing rental equipment.

Provision for income tax increased from \$641 thousand to \$1.4 million or 116.5%, and is the result of the increase in taxable income.

**Table of Contents****NATURAL GAS SERVICES GROUP, INC.*****Nine months ended September 30, 2005, compared to the nine months ended September 30, 2006.***

The table below shows our revenues, percentage of total revenues, gross profit, exclusive of depreciation, and gross profit margin of each of our segments for the nine months ended September 30, 2005 and September 30, 2006. The gross profit margin is the ratio, expressed as a percentage, of gross profit, exclusive of depreciation, to total revenue.

	Revenue				Gross Profit, exclusive of depreciation			
	Nine months Ended September 30, 2005		2006		Nine months Ended September 30, 2005		2006	
Sales	\$ 22,066	62%	\$ 28,509	62%	\$ 5,089	23%	\$ 6,037	21%
Service and Maintenance	1,770	5%	749	2%	625	35%	182	24%
Rental	11,696	33%	16,908	37%	7,157	61%	10,395	61%
Total	\$ 35,532		\$ 46,166		\$ 12,871	36%	\$ 16,614	36%

Total revenue increased from \$35.5 million to \$46.2 million, or 29.9%, for the nine months ended September 30, 2006, compared to the same period ended September 30, 2005. This was mainly the result of increased rental revenue and additional compressor sales. Rental revenue increased 44.6% and sales revenue increased 29.2% and these were offset by a decrease in service and maintenance revenue of 57.7%.

Rental revenue increased from \$11.7 million to \$16.9 million, or 44.6%, for the nine months ended September 30, 2006, compared to the same period ended September 30, 2005. This increase was the result of additional units added to our rental fleet and rented to third parties. The company ended the period with 1052 compressor packages in its rental fleet, up from 805 units at September 30, 2005. The rental fleet has a utilization of 86.4% as of September 30, 2006.

Sales revenue increased from \$22.1 million to \$28.5 million, or 29.2%, for the nine months ended September 30, 2006, compared to the same period ended September 30, 2005. This increase was mainly from the \$4.1 million in sales of rental equipment to an existing rental customer. Sales from outside sources included: (1) compressor unit sales (including used rental equipment), (2) flare sales, (3) parts sales and (4) compressor rebuilds.

Service and maintenance revenue decreased from \$1.8 million to \$749 thousand, or 57.7%, for the nine months ended September 30, 2006, compared to the same period ended September 30, 2005. This decrease was mainly the result of the change in our maintenance contract in Michigan with Dominion Resources beginning January 1, 2006.

The overall gross margin percentage, exclusive of depreciation, remained constant with only a slight decrease to 36.0% for the nine months ended September 30, 2006, from 36.2% for the same period ended September 30, 2005.

Selling expense increased from \$750 thousand, to \$958 thousand or 27.7% for the nine months ended September 30, 2006, as compared to the same period ended September 30, 2005. This increase is the result of increased commissions and also added salaries for sales people added to our sales force.

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**NATURAL GAS SERVICES GROUP, INC.**

General and administrative expenses remained flat from \$2.9 million, to \$2.9 million for the nine months ended September 30, 2006, as compared to the same period ended September 30, 2005.

Depreciation and amortization expense increased from \$3.0 million to \$4.1 million or 36.6% for the nine months ended September 30, 2006, compared to the same period ended September 30, 2005. This increase was the result of 247 new gas compressor rental units being added to rental fleet from September 30, 2005 to September 30, 2006, thus increasing the depreciable base.

Other income net of other expense increased by \$964 thousand for the nine months ended September 30, 2006, compared to the same period ended September 30, 2005. This increase is mainly the result of additional interest income from our short-term investment account as a result of increased cash balances from our March 2006 offering.

Interest expense decreased 9.1% for the nine months ended September 30, 2006, compared to the same period ended September 30, 2005, mainly due to decreases in our loan balances. We made a one time payment of \$5 million from the offering proceeds on our term loans and continued our normal amortization of the existing debt.

Provision for income tax increased from \$1.8 million to \$3.1 million or 72.2%, and is the result of the increase in taxable income.

**Critical Accounting Policies and Practices**

A discussion of our critical accounting policies is included in the Company's Form 10-K for the year ended December 31, 2005.

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

*Share-Based Payment* ( SAB 107 ) in March, 2005, which provides supplemental SFAS 123(R) application guidance based on the views of the SEC. Under the modified prospective transition method, compensation cost recognized in the quarterly period ended September 30, 2006 includes: (a) compensation cost for all share-based payments granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123, and (b) compensation cost for all share-based payments granted beginning January 1, 2006, based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R). In accordance with the modified prospective transition method, results for prior periods have not been restated. The adoption of SFAS 123(R) resulted in stock compensation expense for the nine months ended September 30, 2006 of \$218 thousand to income before income taxes.

**Recently Issued Accounting Pronouncements**

On December 16, 2004, the FASB published FASB Statement No. 123 (revised 2004), *Share-Based Payment* ( Statement 123R ), requiring that the compensation cost relating to share-based payment transactions be recognized in financial statements. That cost will be measured based on the fair value of the equity or liability instruments issued. We adopted Statement 123 (R) as of January 1, 2006. See Note 4 for discussion of the impact of the adoption of Statement No. 123 (R).

**Table of Contents****NATURAL GAS SERVICES GROUP, INC.****Liquidity and Capital Resources**

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

At September 30, 2006, we had cash, cash equivalents and short-term investments of \$31.4 million, working capital of \$45.7 million and total debt of \$19.3 million of which \$4.8 million was classified as current. We had positive net cash flow from operating activities of \$7.1 million during the first nine months of 2006. This was primarily from net income of \$5.3 million, an increase in accounts payable and accrued liabilities of \$1.5 million, an increase in deferred taxes of \$3.1 million offset by an increase in inventories of \$3.2 million during the nine months ended September 30, 2006.

For the nine months ended September 30, 2006, we invested \$21.6 million in equipment for our rental fleet and service vehicles. We financed this activity with bank debt, cash flow from operations and public offering proceeds. In addition we have repaid \$10.4 million of our existing debt.

On March 8, 2006, we sold 2,468,000 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 427,500 shares to cover over-allotments, if any. On March 27, 2006, the underwriter exercised its over-allotment option and on March 30, 2006, the Company sold an additional 427,500 shares, resulting in proceeds to the Company of \$7.1 million, in addition to the net proceeds of \$40.7 million from the sale of the 2,468,000 shares of common stock on March 8, 2006. The net proceeds after offering costs to us were \$47.2 million and a portion has been used to reduce our bank debt by \$5.0 million. The remainder will be used for the 2006 and 2007 capital expenditure budget, working capital and general corporate purposes.

**Contractual Obligations and Commitments**

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

	Obligation Due in Period (in thousands of dollars)						After 5	Total
	2006(1)	2007	2008	2009	2010	Years		
Credit facility (secured)	\$ 961	\$ 3,844	\$ 3,844	\$ 3,568	\$ 3,156	\$ 1,905	\$ 17,278	
Interest on credit facility(2)	315	1,080	792	514	261	72	3,034	
Subordinated debt		1,000	1,000				2,000	
Facilities and office leases	32	129	62	29	29	106	387	
Total	\$ 1,308	\$ 6,053	\$ 5,698	\$ 4,111	\$ 3,446	\$ 2,083	\$ 22,699	

(1) For the three months remaining in 2006.

(2) Assumes no change in the interest rate.





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**NATURAL GAS SERVICES GROUP, INC.**

***Senior Bank Borrowings***

On January 03, 2006, we entered into a Sixth Amended and Restated Loan Agreement with Western National Bank, Midland, Texas, provides for the following loan facilities:

\$8.0 Million Term Loan Facility;

\$10.0 Million Multiple Advance Term Loan Facility;

Revolving Line of Credit Facility; and

Advancing Line of Credit Facility.

All outstanding principal under our \$10.0 Million Multiple Advance Term Loan Facility is due and payable on April 1, 2011, and all outstanding principal under our \$8.0 Million Term Loan Facility is due and payable on January 1, 2012. The outstanding principal balance of our Advancing Line of Credit Facility is due and payable on November 15, 2009.

Our Revolving Line of Credit Facility matures on December 1, 2006.

On March 8, 2006, we paid an additional \$5.0 million on the principal of the Advancing Line of Credit Facility.

On March 24, 2006, we entered into a Modification Agreement with Western National Bank, Midland, Texas. This Modification Agreement reduced the rate per annum from prime rate plus 0.5%, to the prime rate. This Modification Agreement was effective April 1, 2006.

On August 28, 2006, we entered into another Modification Agreement with Western National Bank, Midland, Texas. This Modification Agreement reduced the rate per annum from prime to 7.5%.

On October 26, 2006, we entered into a Seventh Amended and Restated Loan Agreement with Western National Bank for the purpose of consolidating our existing Term Loan and Advancing Line of Credit Facilities into one term loan facility and extending, renewing and increasing our Revolving Line of Credit Facility. The loan facilities provided for under the Seventh Amended and Restated Loan Agreement are evidenced by a Multiple Advance Term Promissory Note, in the original principal amount of \$16.9 million made by Natural Gas Services Group, Inc., bearing interest at a fixed rate of 7.5% per annum and maturing on October 1, 2011, and a Revolving Line of Credit Promissory Note, in the original principal amount of \$40 Million, made by Natural Gas Services Group, Inc., bearing interest at a fixed rate of 7.5% per annum and maturing on October 1, 2008.

The amounts available for borrowing under our Revolving Line of Credit Promissory Note are subject to a borrowing base limitation equal to the lesser of: (a) the face amount of such Note and (b) a borrowing base amount. The borrowing base amount is based on a percentage of the value of our accounts receivable, lease receivables, equipment, work in process and inventory, less the aggregate outstanding principal balances of our Revolving Line of Credit Note and Multiple Advance Term Promissory Note. At the end of each month, we provide a borrowing base report to Western National Bank setting forth our calculation of the borrowing base amount. The bank may, but is not obligated to, re-determine the borrowing base in its sole discretion. If the bank does not re-determine the borrowing base, the amount of the borrowing base set forth in the borrowing base report furnished by us to the bank at the end of each month is deemed to be the re-determined borrowing base, until the bank gives notice to us of a new borrowing base. At October 26, 2006, the borrowing base was \$32.0 million.

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**NATURAL GAS SERVICES GROUP, INC.**

If the outstanding principal balance of our Revolving Line of Credit Promissory Note at any time exceeds the then applicable borrowing base, we must, within fifteen business days after notice from the bank, first prepay the principal amount outstanding under such Note in an aggregate amount at least equal to such excess, together with accrued interest on the amount prepaid to the date of such prepayment and, to the extent the excess is not eliminated by the prepayment of such Note, we must next prepay the outstanding principal of our Multiple Advance Term Promissory Note, in an amount equal to the remaining unpaid excess amount.

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

***Subordinated Debt***

The principal amounts of the promissory notes issued to the three stockholders of SCS as part of the consideration for the acquisition of SCS are in the aggregate principal amounts of \$2.1 million, \$600 thousand and \$300 thousand. The principal of each note is payable in three equal annual installments, which commenced on January 3, 2006. Accrued and unpaid interest on the unpaid principal balance of each note is payable on the same dates as, and in addition to, the installments of principal. Under the terms of our Loan Agreement with our bank lender, we are prohibited from making payments on these notes if at the time of any such payment we are then in default under the Loan Agreement or if any such payment would cause or result in a default under the Loan Agreement.

To secure payment of these notes, our bank lender issued for our account three separate letters of credit for the benefit of the holder of each respective note. The \$2.1 million promissory note is secured by a letter of credit in the face amount of \$1.4 million; the \$600 thousand promissory note is secured by a letter of credit in the face amount of \$400 thousand; and the \$300 thousand promissory note is secured by a letter of credit in the face amount of \$200 thousand.

The letters of credit expire February 3, 2008. Drafts for payment under each beneficiary's respective letter of credit may be made by the beneficiary only upon our default in payment of the promissory note. If a draft for payment is not presented on or before February 3, 2007, the face amount of the letter of credit will automatically be reduced by one-half.

On January 3, 2006, we paid the first installment of the annual payments in the amount of \$1.0 million in principal.

**Off-Balance Sheet Arrangements**

We do not participate in financial transactions that generate relationships with unconsolidated entities or financial partnerships. Such entities often referred to as variable interest entities or special purpose entities are generally established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. We were not involved in any unconsolidated financial transactions with variable interest or special purpose entities during any of the reporting periods in this report and have no intention to participate in such transactions in the foreseeable future.

**SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS**

Please refer to and read Special Note Regarding Forward-Looking Statements in our Annual Report on Form 10-K for the fiscal year ended December 31, 2005.

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**NATURAL GAS SERVICES GROUP, INC.**

**ITEM 3. 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.

**Financial Instruments and Debt Maturities**

Our financial instruments consist of cash and cash equivalents, short-term investments, accounts receivable, accounts payable, bank borrowings, and notes. The carrying amounts of cash and cash equivalents, accounts receivable and accounts payable approximate fair value due to the highly liquid nature of these short-term instruments. The fair value of the bank borrowings approximate the carrying amounts as of September 30, 2006, and were determined based upon interest rates currently available to us for borrowings with similar terms.

**Customer Credit Risk**

We are exposed to the risk of financial non-performance by customers. Our ability to collect on sales to our customers is dependent on the liquidity of our customer base. To manage customer credit risk, we monitor credit ratings of customers and seek to minimize exposure to any one customer where other customers are readily available. Unless we are able to retain our existing customers, or secure new customers if we lose one or more of our significant customers, our revenue and results of operations would be adversely affected.

**Item 4. CONTROLS AND PROCEDURES**

**(a) Evaluation of Disclosure Controls and Procedures.**

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

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**NATURAL GAS SERVICES GROUP, INC.**

**(b) Changes in Internal Controls.**

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

**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

We are a party to one lawsuit arising in the ordinary course of our business. While management is unable to predict the ultimate outcome of this action, management believes that any ultimate liability arising from this action will not have a material adverse effect on our consolidated financial position, results of operations or cash flow. Except as discussed herein, we are not currently a party to any other legal proceedings and we are not aware of any other threatened litigation.

**Item 1A. Risk Factors**

Please refer to and read "Risk Factors" in our Annual Report on Form 10-K for the fiscal year ended December 31, 2005, one of which has been updated as set forth below.

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

As of September 30, 2006, we had an aggregate of approximately \$19.3 million of outstanding indebtedness, not including outstanding letters of credit in the aggregate face amount of \$2.0 million, and accounts payable and accrued expenses of approximately \$7.0 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.

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**NATURAL GAS SERVICES GROUP, INC.**

**Item 6. Exhibits**

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

Exhibit No.	Description
2.1	Purchase and Sale Agreement by and between Hy-Bon Engineering Company, Inc. and NGE Leasing, Inc. (Incorporated by reference to Exhibit 2.1 of the Registrant's Current Report on Form 8-K dated February 28, 2003 and filed with the Securities and Exchange Commission on March 6, 2003)
3.1	Articles of Incorporation, as amended (Incorporated by reference to Exhibit 3.1 of the Registrant's 10-QSB dated November 10, 2004 and filed with the Securities and Exchange Commission on November 10, 2004)
3.2	Bylaws (Incorporated by reference to Exhibit 3.4 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
4.1	Form of warrant certificate (Incorporated by reference to Exhibit 4.1 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
4.2	Form of warrant agent agreement (Incorporated by reference to Exhibit 4.2 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
4.3	Form of representative's option for the purchase of common stock (Incorporated by reference to Exhibit 4.4 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
4.4	Form of representative's option for the purchase of warrants (Incorporated by reference to Exhibit 4.5 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
4.5	Stockholders Agreement, dated January 3, 2005 among Paul D. Hensley, Tony Vohjesus, Jim Hazlett and Natural Gas Services Group, Inc. (Incorporated by reference to Exhibit 4.3 of the Registrant's Form 8-K Report, dated January 3, 2005, as filed with the Securities and Exchange Commission on January 7, 2005) Executive Compensation Plans and Arrangements (Exhibits 10.1, 10.23, 10.24, 10.25, 10.32, 10.33 and 10.35).
10.1	1998 Stock Option Plan, as amended (Incorporated by reference to Exhibit 10.1 of the Registrant's Form 8-K Report dated June 20, 2006 on file with the SEC June 26, 2006)
10.2	Asset Purchase Agreement, dated January 1, 2001, between the Registrant and Great Lakes Compression, Inc. (Incorporated by reference to Exhibit 10.2 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
10.3	Exhibits 3(c)(1), 3(c)(2), 3(c)(3), 3(c)(4), 13(d)(1), 13(d)(2) and 13(d)(3) to Asset Purchase Agreement, dated January 1, 2001, between the Registrant and Great Lakes Compression, Inc. (Incorporated by reference to Exhibit 10.14 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)

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**NATURAL GAS SERVICES GROUP, INC.**

Exhibit No.	Description
10.4	Amendment to Guaranty Agreement between Natural Gas Services Group, Inc. and Dominion Michigan Production Services, Inc. (Incorporated by reference to Exhibit 10.3 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
10.5	Form of Series A 10% Subordinated Notes due December 31, 2006 (Incorporated by reference to Exhibit 10.8 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
10.6	Form of Five-Year Warrants to Purchase Common Stock (Incorporated by reference to Exhibit 10.9 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
10.7	Warrants issued to Berry-Shino Securities, Inc. (Incorporated by reference to Exhibit 10.10 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
10.8	Warrants issued to Neidiger, Tucker, Bruner, Inc. (Incorporated by reference to Exhibit 10.11 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
10.9	Form of warrant issued in March 2001 for guaranteeing debt (Incorporated by reference to Exhibit 10.12 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
10.10	Form of warrant issued in April 2002 for guaranteeing debt (Incorporated by reference to Exhibit 10.13 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
10.11	Articles of Organization of Hy-Bon Rotary Compression, L.L.C., dated April 17, 2000 (Incorporated by reference to Exhibit 10.18 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
10.12	Regulations of Hy-Bon Rotary Compression, L.L.C. (Incorporated by reference to Exhibit 10.19 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
10.13	First Amended and Restated Loan Agreement between the Registrant and Western National Bank (Incorporated by reference to Exhibit 10.1 of the Registrant's Current Report on Form 8-K, dated March 27, 2003 and filed with the Securities and Exchange Commission on April 14, 2003)
10.14	Form of Termination of Employment Agreement Letter relating to the Employment Agreement of Wayne Vinson (Incorporated by reference to Exhibit 10.26 of the Registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 2002)
10.15	Form of Termination of Employment Agreement Letter relating to the Employment Agreement of Earl Wait (Incorporated by reference to Exhibit 10.27 of the Registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 2002)

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**NATURAL GAS SERVICES GROUP, INC.**

Exhibit No.	Description
10.16	Triple Net Lease Agreement, dated June 1, 2003, between NGE Leasing, Inc. and Steven J. & Katherina L. Winer (Incorporated by reference to Exhibit 10.17 of the Registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 2003)
10.17	Lease Agreement, dated June 19, 2003, between NGE Leasing, Inc. and Wise Commercial Properties (Incorporated by reference to Exhibit 10.18 of the Registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 2003)
10.18	Lease Agreement, dated March 1, 2004, between the Registrant and the City of Midland, Texas (Incorporated by reference to Exhibit 10.19 of the Registrant's Form 10-QSB for the fiscal quarter ended June 30, 2004)
10.19	Second Amended and Restated Loan Agreement, dated November 3, 2003, between the Registrant and Western National Bank (Incorporated by reference to Exhibit 10.20 of the Registrant's Form 10-QSB for the fiscal quarter ended June 30, 2004)
10.20	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)
10.21	Stock Purchase Agreement, dated October 18, 2004, by and among the Registrant, Screw Compression Systems, Inc., Paul D. Hensley, Jim Hazlett and Tony Vohjesus (Incorporated by reference to Exhibit 4.1 of the Registrant's Current Report on Form 8-K dated October 18, 2004 and filed with the Securities and Exchange Commission on October 21, 2004)
10.22	Third Amended and Restated Loan Agreement, dated as of January 3, 2005, among Natural Gas Services Group, Inc., Screw Compression Systems, Inc. and Western National Bank (Incorporated by reference to Exhibit 10.1 of the Registrant's Current Report on Form 8-K, dated January 3, 2005, and filed with the Securities and Exchange Commission on January 7, 2005)
10.23	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)
10.24	Employment Agreement between William R. Larkin and Natural Gas Services Group, Inc. (Incorporated by reference to Exhibit 10.25 of the Registrant's Form 10-KSB for the fiscal year ended December 31, 2004, and filed with the Securities and Exchange Commission on March 30, 2005)
10.25	Promissory Note, dated January 3, 2005 in the original principal amount of \$2,100,000.00 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)

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**NATURAL GAS SERVICES GROUP, INC.**

Exhibit No.	Description
10.26	Fourth Amended and Restated Loan Agreement (Incorporated by reference to Exhibit 10.1 of the Registrant's Current Report on Form 8-K, dated March 14, 2005, and filed with the Securities and Exchange Commission on March 18, 2005)
10.27	Modification Agreement, dated as of January 3, 2005, by and between Natural Gas Services Group, Inc. and Western National Bank (Incorporated by reference to Exhibit 10.2 of the Registrant's Current Report on Form 8-K, dated January 3, 2005, and filed with the Securities and Exchange Commission on January 7, 2005)
10.28	Guaranty Agreement, dated as of January 3, 2005, made by Natural Gas Services 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)
10.29	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)
10.30	Fifth Amended and Restated Loan Agreement (Incorporated by reference to Exhibit 10.2 of the Registrant's Form 8-K dated January 3, 2006 and filed with the Securities and Exchange Commission on January 6, 2006)
10.31	First Modification to Fourth Amended and Restated Loan Agreement (Incorporated by reference to Exhibit 10.1 of the Registrant's Form 8-K, dated May 1, 2005 and filed with the Securities and Exchange Commission on May 13, 2005)
10.32	Employment Agreement between Stephen C. Taylor and Natural Gas Services Group, Inc. (Incorporated by reference to Exhibit 10.1 of the Registrant's Form 8-K Report, dated August 24, 2005, and filed with the Securities and Exchange Commission on August 30, 2005)
10.33	Employment Agreement between James R. Hazlett and Natural Gas Services Group, Inc. (Incorporated by reference to Exhibit 10.1 of the Registrant's Form 8-K Report, dated June 14, 2005, and filed with the Securities and Exchange Commission on November 14, 2005)
10.34	Stockholders Agreement, dated January 3, 2005 among Paul D. Hensley, Tony Vohjesus, Jim Hazlett and Natural Gas Services Group, Inc. (Incorporated by reference to Exhibit 4.3 of the Registrant's Form 8-K Report, dated January 3, 2005, and filed with the Securities and Exchange Commission on January 7, 2005)
10.35	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 June 14, 2005, and filed with the Securities and Exchange Commission on November 14, 2005)



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**NATURAL GAS SERVICES GROUP, INC.**

Exhibit No.	Description
10.36	Retirement Agreement, dated December 14, 2005, between Wallace C. Sparkman and Natural Gas Services Group, Inc. (Incorporated by reference to Exhibit 10.1 of the Registrant's Form 8-K Report, dated December 14, 2005, and filed with the Securities and Exchange Commission on December 15, 2005)
10.37	Sixth Amended and Restated Loan Agreement, dated as of January 3, 2006 (Incorporated by reference to Exhibit 10.3 of the Registrant's Current Report on Form 8-K, dated January 3, 2006, and filed with the Securities and Exchange Commission on January 6, 2006)
10.38	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)
10.39	Seventh Amended and Restated Loan Agreement (Incorporated by reference to Exhibit 10.1 of the Registrant's Form 8-K dated October 26, 2006 and filed with the Securities and Exchange Commission on November 1, 2006)
14.0	Code of Ethics (Incorporated by reference to Exhibit 14.0 of the Registrant's Form 10-KSB for the fiscal year ended December 31, 2004, and filed with the Securities and Exchange Commission on March 30, 2005)
21.0	Subsidiaries (Incorporated by reference to Exhibit 21.0 of the Registrant's Form 10-KSB for the fiscal year ended December 31, 2004 and filed with the Securities and Exchange Commission on March 30, 2005)
*31.1	Certification of Chief Executive Officer required by Section 302 of the Sarbanes-Oxley Act of 2002
*31.2	Certification of Chief Financial Officer required by Section 302 of the Sarbanes-Oxley Act of 2002
*32.1	Certification required by Section 906 of the Sarbanes-Oxley Act of 2002
*32.2	Certification required by Section 906 of the Sarbanes-Oxley Act of 2002

\* Filed herewith

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**NATURAL GAS SERVICES GROUP, INC.**

**SIGNATURES**

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

NATURAL GAS SERVICES GROUP,  
INC.

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

By: /s/ Earl R. Wait  
Earl R. Wait  
Principal Accounting Officer And  
Treasurer

November 9, 2006

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**NATURAL GAS SERVICES GROUP, INC.  
INDEX TO EXHIBITS:**

Exhibit No.	Description
2.1	Purchase and Sale Agreement by and between Hy-Bon Engineering Company, Inc. and NGE Leasing, Inc. (Incorporated by reference to Exhibit 2.1 of the Registrant's Current Report on Form 8-K dated February 28, 2003 and filed with the Securities and Exchange Commission on March 6, 2003)
3.1	Articles of Incorporation, as amended (Incorporated by reference to Exhibit 3.1 of the 10QSB filed and dated November 10, 2004)
3.2	Bylaws (Incorporated by reference to Exhibit 3.4 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
4.1	Form of warrant certificate (Incorporated by reference to Exhibit 4.1 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
4.2	Form of warrant agent agreement (Incorporated by reference to Exhibit 4.2 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
4.3	Form of representative's option for the purchase of common stock (Incorporated by reference to Exhibit 4.4 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
4.4	Form of representative's option for the purchase of warrants (Incorporated by reference to Exhibit 4.5 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
4.5	Stockholders Agreement, dated January 3, 2005 among Paul D. Hensley, Tony Vohjesus, Jim Hazlett and Natural Gas Services Group, Inc. (Incorporated by reference to Exhibit 4.3 of the Registrant's Form 8-K Report, dated January 3, 2005, as filed with the Securities and Exchange Commission on January 7, 2005) Executive Compensation Plans and Arrangements (Exhibits 10.1, 10.23, 10.24, 10.25, 10.32, 10.33 and 10.35).
10.1	1998 Stock Option Plan, as amended (Incorporated by reference to Exhibit 10.1 of the Registrant's Form 8-K Report dated June 20, 2006 on file with the SEC June 26, 2006)
10.2	Asset Purchase Agreement, dated January 1, 2001, between the Registrant and Great Lakes Compression, Inc. (Incorporated by reference to Exhibit 10.2 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
10.3	Exhibits 3(c)(1), 3(c)(2), 3(c)(3), 3(c)(4), 13(d)(1), 13(d)(2) and 13(d)(3) to Asset Purchase Agreement, dated January 1, 2001, between the Registrant and Great Lakes Compression, Inc. (Incorporated by reference to Exhibit 10.14 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
10.4	Amendment to Guaranty Agreement between Natural Gas Services Group, Inc. and Dominion Michigan Production Services, Inc. (Incorporated by reference to Exhibit 10.3 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)



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**NATURAL GAS SERVICES GROUP, INC.**

Exhibit No.	Description
10.5	Form of Series A 10% Subordinated Notes due December 31, 2006 (Incorporated by reference to Exhibit 10.8 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
10.6	Form of Five-Year Warrants to Purchase Common Stock (Incorporated by reference to Exhibit 10.9 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
10.7	Warrants issued to Berry-Shino Securities, Inc. (Incorporated by reference to Exhibit 10.10 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
10.8	Warrants issued to Neidiger, Tucker, Bruner, Inc. (Incorporated by reference to Exhibit 10.11 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
10.9	Form of warrant issued in March 2001 for guaranteeing debt (Incorporated by reference to Exhibit 10.12 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
10.10	Form of warrant issued in April 2002 for guaranteeing debt (Incorporated by reference to Exhibit 10.13 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
10.11	Articles of Organization of Hy-Bon Rotary Compression, L.L.C., dated April 17, 2000 (Incorporated by reference to Exhibit 10.18 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
10.12	Regulations of Hy-Bon Rotary Compression, L.L.C. (Incorporated by reference to Exhibit 10.19 of the Registrant's Registration Statement on Form SB-2, No. 333-88314)
10.13	First Amended and Restated Loan Agreement between the Registrant and Western National Bank (Incorporated by reference to Exhibit 10.1 of the Registrant's Current Report on Form 8-K, dated March 27, 2003 and filed with the Securities and Exchange Commission on April 14, 2003)
10.14	Form of Termination of Employment Agreement Letter relating to the Employment Agreement of Wayne Vinson (Incorporated by reference to Exhibit 10.26 of the Registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 2002)
10.15	Form of Termination of Employment Agreement Letter relating to the Employment Agreement of Earl Wait (Incorporated by reference to Exhibit 10.27 of the Registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 2002)
10.16	Triple Net Lease Agreement, dated June 1, 2003, between NGE Leasing, Inc. and Steven J. & Katherina L. Winer (Incorporated by reference to Exhibit 10.17 of the Registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 2003)

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**NATURAL GAS SERVICES GROUP, INC.**

Exhibit No.	Description
10.17	Lease Agreement, dated June 19, 2003, between NGE Leasing, Inc. and Wise Commercial Properties (Incorporated by reference to Exhibit 10.18 of the Registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 2003)
10.18	Lease Agreement, dated March 1, 2004, between the Registrant and the City of Midland, Texas (Incorporated by reference to Exhibit 10.19 of the Registrant's Form 10-QSB for the fiscal quarter ended June 30, 2004)
10.19	Second Amended and Restated Loan Agreement, dated November 3, 2003, between the Registrant and Western National Bank (Incorporated by reference to Exhibit 10.20 of the Registrant's Form 10-QSB for the fiscal quarter ended June 30, 2004)
10.20	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)
10.21	Stock Purchase Agreement, dated October 18, 2004, by and among the Registrant, Screw Compression Systems, Inc., Paul D. Hensley, Jim Hazlett and Tony Vohjesus (Incorporated by reference to Exhibit 4.1 of the Registrant's Current Report on Form 8-K dated October 18, 2004 and filed with the Securities and Exchange Commission on October 21, 2004)
10.22	Third Amended and Restated Loan Agreement, dated as of January 3, 2005, among Natural Gas Services Group, Inc., Screw Compression Systems, Inc. and Western National Bank (Incorporated by reference to Exhibit 10.1 of the Registrant's Current Report on Form 8-K, dated January 3, 2005, and filed with the Securities and Exchange Commission on January 7, 2005)
10.23	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)
10.24	Employment Agreement between William R. Larkin and Natural Gas Services Group, Inc. (Incorporated by reference to Exhibit 10.25 of the Registrant's Form 10-KSB for the fiscal year ended December 31, 2004, and filed with the Securities and Exchange Commission on March 30, 2005)
10.25	Promissory Note, dated January 3, 2005, in the original principal amount of \$2,100,000.00 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)
10.26	Fourth Amended and Restated Loan Agreement (Incorporated by reference to Exhibit 10.1 of the Registrant's Current Report on Form 8-K, dated March 14, 2005, and filed with the Securities and Exchange Commission on March 18, 2005)

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**NATURAL GAS SERVICES GROUP, INC.**

Exhibit No.	Description
10.27	Modification Agreement, dated as of January 3, 2005, by and between Natural Gas Services Group, Inc. and Western National Bank (Incorporated by reference to Exhibit 10.2 of the Registrant's Current Report on Form 8-K, dated January 3, 2005, and filed with the Securities and Exchange Commission on January 7, 2005)
10.28	Guaranty Agreement, dated as of January 3, 2005, mad 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)
10.29	Guaranty Agreement, dated as of January 3, 2005, mad 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)
10.30	Fifth Amended and Restated Loan Agreement (Incorporated by reference to Exhibit 10.2 of the Registrant's Form 8-K dated January 3, 2006 and filed with the Securities and Exchange Commission January 6, 2006)
10.31	First Modification to Fourth Amended and Restated Loan Agreement (Incorporated by reference Exhibit 10.1 of the Registrant's Form 8-K dated May 1, 2005 and filed with Securities and Exchange Commission May 13, 2005)
10.32	Employment Agreement between Stephen C. Taylor and Natural Gas Services Group, Inc. (Incorporated by reference to Exhibit 10.1 of the Registrant's Form 8-K Report, dated August 24, 2005, and filed with the Securities and Exchange Commission on August 30, 2005)
10.33	Employment Agreement between James R. Hazlett and Natural Gas Services Group, Inc. (Incorporated by reference to Exhibit 10.1 of the Registrant's Form 8-K Report, dated June 14, 2005, and filed with the Securities and Exchange Commission on November 14, 2005)
10.34	Stockholders Agreement, dated January 3, 2005 among Paul D. Hensley, Tony Vohjesus, Jim Hazlett and Natural Gas Services Group, Inc. (Incorporated by reference to Exhibit 4.3 of the Registrant's Form 8-K Report, dated January 3, 2005, and filed with the Securities and Exchange Commission on January 7, 2005)
10.35	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 June 14, 2005, and filed with the Securities and Exchange Commission on November 14, 2005)
10.36	Retirement Agreement, dated December 14, 2005, between Wallace C. Sparkman and Natural Gas Services Group, Inc. (Incorporated by reference to Exhibit 10.1 of the Registrant's Form 8-K Report, dated December 14, 2005, and filed with the Securities and Exchange Commission on December 15, 2005)





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**NATURAL GAS SERVICES GROUP, INC.**

Exhibit No.	Description
10.37	Sixth Amended and Restated Loan Agreement, dated as of January 3, 2006 (Incorporated by reference to Exhibit 10.3 of the Registrant's Current Report on Form 8-K, dated January 3, 2006, and filed with the Securities and Exchange Commission on January 6, 2006)
10.38	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)
10.39	Seventh Amended and Restated Loan Agreement (Incorporated by reference to Exhibit 10.1 of the Registrant's Form 8-K dated October 26, 2006 and filed with the Securities and Exchange Commission on November 1, 2006)
14.0	Code of Ethics (Incorporated by reference to Exhibit 14.0 of the Registrant's Form 10-KSB for the fiscal year ended December 31, 2004, and filed with the Securities and Exchange Commission on March 30, 2005)
21.0	Subsidiaries (Incorporated by reference to Exhibit 21.0 of the Registrant's Form 10-KSB for the fiscal year ended December 31, 2004, and filed with the Securities and Exchange Commission on March 30, 2005)
*31.1	Certification of Chief Executive Officer required by Section 302 of the Sarbanes-Oxley Act of 2002
*31.2	Certification of Chief Financial Officer required by Section 302 of the Sarbanes-Oxley Act of 2002
*32.1	Certification required by Section 906 of the Sarbanes-Oxley Act of 2002
*32.2	Certification required by Section 906 of the Sarbanes-Oxley Act of 2002

\* Filed herewith.