NATURAL GAS SERVICES GROUP INC
Form 10QSB
November 12, 2003

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

FORM 10-QSB

(X) QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2003

OR

( ) TRANSITION REPORT UNDER 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 small business issuer as specified in its charter)

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

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

(432) 563-3974
(Issuer's Telephone number)

N/A

(Former name, former address and former fiscal year, if changed since last report)

APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY
PROCEEDINGS DURING THE PRECEDING FIVE YEARS

Check whether the registrant filed all documents and reports required to be filed by Section 12, 13 or 15(d) of the Exchange Act after the distribution of securities under a plan confirmed by a court.

Yes ___ No ____

APPLICABLE ONLY TO CORPORATE ISSUERS

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

Class	Outstanding at September 30, 2003

Common Stock, $.001 par value	5,022,181

Transitional Small Business Disclosure Format (Check one): Yes ___ No X

NATURAL GAS SERVICES GROUP, INC.

Commission File Number: 1-31398

Quarter Ended September 30, 2003

FORM 10-QSB

Part I - FINANCIAL INFORMATION

Part II - OTHER INFORMATION

Natural Gas Services Group, Inc.
Consolidated Balance Sheet
(unaudited)
September 30, 2003

ASSETS

Current Assets:	
Cash and cash equivalents	$ 258,276
Accounts receivable - trade	1,584,767
Inventory	2,546,683
Prepaid expenses	130,344

Total current assets	4,520,070
Lease equipment, net	17,537,997
Other property, plant and equipment, net	2,779,335
Goodwill, net of accumulated amortization	2,589,655
Patents, net of accumulated amortization	120,812
Other assets	79,200
Total assets	$27,627,069

LIABILITIES AND SHAREHOLDERS' EQUITY

Current Liabilities:	
Current portion of long term debt and capital lease	$ 2,342,151
Accounts payable and accrued liabilities	1,411,129
Unearned Income	492,271
Total current liabilities	4,245,551
Long term debt and capital lease, less current portion	6,273,100
Subordinated notes, net	1,393,104
Deferred income tax payable	1,773,202
Total liabilities	13,684,957

SHAREHOLDERS' EQUITY

Preferred stock	3,437
Common stock	50,221
Paid in capital	11,183,715
Retained earnings	2,704,739
Total shareholders' equity	13,942,112
Total liabilities and shareholders' equity	$27,627,069

The accompanying notes are an integral part of the consolidated balance sheet.

Consolidated Income Statements
(unaudited)

	Three months ended September 30		Nine months end
	2003	2002	2003
Revenue:			
Sales	$ 1,372,248	$ 1,438,069	$ 2,877,358
Service and maintenance	452,714	439,522	1,346,597
Leasing income	1,874,594	1,203,793	5,040,161
	3,699,556	3,081,384	9,264,116
Cost of revenue:			
Cost of sales	1,008,771	963,035	2,155,568
Cost of service and maintenance	290,008	373,594	961,237
Cost of leasing	545,309	329,850	1,313,093
	1,844,088	1,666,479	4,429,898
Gross Margin	1,855,468	1,414,905	4,834,218
Operating Cost:			
Selling expense	159,870	134,786	484,421
General and administrative expense	395,918	276,523	1,186,922
Amortization and depreciation	455,563	301,493	1,235,118
	1,011,351	712,802	2,906,461
Operating income	844,117	702,103	1,927,757
Interest expense	(170,971)	(273,568)	(500,760)
Equity in earnings of joint venture	--	132,081	--
Other income	1,253	15,316	2,040
Income before income taxes	674,399	575,932	1,429,037
Income tax expense	289,992	207,000	611,595
Net income	384,407	368,932	817,442
Preferred dividends	30,530	31,009	92,550
Net income available to common shareholders	$ 353,877	$ 337,923	$ 724,892
Earnings per share:			
Basic	$ 0.07	$ 0.10	$ 0.15
Diluted	$ 0.07	$ 0.08	$ 0.14
Weighted average shares:			
Basic	4,995,713	3,357,632	4,910,062
Diluted	5,389,673	4,091,862	5,208,096

The accompanying notes are an integral part of the consolidated income statements.

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Natural Gas Services Group, Inc.
Consolidated Statements of Cash Flows
(unaudited)

	Nine months Ended September 30, 2003	N... Se...
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net Income	$ 817,442	$
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	1,235,120	
Deferred taxes	602,202	
Amortization of debt issuance costs	48,717	
Warrants Issued for debt guarantee	--	
Equity in earnings of joint venture	--	
Gain on disposal of assets	10,547	
Changes in operating assets and liabilities:		
Trade and other receivables	(938,817)	
Inventory and work in progress	(1,000,735)	
Prepaid expenses and other	42,958	
Accounts payable and accrued liabilities	708,971	
Deferred income	174,710	
Other	(60,436)	
NET CASH PROVIDED BY OPERATING ACTIVITIES	1,640,679	
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of property and equipment	(5,900,453)	
Acquisition of remaining interest in joint venture, net of cash acquired	242,753	
Proceeds from sale of property and equipment	112,500	
Decrease in lease receivable	210,512	
Distribution from equity method investee	49,090	
NET CASH USED IN INVESTING ACTIVITIES	(5,285,598)	
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net proceeds from bank loans and line of credit	2,649,811	
Repayments of long term debt	(1,583,951)	
Deferred offering costs	--	
Proceeds from stock offering, net of offering cost	--	
Dividends paid on preferred stock	(92,550)	
Proceeds from exercise of warrants	216,247	
NET CASH PROVIDED BY FINANCING ACTIVITIES	1,189,557	
NET CHANGE IN CASH AND CASH EQUVALENTS	(2,455,362)	
CASH AT BEGINNING OF PERIOD	2,713,638	
CASH AT END OF PERIOD	$ 258,276	$

SUPPLEMENTAL DICLOSURE OF CASH FLOW INFORMATION:

Interest paid	$ 500,760	$
Income taxes paid	$ --	$

The accompanying notes are an integral part of the consolidated statements of cash flows.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(1) Basis of Presentation

The accompanying unaudited financial statements present the consolidated results of our company and its wholly owned subsidiaries 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, 2003 and the results of our operations for the nine months periods ended September 30, 2003 and 2002 not misleading. As permitted by the rules and regulations of the Securities and Exchange Commission (SEC) the accompanying financial statements do not include all disclosures normally required by accounting principles generally accepted in the United States of America. These financial statements should be read in conjunction with the financial statements included in our Annual Report on Form 10-KSB on file with the SEC. Investments in joint ventures in which our company does not have majority voting control are accounted for by the equity method. All intercompany balances and transactions have been eliminated in consolidation. In our opinion, the 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 months ended September 30, 2003 are not necessarily indicative of the results of operations to be expected for the full fiscal year ending December 31, 2003

(2) Stock-based Compensation

Statement of Financial Accounting Standards No. 123, ("SFAS 123") "Accounting for Stock-Based Compensation," encourages, but does not require, the adoption of a fair value-based method of accounting for employee stock-based compensation transactions. We have elected to apply the provisions of Accounting Principles Board Opinion No. 25 ("Opinion 25"), "Accounting for Stock Issued to Employees," and related interpretations, in accounting for our employee stock-based compensation plans. Under Opinion 25, compensation cost is measured as the excess, if any, of the quoted market price of our stock at the date of the grant above the amount an employee must pay to acquire the stock.

Had compensation costs for options granted to our employees been determined based on the fair value at the grant dates consistent with the method prescribed by SFAS No. 123, our pro forma net income and earnings per share would have been reduced to the pro forma amounts listed below:

	Three Months Ended	Nine months

	September 30 2003	2002	Septembe 2003
Pro forma impact of fair value method			
Income applicable to common shares, as reported	$ 353,877	337,923	724,892
Pro-forma stock-based compensation costs under the fair value method, net of related tax	(7,683)	(14,010)	(23,048)
Pro-forma income applicable to common shares under the fair-value method	$ 346,194	$ 323,913	$ 701,844
Earnings per common share			
Basic earnings per share reported	$ 0.07	$ 0.10	$ 0.15
Diluted earnings per share reported	$ 0.07	$ 0.08	$ 0.14

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Pro-forma basic earnings per share under the fair value method	$ 0.07	$ 0.10	$ 0.14
Pro-forma diluted earnings per share under the fair value method	$ 0.06	$ 0.08	$ 0.13
Weighted average Black-Scholes fair value assumptions:			
Risk free rate	4.0%-5.2%		
Expected life	5-10 yrs		
Expected volatility	50.0%		
Expected dividend yield	0.0%		

(3) Acquisitions

On March 31, 2003 we acquired 28 gas compressor packages from Hy-Bon Engineering Company, Inc. ("Hy-Bon"). The adjusted purchase price amounted to approximately $2,140,000. As part of the purchase and sale agreement, Hy-Bon withdrew as a member of Hy-Bon Rotary Compression, L.L.C. ("Joint Venture") effective as of January 1, 2003. We, as the other member retained all assets of the Joint Venture that as of December 31, 2002 had an unaudited aggregate value of $346,511. We plan to dissolve the Joint Venture and have agreed not to operate under the name Hy-Bon. We have consolidated the operations of the Joint Venture beginning January 1, 2003 and then began recording our share of the profit of the acquired interest beginning April 1, 2003.

(4) Long Term Debt

We entered into a new loan agreement with our bank, as of March 26, 2003 that included new borrowing of $2,150,000 in the form of a term loan with monthly principal payments of $35,833 with interest at 1% over prime but not less than 5.25% for 60 months. The proceeds from this new borrowing were used to purchase the 28 gas compressors from Hy-Bon. The new loan agreement also included the renewal of our line of credit for $750,000 with interest at 1% over prime but not less than 5.25% for one year.

(5) Segment Information

FAS No. 131, Disclosures about Segments of an Enterprise and Related Information, establishes standards for public companies relating to the reporting of 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 deciding how to allocate resources and in assessing performance.

Our segment information is set forth in the following table:

(in thousands) Nine Months Ended September 30, 2003	Rotary Gas	NGE Leasing	Great Lakes Compression	Natural Gas Services Group	Total
Revenue	$ 2,192	$ 3,340	$ 3,732	$ --	$ 9,264
Inter-segment revenue	4,179	62	11	(4,252)	--
Net Income (loss)	229	1,272	625	(1,309)	817
Segment Assets	4,654	13,330	9,157	486	27,627

(in thousands) Nine Months Ended September 30, 2002	Rotary Gas	NGE Leasing	Great Lakes Compression	Natural Gas Services Group	Total
Revenue	$ 2,856	$ 1,684	$ 3,661	$ --	$ 8,201
Inter-segment revenue	4,064	--	--	(4,064)	--
Net Income (loss)	504	850	252	(898)	708
Segment Assets	4,064	7,360	9,165	882	21,471

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(in thousands) Three Months Ended September 30, 2003	Rotary Gas	NGE Leasing	Great Lakes Compression	Natural Gas Services Group	Total
Revenue	$ 992	$ 1,270	$ 1,437	$ --	$ 3,699
Inter-segment revenue	1,435	27	3	(1,465)	--
Net Income (loss)	283	398	231	(528)	384

(in thousands) Three Months Ended September 30, 2002	Rotary Gas	NGE Leasing	Great Lakes Compression	Natural Gas Services Group	Total
Revenue	$ 1,285	$ 625	$ 1,171	$ --	$ 3,081
Inter-segment revenue	980	--	--	(980)	--
Net Income (loss)	274	335	97	(338)	368

(6) Earnings per common 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 En September 30	
	2003	2002	2003	

Basic earnings per share Numerator:				
Net income	$ 384,407	$ 368,932	817,442	
Less: dividends on preferred shares	(30,530)	(31,009)	(92,550)	(
Net income available to common shareholders	$ 353,877	$ 337,923	$ 724,892	$
Denominator -				
Weighted average common shares outstanding	4,995,713	3,357,632	4,910,062	3,
Basic earnings per share	$ 0.07	$ 0.10	$ 0.15	$
Diluted earnings per share Numerator:				
Net income	$ 384,407	$ 368,932	817,442	
Less: dividends on preferred shares (1)	(30,530)	(31,009)	(92,550)	(
Net income available to common shareholders	$ 353,877	$ 337,923	$ 724,892	$
Denominator :				
Weighted average common shares outstanding	4,995,713	3,357,632	4,910,062	3,
Common stock options and warrants	393,690	734,230	298,034	
Conversion of preferred shares (1)	--	--	--	
	5,389,673	4,091,862	5,208,096	4,
Diluted earnings per share	$ 0.07	$ 0.08	$ 0.14	$

(1) Preferred shares were anti-dilutive for the nine and three months ended September 30, 2003 and 2002.

Item 2. Management's Discussion and Analysis or Plan of Operation

Overview

We include the operations of Rotary Gas Systems, NGE Leasing and Great Lakes Compression, which are wholly owned subsidiaries. These entities provide products and services to the oil and gas industry and are engaged in (1) the manufacture, service, sale, and rental of natural gas compressors to enhance the productivity of oil and gas wells, and (2) the manufacture, sale and rental of flares and flare ignition systems for plant and production facilities. We are the parent company and provide administrative and management support and, therefore, have expenses associated with that activity.

Liquidity and Capital Resources

We have funded our operations through public and private offerings of our common and preferred stock, subordinated debt and bank debt. Proceeds were primarily used to pay debt and to fund the manufacture and fabrication of additional units for our rental fleet of gas compressors.

At September 30, 2003, we had cash and cash equivalents of $258,276, working capital of $274,519 and non-subordinated debt of $8,615,251, of which $2,342,151 was classified as current. We had net cash flow from operating activities of $1,640,679 during the first nine months of 2003. This was primarily from net income of $817,442 plus depreciation and amortization of $1,235,120, an increase in accounts payable and accrued liabilities of $708,971, an increase in deferred taxes of $602,202 and offset by an increase in inventory of $1,000,735 and accounts receivable of $938,817.

On October 24, 2002, we paid off the note of $6,952,464 payable to Dominion Michigan, used for the acquisition of the compression related assets of Great Lakes Compression. $3,452,464 of the funds to pay the note came from the proceeds of our initial public offering, and $3,500,000 came from additional bank financing to be amortized over 60 months at prime rate plus 1%.

We entered into a new loan agreement with our bank, dated as of March 26, 2003. This included new borrowing of $2,150,000 in the form of a term loan with monthly principal payments of $35,833 with interest at 1% over prime rate but not less than 5.25% for 60 months. The proceeds from this new borrowing were used to purchase the 28 gas compressors from Hy-Bon. The new loan agreement also included the renewal of our line of credit for $750,000 with interest at 1% over prime rate for one year. We have not drawn from the line of credit as of September 30, 2003.

Funds from the initial public offering, which closed on October 24, 2002, have permitted us to actively pursue adding gas compressors to our rental fleet. We expect to fund additional rental units through additional bank debt and cash flow from operations.

A summary of the use of the proceeds from our initial public offering as of September 30, 2003 is as follows:

- $3,458,464 to reduce indebtedness; and
- $3,070,706 for the manufacture of gas compressors placed in our rental fleet

Results of Operations

Nine Months Ended September 30, 2003, Compared to the Nine months Ended September 30, 2002.

(in thousands) Nine Months Ended September 30, 2003	Rotary Gas	NGE Leasing	Great Lakes Compression	Natural Gas Services Group	Tota
Revenue	$ 2,192	$ 3,340	$ 3,732	$ --	$ 9
Inter-segment revenue	4,179	62	11	(4,252)	

Gross margin	1,018	2,358	1,458	--	4
Selling, general and administrative expense	676	128	206	661	1
Depreciation and amortization expense	107	620	490	18	1
Operating income (loss)	235	1,610	762	(679)	1
Interest expense	6	348	129	18	
Other income or (expense)	--	10	(8)	--	
Provision for income tax	--	--	--	612	
Net income	229	1,272	625	(1,309)	
Nine Months Ended September 30, 2002					
Revenue	$ 2,856	$ 1,684	$ 3,661	$ --	$ 8
Inter-segment revenue	4,064	--	--	(4,064)	
Gross margin	1,198	1,209	1,322	--	3
Selling, general and administrative expense	600	120	188	347	1
Depreciation and amortization expense	90	303	412	34	
Operating income (loss)	508	786	722	(381)	1
Interest expense	6	291	470	30	
Equity in earnings from joint venture	--	340	--	--	
Other income or (expense)	2	15	--	--	
Provision for income tax	--	--	--	487	
Net income (loss)	$ 504	$ 850	$ 252	$ (898)	$

Rotary Gas Systems Operations

Revenue from outside sources decreased 23% or $664,000 for the nine months ended September 30, 2003, as compared to the same period ended September 30, 2002. Because our products are custom-built, fluctuations in revenue from outside sources are expected. This decrease was mainly the result of a reduction in the sale of compressor units to third parties.

The gross margin percentage increased from 42% for the nine months ended September 30, 2002, to 46% for the same period ended September 30, 2003. The cost of revenue is comprised of expenses associated with service, parts and manufacturing expenses. This increase resulted mainly from a change in the product mix.

Selling, general and administrative expense increased $76,000 or 13% for the nine months ended September 30, 2003, as compared to the same period ended September 30, 2002. This was mainly the result of the addition of new salesmen in the Farmington, New Mexico and West Texas areas.

Depreciation expense increased 19% or $17,000 for the nine months ended September 30, 2003, as compared to the same period ended September 30, 2002. This increase was mainly due to the purchase of additional sales vehicles, shop and office equipment.

NGE Leasing Operations

Revenue from our rental of natural gas compressors increased $1,656,000 or 98% for the nine months ended September 30, 2003, as compared to the same period in 2002. This increase is the result of units added to our rental fleet. From September 30, 2002, to September 30, 2003, we added 83 gas compressor units to our rental fleet, which included the 28 units we purchased from Hy-Bon on March 31, 2003. The revenue from the Joint Venture, which was previously accounted for using the equity method, has been consolidated beginning January 1, 2003. The profit earned on the units purchased from Hy-Bon is included in our consolidated earnings beginning April 1, 2003.

The gross margin percentage decreased from 72% for the nine months ended September 30, 2002 to 71% for the same period ending 2003. This decrease mainly resulted from a slight increase in maintenance expenses associated with rental compressor units.

Selling, general and administrative expense increased $8,000 or 7% for the nine months ended September 30, 2003, as compared to the same period in 2002. This was mainly the result of an increase in sales commissions from increased rental revenue.

Depreciation expense increased 105% or $317,000 for the nine months ended September 30, 2003, as compared to the same period ended September 30, 2002. This increase was the result of new gas compressor rental units being added to the rental fleet during the period.

There was an increase in interest expense of 20% from $291,000 for the nine months ended September 30, 2002, to $348,000 for the same period ended September 30, 2003. This is mainly as a result of an increase in bank debt used to purchase equipment for the rental fleet.

Great Lakes Compression

Revenue increased 2% for the nine months ended September 30, 2003, compared to the same period in 2002. This increase resulted from a decrease in the sales of compressor units to third parties offset by increases in parts and labor sales. Because our compressor units are custom-built, fluctuations in revenue from outside sources are expected.

The gross margin percentage increased from 36% for the nine months ended September 30, 2002 to 39% for the same period in 2003. The cost of revenue is comprised of expenses associated with the maintenance of the gas compressor rental activity, service, parts and manufacturing expenses. This increase resulted mainly from a change in the sales product mix.

Selling, general and administrative expense increased by 10% or $18,000 for the nine months ended September 30, 2003, as compared to the same period in 2002. This is mainly the result of an increase in advertising and promotional expenses.

Depreciation expense increased from $412,000 for the nine months ended September 30, 2002, to $490,000 for the same period ended September 30, 2003. The increase is the result of equipment that was added to the rental fleet and the replacement of several service vehicles.

There was a decrease in interest expense of 73% from $470,000 for the nine months ended September 30, 2002 to $129,000 for the nine months ended

September 30, 2003. This decrease resulted from a reduction of the debt owed to Dominion Michigan. Part of the proceeds from our initial public offering was used to reduce debt in the amount of $3,452,464 and our bank financed the remaining balance of $3,500,000 at a more favorable interest rate.

Natural Gas Services Group

Selling, general and administrative expense increased 90% from $347,000 for the nine months ended September 30, 2002, as compared to $661,000 for the same period ended September 30, 2003. This was mainly the result of the added expense associated with being a publicly held company such as legal fees, auditor fees, underwriters and public relations fees.

Amortization and depreciation expense decreased 47% from $34,000 for the nine months ended September 30, 2002, to $18,000 for the same period ended September 30, 2003. This mainly resulted from vehicles that were moved to our subsidiary, Great Lakes Compression.

Interest expense decreased 40% from $30,000 for the nine months ended September 30, 2002, to $18,000 for the same period ended September 30, 2003. This decrease resulted from a reduction in the interest rate and from bank notes for vehicles moved to our subsidiary.

Provision for income tax is accounted for on a consolidated basis. Therefore, the tax for all companies is included in the provision for income tax for Natural Gas Services Group. Income tax expense increased $125,000 or 26%, which is consistent with and pursuant to changes in state and federal tax statutes and the increase in net taxable income.

Three months Ended September 30, 2003. Compared to the Three Months Ended September 30, 2002

(in thousands) Three months Ended September 30, 2003	Rotary Gas	NGE Leasing	Great Lakes Compression	Natural Gas Services Group
Revenue	$ 992	$ 1,270	$ 1,437	$ --
Inter-segment revenue	1,435	27	3	(1,465)
Gross margin	539	804	512	--
Selling, general and administrative expense	216	42	71	227
Depreciation and amortization Expense	37	241	171	6
Operating income (loss)	286	521	270	(233)
Interest expense	3	124	40	5
Other income or (expense)	--	1	1	--
Provision for income tax	--	--	--	290
Net income (loss)	$ 283	$ 398	$ 231	$ (528)

Three months Ended September 30, 2002					
Revenue	$ 1,285	$ 625	$ 1,171	$ --	$
Inter-segment revenue	980	--	--	(980)	
Gross margin	509	448	458	--	
Selling, general and administrative expense	203	40	62	107	
Depreciation and amortization Expense	31	114	143	13	
Operating income (loss)	275	294	253	(120)	
Equity in earning of joint venture	132	132			
Interest expense	2	105	156	11	
Other income or (expense)	1	14	--	--	
Provision for income tax	--	--	--	207	
Net Income (loss)	$ 274	$ 335	$ 97	$ (338)	$

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Rotary Gas Systems Operations

Revenue from outside sources decreased $293,000 or 23% for the three months ended September 30, 2003, as compared to the same period ended September 30, 2002. Because our products are custom-built, fluctuations in revenue from outside sources are expected. This decrease was mainly the result of a reduction in the sale of compressor units to third parties. The quarter ending September 30, 2002 included 10 compressor units sold to a major customer while the same period for 2003 had no compressor sales but this was offset by an increase in flare unit sales, rebuild service and parts.

The gross margin percentage increased to 54% for the three months ended September 30, 2003, as compared to 40% for the same period ended September 30, 2002. The cost of revenue is comprised of expenses associated with service, parts and manufacturing expenses. This increase resulted mainly from a change in the product-mix.

Selling, general and administrative expense increased 6% or $13,000 for the three months ended September 30, 2003, as compared to the same period ended September 30, 2002. This was mainly the result of the addition of new salesmen in the Farmington, New Mexico and West Texas areas. Depreciation expense increased 19% from $31,000 for the three months ended September 30, 2002, to $37,000 for the same period ended September 30, 2003. This increase was mainly due to the purchase of additional service vehicles, shop and office equipment.

There was a slight decrease in interest expense for the three months ended September 30, 2003, as compared to the same period ended September 30, 2002, mainly due to the reduction in loan balances on vehicles.

NGE Leasing Operations

Revenue from the rental of natural gas compressors increased 103% for the three months ended September 30, 2003, as compared to the same period in 2002. This increase is the result of the revenue from units added to our rental fleet, both from the units we manufactured and the units we acquired from the Hy-Bon transaction.

The gross margin percentage decreased from 72% for the three months ended September 30, 2002, to 63% the same period in 2003. This decrease mainly resulted from an increase in the maintenance expenses associated with the compressor units. This does not represent a trend since repairs cost often fluctuate from period to period on our rental equipment.

Selling, general and administrative expense increased from $40,000 for the three months ended September 30, 2002, to $42,000 for the same period in 2003. This was mainly the result of an increase in sales commissions due to increased rental revenue.

Depreciation expense increased 111% from $143,000, for the three months ended September 30, 2002 to $241,000 for the three months ended September 30, 2003. This increase was the result of new gas compressor rental units being added to the rental fleet during the period.

There was an increase in interest expense from $105,000 for the three months ended September 30, 2002, to $124,000 for the same period ended September 30, 2003. This is mainly a result of an increase in bank debt used to purchase equipment for the rental fleet.

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Great Lakes Compression

Revenue increased 23% for the three months ended September 30, 2003, as compared to the same period in 2002. This increase was the result of a significant increase in maintenance and labor sales to third parties.

The gross margin percentage decreased from 39% for the three months ended September 30, 2002, to 36% for the same period in 2003. The cost of revenue is comprised of expenses associated with the maintenance of the gas compressor rental activity, service, parts and manufacturing expenses. This decrease resulted mainly from a change in the sales product mix.

Selling, general and administrative expense increased from $62,000 for the three months ended September 30, 2002, to $71,000 for the same period in 2003. This is mainly the result of an increase in advertising and promotional expenses.

Depreciation expense increased from $143,000 for the three months ended September 30, 2002, to $171,000 for the same period ended September 30, 2003. The increase is the result of equipment that was added to the rental fleet and the replacement of service vehicles.

There was a decrease in interest expense from $156,000 for the three months ended September 30, 2002, to $40,000 for the same period ended September 30, 2003. This decrease resulted from a reduction of the debt owed to Dominion Michigan. Part of the proceeds from our initial public offering was used to reduce debt in the amount of $3,452,464 and our bank financed the remaining balance of $3,500,000 at a more favorable interest rate.

Natural Gas Services Group

Selling, general and administrative expense increased 112% from $107,000 for the three months ended September 30, 2002, to $227,000 for the same period ended September 30, 2003. This was mainly the result of an added expense associated with being a publicly held company such as legal fees, auditor fees, underwriters and public relations fees.

Amortization and depreciation expense decreased 54% from $13,000 for the three months ended September 30, 2002, to $6,000 for the same period ended September 30, 2003. This mainly resulted from vehicles that were moved to our subsidiary, Great Lakes Compression.

Interest expense decreased 55% from $11,000 for the three months ended September 30, 2002, to $5,000 for the same period ended September 30, 2003. This decrease resulted from a reduction in the interest rate and for bank notes for vehicles moved to our subsidiary.

Provision for income tax is accounted for on a consolidated basis. Therefore, the tax for all companies is included in the provision for income tax for Natural Gas Services Group. Income tax expense increased $83,000 or 40%, which is consistent with and pursuant to changes in state and federal tax statutes. This increase is mainly due to an increase in income before taxes.

Item 3. Controls and Procedures

(a) Evaluation of disclosure controls and procedures.

Under the supervision and with the participation of our management, including our chief executive officer and chief financial officer, we evaluated

the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-14(c) under the Securities Exchange Act of 1934) as of a September 30, 2003. Based upon that evaluation, our chief executive officer and chief financial officer concluded that, as of the Evaluation Date, our disclosure controls and procedures are effective in timely alerting them to the material information relating to us and our consolidated subsidiaries required to be included in our periodic filings with the SEC.

(b) Changes in internal controls.

There were no significant changes made in our internal controls during the period covered by this report or, to our knowledge, in other factors that could significantly affect these controls subsequent to the date of their evaluation.

PART II - OTHER INFORMATION

Item 2. Changes in Securities and Use of Proceeds

(c) During the three months ended September 30, 2003, holders of 14,000 shares of our outstanding 10% Convertible Series A Preferred Stock converted the shares into 14,000 shares of our common stock. There was no underwriter involved in the transactions. The shares of our common stock were all issued in reliance upon the exemption contained in Section 4(2) of the Securities Act of 1933, as amended, because all of the persons were accredited investors and appropriate restrictive legends were placed on the certificates unless the shares were sold pursuant to the provisions of Rule 144.

(d) On October 21, 2002, our Registration Statement (File No. 333-88314) was declared effective.

Since October 21, 2002, we have incurred an aggregate of approximately $1,345,830 of expenses in connection with the offering, including underwriting discounts ($708,750), expenses paid to or for the underwriter ($157,500), and other expenses of the offering ($479,680). Such amounts were not paid directly or indirectly to the directors, the officers or to persons owning 10% or more of any class of our equity securities or to our affiliates. Rather, such payments were to non-associated third parties. After deducting the total expenses, we received net offering proceeds of approximately $6,529,170. Through September 30, 2003, the net offering proceeds have been used for:

- $3,458,464 to reduce indebtedness; and
- $3,070,706 for the manufacture of gas compressors placed in our rental fleet.

The above reflects that we have used all of the net proceeds that we received from our offering of common stock and warrants. None of the warrants have been exercised so we have realized no proceeds from the exercise thereof.

Item 5. Other Information

Changes in Board of Directors:

Effective September 10, 2003 Scott W. Sparkman resigned as a member of the Board of Directors and was replaced by Wallace C. Sparkman.

Effective October 23, 2003 James T. Grigsby resigned as a member of the Board of Directors to pursue his personal interests.

NATURAL GAS SERVICES GROUP, INC.

Commission File Number: 1-31398
Quarter Ended September 30, 2003
Form 10-QSB

Item 6. Exhibits and Reports on Form 8-K
(a) Exhibits

31.1 Certification of Chief Executive Officer Pursuant to Rule 13a-14(a)

31.2 Certification of Chief Financial Officer Pursuant to Rule 13a-14(a)

32.1 Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350

32.2 Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350

(b) On August 6, 2003, we filed a Current Report on Form 8-K dated August 6, 2003, filing a news release as an Exhibit under Item 7 and describing the news release under Items 9 and 12.

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SIGNATURES

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

NATURAL GAS SERVICES GROUP, INC.

By: /s/ Wayne L. Vinson

Wayne L. Vinson
President and Chief Executive Officer

By: /s/ Earl R. Wait

Earl R. Wait
Chief Financial Officer
And Treasurer

November 12, 2003

EXHIBIT INDEX

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