

KEY ENERGY SERVICES INC
Form 10-KT/A
April 10, 2003

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-K/A
Amendment No. 1**

(Mark One)

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

For the fiscal year ended _____

or

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

For the transition period from July 1, 2002 to December 31, 2002
Commission file number 1-8038

KEY ENERGY SERVICES, INC.

(Exact name of registrant as specified in its charter)

Maryland
(State or other jurisdiction of
incorporation or organization)

04-2648081
(I.R.S. Employer Identification No.)

6 Desta Drive, Midland, Texas
(Address of principal executive offices)

79705
(Zip Code)

Registrant's telephone number, including area code: **(915) 620-0300**

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT:

Title of Each Class

Name of Each Exchange on Which Registered

Common Stock, \$.10 par value

New York Stock Exchange

SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT:

5% Convertible Subordinated Notes Due 2004

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

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

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

The aggregate market value of the Common Shares held by nonaffiliates of the Registrant as of April 9, 2003 was approximately \$1,136,543,362.

Common Shares outstanding at April 9, 2003: 128,475,639

DOCUMENTS INCORPORATED BY REFERENCE: Portions of the Proxy Statement with respect to the Annual Meeting of Shareholders for the fiscal year ended June 30, 2002 and the six months ended December 31, 2002 are incorporated by reference in Part III of this report.

Key Energy Services, Inc.

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SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

The statements in this document that relate to matters that are not historical facts are "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. When used in this document and the documents incorporated by reference, words such as "anticipate," "believe," "expect," "plan," "intend," "estimate," "project," "will," "could," "may," "predict" and similar expressions are intended to identify forward-looking statements. Further events and actual results may differ materially from the results set forth in or implied in the forward-looking statements. Factors that might cause such a difference include:

fluctuations in world-wide prices and demand for oil and natural gas;

fluctuations in level of oil and natural gas exploration and development activities;

fluctuations in the demand for well servicing, contract drilling and ancillary oilfield services;

the existence of competitors, technological changes and developments in the industry;

the existence of operating risks inherent in the well servicing, contract drilling and ancillary oilfield services; and

general economic conditions, the existence of regulatory uncertainties, and the possibility of political instability in any of the countries in which Key does business, in addition to other matters discussed under "Part II Item 7 Management's Discussion and Analysis of Results of Operations and Financial Condition."

These forward looking-statements speak only as of the date of this report and Key disclaims any duty or obligation to update the forward looking statement in this report.

PART I

ITEM 1. BUSINESS.

THE COMPANY

Based on the number of rigs owned and available industry data, Key Energy Services, Inc. (the "Company" or "Key"), is the largest onshore, rig-based well servicing contractor in the world, with approximately 1,489 well service rigs and 2,295 oilfield service vehicles as of December 31, 2002. Key provides a complete range of well services to major oil companies and independent oil and natural gas production companies, including: rig-based well maintenance, workover, completion, and recompletion services (reentering a well to complete the well in a new zone or formation) (including horizontal recompletions); well intervention services; oilfield trucking services; and ancillary oilfield services. Key conducts well servicing operations onshore the continental United States in the following regions: Gulf Coast (including South Texas, Central Gulf Coast of Texas and South Louisiana), Permian Basin of West Texas and Eastern New Mexico, Mid-Continent (including the Anadarko, Hugoton and Arkoma Basins, Fort Worth Basin and the ArkLaTex region), Four Corners (including the San Juan, Piceance, Uinta, and Paradox Basins), Eastern (including the Appalachian, Michigan and Illinois Basins), Rocky Mountains (including the Denver-Julesberg, Powder River, Wind River, Green River and Williston Basins), and California (the San Joaquin Basin), and internationally in Argentina, Egypt and Canada (Ontario). Based on the number of rigs owned and available industry data, Key is also a leading onshore drilling contractor, with

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approximately 79 land drilling rigs as of December 31, 2002. Key conducts land drilling operations in a number of major domestic producing basins, as well as in Argentina and in Canada (Ontario). Key also produces and develops oil and natural gas reserves in the Permian Basin region and Texas Panhandle.

Key's principal executive office is located at 6 Desta Drive, Midland, Texas 79705. Key's phone number is (915) 620-0300 and its website address is www.keyenergy.com. Key makes available free of charge

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through its website its annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports as soon as reasonably practicable after such material is electronically filed with the Securities and Exchange Commission. Information on Key's website is not a part of this report.

BUSINESS STRATEGY

Key has built its leadership position through the acquisition and consolidation of smaller, regional competitors. This consolidation of assets and employees, together with a continuing decline in the number of available domestic well service rigs due to attrition, cannibalization and transfers outside of the United States, has given Key the opportunity to strengthen its position within the industry during the year ended June 30, 2002 and the six-month period ended December 31, 2002. Key has focused on maximizing results by reducing debt, building strong customer alliances, refurbishing rigs and related equipment, and training personnel to maintain a qualified and safe employee base.

Reducing Debt. An important element of Key's long-term business strategy is to reduce its debt and strengthen its balance sheet by repaying debt using a portion of available operating cash flow and by restructuring its debt to minimize cash interest expense and restructure debt maturities. Since March 1999, Key has reduced its long-term funded debt net of cash ("net funded debt") and its net funded debt to capitalization ratio from approximately \$839 million and 87.5%, respectively, to approximately \$485 million and 41.0%, respectively, as of December 31, 2002. In addition, during the six-month period ended December 31, 2002, Key restructured its senior credit facility in order to increase its borrowing capacity with a minimal effect on interest expense. Key expects to be able to continue to reduce debt and strengthen its balance sheet in the future.

Building Strong Customer Alliances. Key seeks to maximize customer satisfaction by offering a broad range of equipment and services combined with a highly trained and motivated labor force. As a result, Key is able to offer proactive solutions for most of its customer's wellsite needs. Key ensures consistent high standards of quality and customer satisfaction by continually evaluating its performance. Key maintains strong alliances with major oil companies as well as numerous independent oil and natural gas production companies and believes that such alliances improve the stability of demand for its oilfield services.

Remanufacturing Rigs and Related Equipment. Key intends to continue actively remanufacturing its rigs and related equipment to maximize the utilization of its rig fleet. The Company believes that it has adequate cash flow and resources necessary to continue to make the capital expenditures required to continue its remanufacturing program.

Training and Developing Employees. Key has, and will continue to, devote significant resources to the training and professional development of its employees with a special emphasis on safety. Key currently has two training centers in Texas, one training center in New Mexico and one training center in California to improve its employees' understanding of operating and safety procedures. Key recognizes the historically high turn-over rate in the industry and is committed to offering compensation, benefits and incentive programs for its employees that are attractive and competitive in its industry, in order to ensure a steady stream of qualified, safety-conscious personnel to provide quality service to its customers.

DEVELOPMENTS DURING AND SUBSEQUENT TO THE SIX MONTHS ENDED DECEMBER 31, 2002

CHANGE IN FISCAL YEAR END

In December 2002, the Company's Board of Directors approved the Company's change of its fiscal year end from June 30 to December 31 of each year. As a result, this report covers the transition period

from July 1, 2002 through December 31, 2002 (referred to as "the six month period ended December 31, 2002" or the "Transition Period").

INDUSTRY CONDITIONS

During the Transition Period, operating conditions improved modestly; however, demand for services remained comparatively weak given the underlying strength of commodity prices and the historical relationship between commodity prices and activity levels. Although WTI Cushing prices for light sweet crude averaged approximately \$28.49 per barrel during the Transition Period and Nymex Henry Hub natural gas prices averaged approximately \$3.76 per MMBtu during the Transition Period, as compared to an average WTI Cushing price for light sweet crude of \$23.81 per barrel and an average Nymex Henry Hub natural gas price of \$2.77 per MMBtu during the fiscal year ended June 30, 2002, the Company did not experience a corresponding increase in its well servicing business. The Company believes the causes for this disparity include: (i) high natural gas inventories at the beginning of the Transition Period, which may have caused some of Key's customers to question the sustainability of the then current high natural gas price; (ii) negative impact on customers' hedging positions caused by the financial collapse of dominant counter-parties such as Enron and Dynegy; (iii) limited access to the capital markets for small to mid-size independents oil and natural gas production companies for development projects; (iv) focus by customers on use of cash flow for debt reduction or share repurchase programs; (v) uncertainty over the war in Iraq and political instability in the Middle East; and (v) overall concern about the U.S. and world economies.

Management believes that the current natural gas supply and storage conditions combined with declining U.S. natural gas production will eventually lead to increased demand for natural gas drilling. Furthermore, the Company believes that oilfield service activity, including well servicing, oilfield trucking and land drilling, tends to lag its customers' cash flows by several quarters which would imply that activity could improve during the later part of 2003.

The level of Key's revenues, cash flows, losses and earnings are substantially dependent upon, and affected by, the level of domestic and international oil and gas exploration and development activity (See Part II Item 7 Management's Discussion and Analysis of Results of Operations and Financial Condition).

ACQUISITIONS

Q Services, Inc. On July 19, 2002, Key acquired QSI pursuant to an Agreement and Plan of Merger dated May 13, 2002, as amended, by and among Key, Key Merger Sub, Inc. and QSI. As consideration for the acquisition, the Company issued approximately 17.1 million shares of its common stock to the QSI shareholders and paid approximately \$94.2 million in cash at the closing to retire debt and preferred stock of QSI and to satisfy certain other obligations of QSI. In addition to assuming the positive working capital of QSI, the Company incurred other direct acquisition costs and assumed certain other liabilities of QSI, resulting in the Company recording an aggregate purchase price of approximately \$250 million. The value of the shares issued was based on the closing price of the Key common stock on the closing date of \$8.75 per share. The results of QSI's operations have been included in the consolidated financial statements since the closing date. Prior to the acquisition, QSI was a privately held corporation conducting field production, pressure pumping and other service operations in Louisiana, New Mexico, Oklahoma, Texas and the Gulf of Mexico. The Company and QSI operated in adjacent and/or overlapping locations and expect to realize future cost savings and synergies in connection with the merger. The combination of the companies formed one of the largest oilfield trucking fleets in the United States complementing the Company's well service rig fleet, which based on the number of rigs owned and available industry data, is the largest in the world.

Other Acquisitions. During the Transition Period, the Company completed several small acquisitions for total consideration of \$15,620,000, which consisted of a combination of cash, a deferred non-compete

payment and shares of the Company's common stock. Other than QSI, none of the other acquisitions completed in the Transition Period were material individually or in the aggregate, thus the pro forma effect of these acquisitions is not presented. Each of the acquisitions was accounted for using the purchase method and the results of the operations generated from the acquired assets are included in the Company's results of operations as of the completion date of each acquisition.

NEW SENIOR CREDIT FACILITY

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On July 15, 2002, the Company entered into a Third Amended and Restated Credit Agreement, as amended by the First Amendment to the Third Amended and Restated Credit Agreement (the "Senior Credit Facility"). The Senior Credit Facility consists of a \$150,000,000 revolving loan facility with a \$75,000,000 sublimit for letters of credit. The loans are secured by most of the tangible and intangible assets of the Company. The revolving loan commitment will terminate on July 15, 2005 and all revolving loans must be paid on or before that date. The revolving loans bear interest based upon, at the Company's option, the prime rate plus a variable margin of 0.00% to 1.00% or a Eurodollar rate plus a variable margin of 1.75% to 3.00%. The Senior Credit Facility has customary affirmative and negative covenants including maximum leverage ratios, a minimum fixed charge coverage ratio and a minimum net worth, as well as limitations on liens and indebtedness and restrictions on dividends, acquisitions and dispositions.

DESCRIPTION OF BUSINESS SEGMENTS

Key operates in two primary business segments, which are well servicing and contract drilling. Key's operations are conducted domestically and internationally in Argentina, Egypt and Canada. The following is a description of each of these business segments (for financial information regarding these business segments, see Note 13 to Consolidated Financial Statements Business Segment Information).

WELL SERVICING

Key provides a full range of well services, including rig-based services, oilfield trucking services, well intervention services and other ancillary oilfield services necessary to maintain and workover oil and natural gas producing wells. Rig-based services include: maintenance of existing wells, workovers of existing wells, completion of newly drilled wells, recompletion of existing wells (including horizontal recompletions) and plugging and abandonment of wells at the end of their useful lives. Well intervention services include fishing and rental tool services and pressure pumping services.

Well Service Rigs

Key uses its well service rig fleet to perform four major categories of rig services for oil and natural gas producers.

Maintenance Services. Key provides the well service rigs, equipment and crews for maintenance services, which are performed on both oil and natural gas wells, but which are more commonly required on oil wells. While some oil wells in the United States flow oil to the surface without mechanical assistance, most require pumping or some other method of artificial lift. Oil wells that require pumping characteristically require more maintenance than flowing wells due to the operation of the mechanical pumping equipment. Few natural gas wells have mechanical pumping systems in the wellbore, and, as a result, maintenance work on natural gas wells is less frequent.

Maintenance services are required throughout the life of most producing oil and natural gas wells to ensure efficient and continuous operation. These services consist of routine mechanical repairs necessary to maintain production from the well, such as repairing inoperable pumping equipment in an oil well or replacing defective tubing in an oil or natural gas well, and removing debris such as sand and paraffin from the well. Other services include pulling the rods, tubing, pumps and other downhole equipment out of the wellbore to identify and repair a production problem.

Maintenance services are often performed on a series of wells in proximity to each other and typically require less than 48 hours per well to complete. The general demand for maintenance services is closely related to the total number of producing oil and natural gas wells in a geographic market, and maintenance services are generally the most stable type of well service activity.

Workover Services. In addition to periodic maintenance, producing oil and natural gas wells occasionally require major repairs or modifications, called "workovers." Workover services are performed to enhance the production of existing wells. Such services include extensions of existing wells to drain new formations either through deepening wellbores to new zones or by drilling horizontal lateral wellbores to improve reservoir drainage patterns. In less extensive workovers, Key's rigs are used to seal off depleted zones in existing wellbores and access previously bypassed productive zones. Key's workover rigs are also used to convert former producing wells to injection wells through which water or carbon dioxide is pumped into the formation for enhanced recovery operations. Other workover services include: major subsurface repairs such as casing repair or replacement, recovery of tubing and removal of foreign objects in the wellbore, repairing downhole equipment failures, plugging back the bottom of a well to reduce the amount of water being produced with the oil and natural gas, cleaning out and recompleting a well if production has declined, and repairing leaks in the tubing and casing. These extensive workover operations are normally performed by a well service rig with a workover package, which may include rotary drilling equipment, mud pumps, mud tanks and blowout preventers depending upon the particular type of workover operation. Most of Key's well service rigs are designed for and can be

equipped to perform complex workover operations.

Workover services are more complex and time consuming than routine maintenance operations and consequently may last from a few days to several weeks. These services are almost exclusively performed by well service rigs.

Completion Services. Key's completion services prepare a newly drilled oil or natural gas well for production. The completion process may involve selectively perforating the well casing to access producing zones, stimulating and testing these zones and installing downhole equipment. Key typically provides a well service rig and may also provide other equipment such as a workover package to assist in the completion process. Producers use well service rigs to complete their wells because the rigs have specialized equipment, properly trained employees and the experience necessary to perform these services. However, during periods of weak drilling rig demand, drilling contractors may compete with service rigs for completion work.

The completion process typically requires a few days to several weeks, depending on the nature and type of the completion, and generally requires additional auxiliary equipment that can be provided for an additional fee. The demand for well completion services is directly related to drilling activity levels, which are highly sensitive to expectations relating to, and changes in, oil and natural gas prices. As the number of newly drilled wells decreases, the number of completion jobs correspondingly decreases.

Plugging and Abandonment Services. Well service rigs and workover equipment are also used in the process of permanently closing oil and natural gas wells at the end of their productive lives. Plugging and abandonment work can be performed with a well servicing rig along with wireline and cementing equipment. The services generally include the sale or disposal of equipment salvaged from the well as part of the compensation received and require compliance with state regulatory requirements. The demand for oil and natural gas does not significantly affect the demand for plugging and abandonment services, as well operators are required by state regulations to plug a well that it is no longer productive. The need for these services is also driven by lease and/or operator policy requirements.

Oilfield Trucking

Upon completion of the acquisition of QSI, Key had substantially expanded its liquid/vacuum truck services and fluid transportation and disposal services for operators whose wells produce saltwater and

other fluids, in addition to oil and natural gas. Of the approximately 2,295 heavy oilfield service vehicles operated by the Company following the acquisition of QSI, the Company operates approximately 1,026 vacuum and transport trucks in the United States. In addition, Key owns approximately 2,968 frac tanks which are used in conjunction with its fluid hauling operations.

Fluid hauling trucks are utilized in connection with drilling and workover projects, which tend to produce and use large amounts of various oilfield fluids. Fluid hauling companies transport fresh water to the well site and provide temporary storage and disposal of produced salt water and drilling/workover fluids. These fluids are picked up at the well site and transported for disposal in a salt water disposal well of which Key owns approximately 130. In addition, Key provides haul/equipment trucks that are used to move large pieces of equipment from one wellsite to the next and operates a fleet of approximately 132 hot oilers, which are capable of heating pumped fluids that may be used to clear restrictions in a wellbore such as paraffin build-up. Demand and pricing for these services are generally related to demand for Key's well service and drilling rigs. Fluid hauling and equipment hauling services are typically priced on a per hour basis while frac tank rentals are typically billed on a per day basis.

Well Intervention Services

Through its acquisition of QSI in July 2002, Key significantly expanded its fishing and rental tool operations and added a pressure pumping business.

Fishing and Rental Tool Services. Founded in 1993, QSI's fishing and rental tool operation, Quality Tubular Services, Inc. ("QTS"), provides fishing and rental tool services to major and independent oil and natural gas production companies primarily in the Gulf Coast region of the United States. Fishing services involve recovering downhole equipment that has been lost or become trapped in the wellbore and a "fishing tool" is a tool specifically designed to recover that equipment lost or trapped in the well. QTS operates nine 24-hour service locations and four regional sales offices. The fishing tool supervisors have extensive experience with downhole problems. In addition, QTS offers a full line of services and equipment designed for the harsh elements from land to offshore. The rental tool inventory consists of tubulars, handling tools, pressure-control equipment and a fleet of power swivels. Key also provides fishing and rental tools through its Landmark Fishing and Rental Tools operation in the Mid-Continent region and at various other locations throughout the country.

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Pressure Pumping Services. Key's pressure pumping business operates under the name American Energy Services ("AES"). AES provides stimulation services, cementing services, nitrogen services, hydro-testing and production chemistry services to oil and natural gas producers. Key offers a full complement of acidizing technology, fracturing technology, nitrogen technology and cementing technology services. AES was established in December 1996 and operates in the Permian Basin, the San Juan Basin, and the Mid-Continent Region.

Ancillary Oilfield Services

Key provides ancillary oilfield services, which includes: wireline operations (lowering mechanical and electrical tools in the well); well site construction (preparation of a wellsite for drilling activities); roustabout services (coordination of equipment and supplies from an offshore rig to the shore base); foam units (drilling technique using air or gas to which a foaming agent has been added); and air drilling services (drilling technique using compressed air). Demand and pricing for these services are generally related to demand for Key's well service and drilling rigs.

CONTRACT DRILLING

Key provides contract drilling services to major oil companies and independent oil and natural gas producers onshore the continental United States in the Permian Basin, the Four Corners region, Michigan, the Northeast, and the Rocky Mountains and internationally in Argentina and Canada (Ontario). Contract

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drilling services are primarily provided under standard dayrate, and, to a lesser extent, footage or turnkey contracts. Drilling rigs vary in size and capability and may include specialized equipment. The majority of Key's drilling rigs are equipped with mechanical power systems and have depth ratings ranging from approximately 4,500 to 12,000 feet. Key has one drilling rig with a depth rating of approximately 18,000 feet. Like workover services, the demand for contract drilling is directly related to expectations relating to, and changes in, oil and natural gas prices which in turn, are driven by the supply of and demand for these commodities.

FOREIGN OPERATIONS

Key also operates each of its business segments discussed above in Argentina, Canada (Ontario) and Egypt. Key's foreign operations currently own approximately 25 well servicing rigs, 75 oilfield trucks and seven drilling rigs in Argentina, four well servicing rigs, four oilfield trucks and two drilling rigs in Ontario, Canada and five well servicing rigs and 10 oilfield trucks in the Arab Republic of Egypt.

CUSTOMERS

Key's customers include major oil companies, independent oil and natural gas production companies, and foreign national oil and natural gas production companies. One customer in the year ended June 30, 2002, Occidental Petroleum Corporation, accounted for approximately 10% of Key's consolidated revenues. No single customer in the six months ended December 31, 2002 accounted for 10% or more of Key's consolidated revenues.

COMPETITION AND OTHER EXTERNAL FACTORS

Despite the significant consolidation that has occurred in the domestic well servicing industry, there are numerous smaller companies that compete in Key's well servicing markets. Nonetheless, Key believes that its performance, equipment, safety, and availability of equipment to meet customer needs and availability of experienced, skilled personnel is superior to that of its competitors.

In the well servicing markets, an important competitive factor in establishing and maintaining long-term customer relationships is having an experienced, skilled and well-trained work force. In recent years, many of Key's larger customers have placed increased emphasis on the safety records and quality of the crews, equipment and services provided by their contractors. Key has, and will continue to devote substantial resources toward employee safety and training programs. Management believes that many of Key's competitors, particularly small contractors, have not undertaken similar training programs for their employees. Management believes that Key's safety record and reputation for quality equipment and service are among the best in the industry.

In the contract drilling market, Key competes with other regional and national oil and natural gas drilling contractors, some of which have larger rig fleets with greater average depth capabilities and a few that have better capital resources than Key. Management believes that the contract drilling industry is less consolidated than the well servicing industry, resulting in a contract drilling market that is more price competitive. Nonetheless, Key believes that it is competitive in terms of drilling performance, equipment, safety, pricing, availability of equipment to meet customer needs and availability of experienced, skilled personnel in those regions in which it operates.

The need for well servicing and contract drilling fluctuates, primarily, in relation to expectations relating to, and fluctuations in, the price of oil and natural gas which, in turn, is driven by the supply of and demand for oil and natural gas. As supply of those commodities decreases and demand increases, service and maintenance requirements tend to eventually increase as oil and natural gas producers attempt to maximize the producing efficiency of their wells in a higher priced environment.

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EMPLOYEES

As of December 31, 2002, Key employed approximately 8,409 persons (approximately 8,287 employees in its well servicing and contract drilling businesses and approximately 122 employees on its corporate staff). Key's employees are not represented by a labor union and are not covered by collective bargaining agreements. Key has not experienced work stoppages associated with labor disputes or grievances and considers its relations with its employees to be satisfactory.

ENVIRONMENTAL REGULATIONS

Key's operations are subject to various local, state and federal laws and regulations intended to protect the environment. Key's operations routinely involve the handling of waste materials, some of which are classified as hazardous substances. Consequently, the regulations applicable to Key's operations include those with respect to containment, disposal and controlling the discharge of any hazardous oilfield waste and other non-hazardous waste material into the environment, requiring removal and cleanup under certain circumstances, or otherwise relating to the protection of the environment. Laws and regulations protecting the environment have become more stringent in recent years, and may in certain circumstances impose "strict liability," rendering a party liable for environmental damage without regard to negligence or fault on the part of such party. Such laws and regulations may expose Key to liability for the conduct of, or conditions caused by, others, or for Key's acts, which were in compliance with all applicable laws at the times such acts were performed. Cleanup costs and other damages arising as a result of environmental laws, and costs associated with changes in environmental laws and regulations could be substantial and could have a material adverse effect on Key's financial condition. From time to time, claims have been made and litigation has been brought against Key under such laws. However, the uninsured costs incurred in connection with such claims and other costs of environmental compliance have not had any material adverse effect on Key's operations or financial statements in the past, and management is not currently aware of any situation or condition that it believes is likely to have any such material adverse effect in the future. Management believes that it conducts Key's operations in substantial compliance with all material federal, state and local regulations as they relate to the environment. Although Key has incurred certain costs in complying with environmental laws and regulations, such amounts have not been material to Key's financial results during the past three and one half years.

ITEM 2. PROPERTIES.

Key's corporate headquarters are located in Midland, Texas. In addition to its corporate headquarters, the corporate division leases two administrative office locations in Houston, Texas and New Hope, Pennsylvania. Key leases these office spaces from independent third parties. The Company leases the office space in Midland, Texas for approximately \$42,000 per month and the lease terminates on October 31, 2007. The lease in New Hope, Pennsylvania is for a term of 10 years beginning September 1, 2001 and the lease in Houston, Texas terminates on November 14, 2005. The Company pays an aggregate of approximately \$37,000 per month for each of the other two leases.

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WELL SERVICING AND CONTRACT DRILLING

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The following table sets forth the type, number and location of the major equipment owned and operated by Key's operating divisions as of December 31, 2002:

Operating Division	Well Service and Workover Rigs	Oilfield Trucks	Drilling Rigs
<i>Domestic:</i>			
Permian Basin (well servicing)	470	533	0
Gulf Coast	249	553	0
Mid-Continent	211	150	0
Four Corners	45	90	15
Eastern	91	253	3
Rocky Mountains	133	62	14
California	140	38	0
Ark-La-TX	116	250	0
North Texas	0	111	0
Quality Tubular Services	0	2	0
American Energy Services	0	114	0
Key Energy Drilling (Permian Basin)	0	50	38
Domestic Subtotal	1,455	2,206	70
<i>International:</i>			
Argentina	25	75	7
Canada	4	4	2
Egypt	5	10	0
International Subtotal	34	89	9
Totals	1,489	2,295	79

The Permian Basin Well Servicing division owns 39 and leases seven office and yard locations. The Gulf Coast division owns 26 and leases ten office and yard locations. The Mid-Continent division owns 17 and leases 16 office and yard locations. The Four Corners division owns six and leases two office and yard locations. The Eastern division owns three and leases ten office and yard locations. The Rocky Mountain division owns 16 and leases two office and yard locations. The California division owns one and leases three office and yard locations. The Permian Basin Drilling division owns two and leases two office and yard locations. The North Texas division owns three and leases three office and yard locations. The American Energy Services division leases 10 office and yard locations. The Quality Tubular Services division owns one and leases 10 office and yard locations. The Ark-La-Tx division owns 12 and leases six office and yard locations. The Argentina division owns one and leases two office and yard locations. The Canadian operation leases one yard location. The Egypt operation leases one yard location. Odessa Exploration owns interests in 223 gross (172 proved developed) oil leases and 57 gross (50 proved developed) gas leases.

The operating facilities are one or two story office and/or shop buildings. The buildings are occupied and considered to be in satisfactory condition.

ITEM 3. LEGAL PROCEEDINGS AND OTHER ACTIONS.

Various suits and claims arising in the ordinary course of business are pending against the Company. Management does not believe that the disposition of any of these items will result in a material adverse impact to the consolidated financial position, results of operations or cash flows of the Company.

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

None.

PART II**ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS.**

Key's common stock is currently traded on the New York Stock Exchange, under the symbol "KEG." As of December 31, 2002, there were 645 registered holders of 128,341,027 issued and outstanding shares of common stock, excluding 416,666 shares of common stock held in treasury.

The following table sets forth, for the periods indicated, the high and low sales prices of Key's common stock on the New York Stock Exchange for the six months ended December 31, 2002 and the years ended June 30, 2002 and 2001, as derived from published sources.

	<u>High</u>	<u>Low</u>
Six months ended December 31, 2002:		
Second Quarter	\$ 9.88	\$ 6.90
First Quarter	10.45	7.05
Year Ended June 30, 2002:		
Fourth Quarter	\$ 12.59	\$ 9.63
Third Quarter	11.45	7.20
Second Quarter	9.70	5.99
First Quarter	11.01	5.58
Year Ended June 30, 2001:		
Fourth Quarter	\$ 15.33	\$ 9.55
Third Quarter	13.52	8.13
Second Quarter	10.50	6.81
First Quarter	11.44	7.06

There were no dividends paid on Key's common stock during the six months ended December 31, 2002 or during years ended June 30, 2002, 2001 or 2000. Key does not intend to consider paying dividends on its common stock until its net funded debt to capitalization ratio is less than 25%. In addition, Key is contractually restricted from paying dividends under the terms of its existing credit facilities.

RECENT SALES OF UNREGISTERED SECURITIES

Key did not make any unregistered sales of its securities during the six months ended December 31, 2002 that were not previously reported in its Quarterly Reports filed for such period.

EQUITY COMPENSATION PLAN INFORMATION

The following table summarizes information, as of December 31, 2002, about the Company's common stock that may be issued upon the exercise of options that have been granted (i) under equity compensation plans that have been approved by the Company's shareholders and (ii) outside such plans. The only equity compensation plan that has been approved by the Company's shareholders is the Key Energy Group, Inc. 1997 Incentive Plan (the "Incentive Plan"). For a description of the Incentive Plan, see Note 8 to Consolidated Financial Statements Stockholders' Equity. All options not issued under the Incentive Plan (the "Non-Plan Options") were approved by the Board or the Compensation Committee under individual option grants (rather than under a separate equity compensation plan not approved by the Company's shareholders). The Non-Plan Options (i) expire in ten years, (ii) vest either on the grant date or ratably over a three-year period following the grant date, (iii) have exercise prices equal to or

greater than the market price at the date of the grant and (iv) have other terms similar to those options granted under the Incentive Plan.

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants, and rights (in thousands) (a)	Weighted-average exercise price of outstanding options, warrants, and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (in thousands) (c)
Equity compensation plans approved by the security holders	6,316	\$ 7.54	2,191(1)
Equity compensation plans not approved by the security holders	3,710	\$ 8.45	(2)
Total	10,026	\$ 7.88	2,191

- (1) The number of shares of the Company's common stock available for issuance under the Incentive Plan on any given date, subject to adjustment in certain circumstances, is equal to (i) 10% of the number of shares of the Company's common stock issued and outstanding on the last day of the calendar quarter immediately preceding such date (provided, however, that such number cannot decrease from one quarter to the next quarter), less (ii) the number of shares of the Company's common stock previously granted under the Incentive Plan through such date, plus (iii) the number of shares of the Company's common stock previously granted under the Incentive Plan that have been forfeited through such date.
- (2) Because the Non-Plan Options are comprised of individual grants outside the Incentive Plan, all shares available for issuance under the Non-Plan Options are reflected in column (a).

Item 6. Selected Financial Data.

	Six Months Ended December 31, 2002(1)	Year Ended June 30,				
		2002	2001	2000	1999(2)	1998
(in thousands, except per share amounts)						
OPERATING DATA:						
Revenues	\$ 408,998	\$ 802,564	\$ 873,262	\$ 637,732	\$ 491,817	\$ 424,543
Operating costs:						
Direct costs	288,945	554,773	582,154	471,169	374,308	296,328
Depreciation, depletion and amortization	51,111	78,265	75,147	70,972	62,074	31,001

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	Year Ended June 30,					
General and administrative	48,239	59,494	60,118	51,637	56,156	36,933
Interest	22,743	43,332	56,560	71,930	67,401	21,476
Foreign currency transaction loss, Argentina		1,443				
Debt issuance costs					6,307	
Restructuring charge					4,504	
(Gain) loss on retirement of debt	(18)	4,812	(684)	(2,191)		
Income (loss) before income taxes, minority interest, and cumulative effect	(2,022)	60,445	99,967	(25,785)	(78,933)	38,805
Net income (loss)	(4,376)	38,146	62,710	(18,959)	(53,258)	24,175
<i>Income (loss) per common share:</i>						
Basic	\$ (0.03)	\$ 0.36	\$ 0.64	\$ (0.23)	\$ (1.94)	1.41
Diluted	\$ (0.03)	\$ 0.35	\$ 0.61	\$ (0.23)	\$ (1.94)	1.23
<i>Average common shares outstanding:</i>						
Basic	125,367	105,766	98,195	83,815	27,501	17,153
Assuming full dilution	125,367	107,462	102,271	83,815	27,501	24,024
Common shares issued at period end	128,758	110,308	101,440	97,210	82,738	18,267
Market price per common share at period end	\$ 8.97	\$ 10.50	\$ 10.84	\$ 9.64	\$ 3.56	\$ 13.12
Cash dividends paid on common shares						
BALANCE SHEET DATA:						
Cash	\$ 9,044	\$ 54,147	\$ 2,098	\$ 109,873	\$ 23,478	\$ 25,265
Current assets	175,574	192,073	206,150	253,589	132,543	127,557
Property and equipment	1,291,853	1,093,104	1,014,675	920,437	871,940	547,537
Property and equipment, net	956,505	808,900	793,716	760,561	769,562	499,152
Total assets	1,502,002	1,242,995	1,228,284	1,246,265	1,148,138	698,640
Current liabilities	108,875	96,628	115,553	92,848	73,151	48,029
Long-term debt, including current portion	493,565	443,610	493,907	666,600	699,978	399,779
Stockholders' equity	696,368	536,866	476,878	382,887	288,094	154,928
OTHER DATA:						
Net cash provided by (used in):						
Operating activities	57,594	178,716	143,347	34,860	(13,427)	40,925
Investing activities	(146,073)	(108,749)	(83,980)	(37,766)	(294,654)	(306,339)
Financing activities	44,054	(17,315)	(167,142)	89,301	306,294	248,975
Working capital	66,699	95,445	90,597	160,741	59,392	79,528
Book value per common share(3)	\$ 5.41	\$ 4.87	\$ 4.70	\$ 3.94	\$ 3.47	\$ 8.48

- (1) Financial data for the six months December 31, 2002 includes the allocated purchase price of Q Services, Inc. and the results of their operations, beginning July 19, 2002.
- (2) Financial data for the year ended June 30, 1999 includes the allocated purchase price of Dawson Production Services, Inc. and the results of their operations, beginning September 15, 1998.
- (3) Book value per common share is stockholders' equity at period end divided by the number of issued common shares at period end.

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

Special Note: Certain statements set forth below under this caption constitute "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. See "Special Note Regarding Forward-Looking Statements" for additional factors relating to such statements.

The following discussion provides information to assist in the understanding of the Company's financial condition and results of operations. It should be read in conjunction with the consolidated financial statements and related notes appearing elsewhere in this report. Certain reclassifications have been made to the consolidated financial statements for the years ended June 30, 2001 and 2000 to conform to the six months ended December 31, 2002 and the year ended June 30, 2002 presentation. The reclassifications consist primarily of reclassifying certain items from general and administrative expense to direct expenses. In addition on July 1, 2002, the Company adopted the provisions of SFAS 145. See Note 19 to the consolidated financial statements. As used in this Item 7, references to composite well servicing rig rates means, for a given period, the total well servicing revenues for that period divided by the total well servicing hours for that period. As used in this Item 7, references to composite contract drilling rig rates means, for a given period, the total contract drilling revenues for that period divided by the total contract drilling hours for that period. As used in this Item 7, references to composite truck rates means, for a given period, the total trucking revenues for that period divided by the total trucking hours for that period.

RESULTS OF OPERATIONS

SIX MONTHS ENDED DECEMBER 31, 2002 VERSUS SIX MONTHS DECEMBER 31, 2001

The Company's results of operations for the six months ended December 31, 2002 reflect the general uncertainty about future oil and natural gas prices, including the customers' perception that commodity prices may decrease, which in turn caused a decline in demand for the Company's equipment and services partially offset by minimizing rate concessions (see Part I Item 1 Developments During and Subsequent to the Six Months Ended December 31, 2002).

The Company

The Company's revenue for the six months ended December 31, 2002 decreased \$53,576,000, or 11.6%, to \$408,998,000 from \$462,574,000 for the six months ended December 31, 2001. For the six months ended December 31, 2002, the Company incurred a net loss of \$4,376,000, representing a decrease of \$53,011,000, or 109.0%, from net income of \$48,635,000, for the six months ended December 31, 2001. The decrease in revenues and net income is principally due to lower levels of activity and lower pricing partially offset by the acquisition of QSI. Total rig hours for the six months ended December 31, 2002 declined approximately 20% compared to total rig hours for the six months ended December 31, 2001 coupled with a decrease in composite well servicing rig rates for the six months ended December 31, 2002 of approximately 7% and composite contract drilling rig rates for the six months ended December 31, 2002 of approximately 7% compared to composite well servicing rig rates and composite contract drilling rig rates for the six months ended December 31, 2001. While trucking hours for the six-month period ended December 31, 2002 increased approximately 29% compared to trucking hours for the six-month period ended December 31, 2001, the increase was principally due to the acquisition of QSI. Further, composite truck rates for the six-month period ended December 31, 2002 declined approximately 16% compared to the composite truck rates for six-month period ended December 31, 2001. The net loss in the six months ended December 31, 2002 was also affected by the cumulative effect of the Company's mandatory adoption of SFAS 143, costs associated with the integration of QSI, and unusually high general liability costs and start-up costs associated with the Company's new Egypt project.

Operating Revenues

Well Servicing. Well servicing revenues for the six months ended December 31, 2002 decreased \$27,968,000, or 7.0%, to \$370,871,000 from \$398,839,000 for the six months ended December 31, 2001. The

decrease in revenues was primarily due to a decline in activity and oilfield service rates partially offset by the acquisition of QSI. Well servicing hours for the six months ended December 31, 2002 declined approximately 18% compared to well servicing hours for the six months ended December 31, 2001, which was exacerbated by a decline in composite well servicing rig rates for the six months ended December 31, 2002 of approximately 7% compared to composite well servicing rig rates for the six months ended December 31, 2001. Trucking hours for the six months ended December 31, 2002 increased approximately 28% compared to trucking hours for the six months ended December 31, 2001. The increase was principally due to the acquisition of QSI. Further, composite truck rates for the six months ended December 31, 2002 declined

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approximately 16% compared to composite truck rates for the six months ended December 31, 2001.

Contract Drilling. Contract drilling revenues for the six months ended December 31, 2002 decreased \$25,658,000, or 43.3%, to \$33,632,000 from \$59,290,000 for the six months ended December 31, 2001. The decrease in revenues was primarily due to a decline in equipment utilization and pricing of contract drilling services. Contract drilling hours for the six months ended December 31, 2002 declined approximately 39% compared to contract drilling hours for the six months ended December 31, 2001. Composite contract drilling rig rates for the six months ended December 31, 2002 declined approximately 7% compared to composite contract drilling rig rates for the six months ended December 31, 2001.

Operating Expenses

Well Servicing. Well servicing expenses for the six months ended December 31, 2002 increased \$7,695,000, or 3%, to \$263,595,000 from \$255,900,000 for the six months ended December 31, 2001. Although well servicing hours decreased, expenses increased due to the acquisition and integration costs associated with QSI, higher insurance costs primarily in workers' compensation and health care, and start-up costs for the Company's new Egypt project. Well servicing expenses as a percentage of well servicing revenues increased from 64.2% for the six months ended December 31, 2001 to 71.1% for the six months ended December 31, 2002.

Contract Drilling. Contract drilling expenses for the six months ended December 31, 2002 decreased \$15,112,000, or 39.2%, to \$23,416,000 from \$38,528,000 for the six months ended December 31, 2001. The decrease is primarily due to lower activity levels, which was partially offset by higher insurance costs primarily in workers' compensation and health care. Contract drilling expenses as a percentage of contract drilling revenues increased from 65.0% for the six months ended December 31, 2001 to 69.6% for the six months ended December 31, 2002.

Depreciation, Depletion and Amortization Expense

The Company's depreciation, depletion and amortization expense for the six months ended December 31, 2002 increased \$13,518,000, or 36.0%, to \$51,111,000 from \$37,593,000 for the six months ended December 31, 2001. The increase is primarily due to the acquisition of QSI, which added approximately \$142,264,000 in net depreciable assets, and capital expenditures during the prior year as the Company continued remanufacturing well servicing and contract drilling equipment.

General and Administrative Expenses

The Company's general and administrative expenses for the six months ended December 31, 2002 increased \$19,320,000, or 66.8%, to \$48,239,000 from \$28,919,000 for the six months ended December 31, 2001. The increase was primarily due to the acquisition of QSI and costs associated with the integration of QSI, higher general liability costs including settlement expenses, and additional personnel supporting the implementation of information technology. General and administrative expenses, as a percentage of revenues, increased from 6.3% for the six months ended December 31, 2001 to 11.8% for the six months ended December 31, 2002.

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Interest Expense

The Company's interest expense for the six months ended December 31, 2002 decreased \$303,000, or 1.3%, to \$22,743,000 from \$23,046,000 for the six months ended December 31, 2001. The restructuring of the Company's long-term debt resulted in a decline in the Company's incremental borrowing rate of approximately 1%. Included in the interest expense was the amortization of debt issuance costs of \$2,103,000 and \$1,393,000 for the six months ended December 31, 2002 and 2001, respectively.

Gain on Retirement of Debt

During the six months ended December 31, 2002, the Company repurchased an aggregate principal amount of \$397,000 of its long-term debt at various discounts and premiums to par value and expensed related unamortized debt issuance costs, all of which resulted in a gain of \$18,000. The repurchase of the long term debt was part of the Company's overall plan to reduce and restructure its long term debt and to restructure debt maturities.

Cumulative Effect on Prior Years of a Change in Accounting Principle

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On July 1, 2002, the Company adopted Statement of Financial Accounting Standards No. 143, Accounting for Asset Retirement Obligations ("SFAS 143"). Adoption of SFAS 143 is required for all companies with fiscal years beginning after June 15, 2002. The new standard requires the Company to recognize a liability for the present value of all legal obligations associated with the retirement of tangible long-lived assets and capitalize an equal amount as a cost of the asset depreciating the additional cost over the estimated useful life of the asset. On July 1, 2002, the Company recorded additional costs, net of accumulated depreciation, of approximately \$3,347,000, a non-current liability of approximately \$7,980,000 and an after-tax charge of approximately \$2,873,000 for the cumulative effect on prior years for depreciation of the additional costs and accretion expense on the liability related to expected abandonment costs of its oil and natural gas producing properties and salt water disposal wells. At December 31, 2002, the asset retirement obligation was \$9,231,000, and the increase in the balance from July 1, 2002 of \$1,251,000 is due to accretion expense of \$226,000 and asset retirement obligations of QSI of \$1,025,000 assumed in the purchase transaction. The pro forma amounts of the asset retirement obligation as of June 30, 2002, 2001, 2000 and 1999, were approximately \$7,980,000, \$7,581,000, \$7,182,000 and \$6,783,000, respectively. The pro forma amounts of the asset retirement obligation were measured using information, assumptions and interest rates as of the adoption date of July 1, 2002. Pro forma net income (loss) and related per share amounts for the years ended June 30, 2002, 2001 and 2000, assuming SFAS 143 had been applied in each year are as follows:

	Year Ended		
	2002	2001	2000
	(Thousands, except per share amount)		
Pro forma net income (loss)	\$ 37,894	\$ 62,460	\$ (19,252)
Earnings (loss) per share			
Basic	\$ 0.36	\$ 0.64	\$ (0.23)
Diluted	\$ 0.35	\$ 0.61	\$ (0.23)

Income Taxes

The Company's income tax expense for the six months ended December 31, 2002 decreased \$29,938,000 from an income tax expense of \$29,419,000 for the six months ended December 31, 2001 to an income tax benefit of \$519,000. The decrease in income tax expense is due to decreased pre-tax income. The Company's effective tax rate for the six months ended December 31, 2002 and 2001 was 25.7% and 37.7%, respectively. The effective tax rates are different from the statutory rate of 35% primarily because of non-deductible expenses and the effects of state and local taxes.

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Cash Flow

The Company's net cash provided by operating activities for the six months ended December 31, 2002 decreased \$45,223,000 to \$57,594,000 from \$102,817,000 for the six months ended December 31, 2001. The decrease is primarily due to decreased net income.

The Company's net cash used in investing activities for the six months ended December 31, 2002 increased \$96,125,000 to \$146,073,000 from \$49,948,000 for the six months ended December 31, 2001. The Company used cash of approximately \$105,365,000 for the purchase of QSI and other smaller acquisitions, which principally accounts for the increase in net cash used in investing activities.

The Company's net cash provided by financing activities for the six months ended December 31, 2002 was \$44,054,000, representing an increase of \$90,863,000 from a use of \$46,809,000 for the six months ended December 31, 2001. For the six months ended December 31, 2002, the Company increased net borrowings by \$46,685,000 principally in connection with the purchase of QSI. For the six months ended December 31, 2001, the Company reduced net borrowings by \$90,930,000 which was partially funded by net proceeds of \$42,590,000 from an equity offering.

The effect of exchange rates on cash for the six months ended December 31, 2002 and 2001 was a use of \$678,000 and \$192,000, respectively. This was a result of the devaluation of the Argentine peso for the six months ended December 31, 2002 and 2001.

YEAR ENDED JUNE 30, 2002 VERSUS YEAR ENDED JUNE 30, 2001

The Company's results of operations for the year ended June 30, 2002 reflect the impact of a decline in industry conditions resulting from decreased commodity prices (and its customers' perception that commodity prices may decrease further) which in turn caused a decline in demand for the Company's equipment and services partially offset by minimizing rate concessions and lower interest charges during the year

ended June 30, 2002.

The Company

Revenues for the year ended June 30, 2002 decreased \$70,698,000, or 8.1%, to \$802,564,000 from \$873,262,000 for the year ended June 30, 2001, while net income for the year ended June 30, 2002 decreased \$24,564,000, or 39.2%, to \$38,146,000 from a net income of \$62,710,000 for the year ended June 30, 2001. The decrease in revenues and net income is due to lower levels of activity partially offset by higher pricing, with lower interest expense from debt reduction also contributing to net income. Composite truck rates for the year ended June 30, 2002 increased approximately 23% compared to composite truck rates for the year ended June 30, 2001. Composite well servicing rig rates and composite contract drilling rig rates for the year ended June 30, 2002 increased approximately 13% and 11%, respectively, compared to composite well servicing rig rates and composite contract drilling rig rates for the year ended June 30, 2001. However, total rig and trucking hours for the year ended June 30, 2002 decreased approximately 14% and 5%, respectively, compared to total rig and trucking hours for the year ended June 30, 2001. In addition, well servicing rig rates and contract drilling rig rates experienced later in the year ended June 30, 2002 had declined significantly from those rates experienced earlier in the period.

Operating Revenues

Well Servicing. Well servicing revenues for the year ended June 30, 2002 decreased \$51,644,000, or 6.8%, to \$706,629,000 from \$758,273,000 for the year ended June 30, 2001. The decrease was due to lower demand for the Company's well servicing equipment and services partially offset by higher pricing. Well servicing hours for the year ended June 30, 2002 decreased approximately 13% compared to well servicing hours for the year ended June 30, 2001, while composite well servicing rig rates for the year ended June 30, 2002 increased approximately 13% compared to composite well servicing rig rates for the year ended June 30, 2001.

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Contract Drilling. Contract drilling revenues for the year ended June 30, 2002 decreased \$20,562,000, or 19.1%, to \$87,077,000 from \$107,639,000 for the year ended June 30, 2001. The decrease was due to lower demand for the Company's contract drilling equipment and services partially offset by higher pricing. Contract drilling hours for the year ended June 30, 2002 declined approximately 27% compared to contract drilling hours for the year ended June 30, 2001, while composite contract drilling rig rates for the year ended June 30, 2002 increased approximately 11% compared to composite contract drilling rig rates for the year ended June 30, 2001.

Operating Expenses

Well Servicing. Well servicing expenses for the year ended June 30, 2002 decreased \$10,643,000, or 2.1%, to \$489,681,000 from \$500,324,000 for the year ended June 30, 2001. The decrease in expenses is due to lower activity levels partially offset by higher insurance costs primarily in workers' compensation and health care. Despite the decreased costs, well servicing expenses as a percentage of well servicing revenues increased from 66.0% for the year ended June 30, 2001 to 69.3% for the year ended June 30, 2002 primarily due to the increase in insurance costs.

Contract Drilling. Contract drilling expenses for the year ended June 30, 2002 decreased \$16,805,000, or 21.7%, to \$60,561,000 from \$77,366,000 for the year ended June 30, 2001. The decrease is due to lower activity levels partially offset by higher insurance costs primarily in workers' compensation and health care. Contract drilling expenses as a percentage of contract drilling revenues decreased from 71.9% for the year ended June 30, 2001 to 69.6% for the year ended June 30, 2002. The marginal improvement is due to improved operating efficiencies and the effects of higher pricing partially offset by the increase in insurance costs.

Depreciation, Depletion and Amortization Expense

The Company's depreciation, depletion and amortization expense for the year ended June 30, 2002 increased \$3,118,000, or 4.1%, to \$78,265,000 from \$75,147,000 for the year ended June 30, 2001. The increase is due to recent acquisitions and increased capital expenditures during the past year as the Company continued remanufacturing well servicing and contract drilling equipment partially offset by discontinued amortization of goodwill, which amounted to \$9,322,000 for the year ended June 30, 2001, because of the Company's adoption of SFAS 142.

General and Administrative Expenses

The Company's general and administrative expenses for the year ended June 30, 2002 decreased \$624,000, or 1.0%, to \$59,494,000 from \$60,118,000 for the year ended June 30, 2001. The decrease was due to reductions in incentive payroll costs partially offset by additional expenses incurred as a result of moving the corporate headquarters to Midland, Texas from East Brunswick, New Jersey and increases in personnel supporting information technology functions. Despite the decreased costs, general and administrative expenses as a percentage of total

revenues increased from 6.9% for the year ended June 30, 2001 to 7.4% for the year ended June 30, 2002.

Interest Expense

The Company's interest expense for the year ended June 30, 2002 decreased \$13,228,000, or 23.4%, to \$43,332,000 from \$56,560,000 for the year ended June 30, 2001. The decrease was primarily due to a significant reduction in the Company's long-term debt using proceeds from an equity offering, a debt offering and operating cash flow, and to a lesser extent, lower interest rates. Included in the interest expense was the amortization of debt issuance costs of \$2,581,000 and \$3,578,000 for the years ended June 30, 2002 and 2001, respectively.

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Foreign Currency Transaction Loss

During the year ended June 30, 2002, the Company recorded an Argentine foreign currency transaction loss of approximately \$1,443,000 related to dollar-denominated receivables resulting from the recent devaluation of Argentina's currency.

Loss on Retirement of Debt

During the year ended June 30, 2002, the Company repurchased an aggregate principal amount of \$150,908,000 of its long-term debt at various discounts and premiums to par value and expensed related unamortized debt issuance costs, all of which resulted in a loss of \$4,812,000. The repurchase of the long-term debt was part of the Company's overall plan to reduce and restructure its long-term debt. The repurchase of the long-term debt was intended to reduce interest rates and restructure debt maturities.

Income Taxes

The Company's income tax expense for the year ended June 30, 2002 decreased \$14,958,000 to \$22,299,000 from \$37,257,000 for the year ended June 30, 2001. The decrease in income tax expense is due to decreased pre-tax income. The Company's effective tax rate for the years ended June 30, 2002 and 2001 was 36.9% and 37.3%, respectively. The effective tax rates vary from the statutory federal rate of 35% principally because of the disallowance of certain goodwill amortization (for the year ended June 30, 2001), and other non-deductible expenses and the effects of state and local taxes.

Cash Flow

The Company's net cash provided by operating activities for the year ended June 30, 2002 increased \$35,369,000 to \$178,716,000 from \$143,347,000 for the year ended June 30, 2001. The increase, despite lower net income for the year ended June 30, 2002 compared to the net income for the year ended June 30, 2001, is primarily due to a decrease in the components of working capital, specifically accounts receivable and accounts payable. The reduction in working capital is primarily due to lower levels of activity.

The Company's net cash used in investing activities for the year ended June 30, 2002 increased \$24,769,000 to \$108,749,000 from \$83,980,000 for the year ended June 30, 2001. The increase for the year ended June 30, 2002 is due primarily to higher capital expenditures, approximately 13% higher than that incurred in the year ended June 30, 2001, and an increase in acquisitions of well servicing and contract drilling equipment.

The Company's net cash used in financing activities for the year ended June 30, 2002 decreased \$149,827,000 to \$17,315,000 from \$167,142,000 for the year ended June 30, 2001. The decrease is primarily the result of higher proceeds from debt and equity offerings completed during the year ended June 30, 2002 compared to financing proceeds received in the year ended June 30, 2001. While the Company continued its debt reduction strategy during the year ended June 30, 2002, total debt reductions for the year ended June 30, 2002 decreased to approximately \$51 million compared to the year ended June 30, 2001 of approximately \$169 million.

The effect of exchange rates on cash for the year ended June 30, 2002 was a use of \$603,000. This was a result of the devaluation of the Argentine peso for the year ended June 30, 2002.

YEAR ENDED JUNE 30, 2001 VERSUS YEAR ENDED JUNE 30, 2000

The Company's results of operations for the year ended June 30, 2001 reflect the impact of favorable industry conditions resulting from increased commodity prices which in turn caused increased demand for the Company's equipment and services during the year ended June 30, 2001. The positive impact of this increased demand on the Company's operating results was partially offset by increased operating expenses

incurred as a result of the increase in the Company's business activity.

The Company

Revenues for the year ended June 30, 2001 increased \$235,530,000, or 36.9%, to \$873,262,000 from \$637,732,000 for the year ended June 30, 2000, while net income for the year ended June 30, 2001 increased \$81,669,000 to \$62,710,000 from a net loss of \$18,959,000 for the year ended June 30, 2000. The increase in revenues and net income is due to improved operating conditions, higher rig hours, and increased pricing, with lower interest expense from debt reduction also contributing to net income. Total rig and trucking rig hours for the year ended June 30, 2001 increased approximately 18% and 9%, respectively, compared to the total rig and trucking hours for the year ended June 30, 2000. Composite well servicing rig rates and composite contract drilling rig rates for the year ended June 30, 2001 improved approximately 19% and 17%, respectively, compared to composite well servicing rig rates and composite contract drilling rig rates for the year ended June 30, 2000, while composite truck rates for the year ended June 30, 2001 improved approximately 20% compared to composite truck rates for the year ended June 30, 2000.

Operating Revenues

Well Servicing. Well servicing revenues for the year ended June 30, 2001 increased \$198,781,000, or 35.5%, to \$758,273,000 from \$559,492,000 for the year ended June 30, 2000. The increase was due to increased demand for the Company's well servicing equipment and services and higher pricing. Well servicing hours for the year ended June 30, 2001 increased approximately 16% compared to the well servicing hours for the year ended June 30, 2000, while composite well servicing rates for the year ended June 30, 2001 improved approximately 19% compared to the composite well servicing rates for the year ended June 30, 2000.

Contract Drilling. Contract drilling revenues for the year ended June 30, 2001 increased \$39,211,000, or 57.3%, to \$107,639,000 from \$68,428,000 for the year ended June 30, 2000. The increase was due to increased demand for the Company's contract drilling equipment and services and higher pricing. Contract drilling hours for the year ended June 30, 2001 increased approximately 35% compared to the contract drilling hours for the year ended June 30, 2000, while composite contract drilling rates improved approximately 17% compared to the composite contract drilling rates for the year ended June 30, 2000.

Operating Expenses

Well Servicing. Well servicing expenses for the year ended June 30, 2001 increased \$91,601,000, or 22.4%, to \$500,324,000 from \$408,723,000 for the year ended June 30, 2000. The increase in expenses is due to higher utilization of the Company's well servicing equipment, higher labor costs and the overall increase in the Company's well servicing business. Despite the increased costs, well servicing expenses as a percentage of well servicing revenues decreased from 73.1% for the year ended June 30, 2000 to 66.0% for the year ended June 30, 2001. The marginal improvement is due to improved operating efficiencies and the effects of higher pricing.

Contract Drilling. Contract drilling expenses for the year ended June 30, 2001 increased \$19,067,000, or 32.7%, to \$77,366,000 from \$58,299,000 for the year ended June 30, 2000. The increase is due to higher utilization of the Company's contract drilling equipment, higher labor costs and the overall increase in the Company's contract drilling business. Despite the increased costs, contract drilling expenses as a percentage of contract drilling revenues decreased from 85.2% for the year ended June 30, 2000 to 71.9% for the year ended June 30, 2001. The marginal improvement is due to improved operating efficiencies and the effects of higher pricing.

Depreciation, Depletion and Amortization Expense

The Company's depreciation, depletion and amortization expense for the year ended June 30, 2001 increased \$4,175,000, or 5.9%, to \$75,147,000 from \$70,972,000 for the year ended June 30, 2000. The increase is due to higher capital expenditures incurred during the year ended June 30, 2001 as the

Company remanufactured equipment and increased utilization of its contract drilling equipment (which it depreciates partially based on utilization).

General and Administrative Expenses

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The Company's general and administrative expenses for the year ended June 30, 2001 increased \$8,481,000, or 16.4%, to \$60,118,000 from \$51,637,000 for the year ended June 30, 2000. The increase was due to higher administrative costs resulting from the growth of the Company's operations as a result of improved industry conditions. Despite the increased costs, general and administrative expenses as a percentage of total revenues declined from 8.1% for the year ended June 30, 2000 to 6.9% for the year ended June 30, 2001.

Interest Expense

The Company's interest expense for the year ended June 30, 2001 decreased \$15,370,000, or 21.4%, to \$56,560,000 from \$71,930,000 for the year ended June 30, 2000. The decrease was primarily due to the impact of the long-term debt reduction during the year ended June 30, 2001 and, to a lesser extent, lower short-term interest rates and borrowing margins on floating rate debt.

Gain on Retirement of Debt

During the year ended June 30, 2001, the Company repurchased \$257,115,000 of its long-term debt at various discounts and premiums to par value and expensed related unamortized debt issue costs, all of which resulted in a gain of \$684,000. The repurchase of the long-term debt was made in connection with the Company's overall strategy to reduce and restructure its long-term debt. The repurchase was intended to lower fixed interest rates and restructure debt maturities.

Income Taxes

The Company's income tax expense for the year ended June 30, 2001 increased \$44,083,000 to \$37,257,000 from a benefit of \$6,826,000 for the year ended June 30, 2000. The increase in income tax expense is due to increased pre-tax income. The Company's effective tax rate for the years ended June 30, 2001 and 2000 was 37.3% and (26.5)%, respectively. The effective tax rates vary from the statutory federal rate of 35% principally because of certain non-deductible goodwill amortization, other non-deductible expenses and state and local taxes.

Cash Flow

The Company's net cash provided by operating activities for the year ended June 30, 2001 increased \$108,487,000 to \$143,347,000 from \$34,860,000 for the year ended June 30, 2000. The increase is due to higher revenues resulting from increased demand for the Company's equipment and services and higher pricing, partially offset by higher operating and general and administrative expenses resulting from increased business activity.

The Company's net cash used in investing activities for the year ended June 30, 2001 increased \$46,214,000 to \$83,980,000 from \$37,766,000 for the year ended June 30, 2000. The increase is due primarily to higher capital expenditures.

The Company's net cash used in financing activities for the year ended June 30, 2001 increased \$256,443,000 to a use of \$167,142,000 from cash provided of \$89,301,000 for the year ended June 30, 2000. The increase is primarily the result of significant debt reduction during the year ended June 30, 2001, partially offset by proceeds from a debt offering and the exercise of stock options and warrants during the year ended June 30, 2001.

LIQUIDITY AND CAPITAL RESOURCES

The Company has historically funded its operations, acquisitions, capital expenditures and working capital requirements from cash flow from operations, bank borrowings and the issuance of equity and

long-term debt. The Company believes that its current reserves of cash and cash equivalents, availability of its existing credit lines, access to capital markets and internally generated cash flow from operations are sufficient to finance the cash requirements of its current and future operations, acquisitions and capital expenditures.

The Company's cash and cash equivalents decreased \$45,103,000 to \$9,044,000 as of December 31, 2002 from \$54,147,000 as of June 30, 2002. The Company used its available cash to partially fund the acquisition of QSI.

As of December 31, 2002 the Company had working capital (excluding the current portion of long-term debt of \$7,008,000) of approximately \$73,707,000, which includes cash and cash equivalents of approximately \$9,044,000, as compared to working capital (excluding

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the current portion of long-term debt of \$7,674,000) of approximately \$103,119,000, which includes cash and cash equivalents of approximately \$54,147,000 as of June 30, 2002. The decrease in working capital is primarily due to a decrease in cash and cash equivalents, which was used to partially fund the acquisition of QSI that was partially offset by an increase in accounts receivable and inventories from the QSI acquisition.

LONG-TERM DEBT

Other than capital lease obligations and miscellaneous notes payable, as of December 31, 2002, the Company's long-term debt was comprised of (i) a senior credit facility, (ii) a series of 8³/₈% Senior Notes Due 2008, (iii) a series of 14% Senior Subordinated Notes Due 2009, and (iv) a series of 5% Convertible Subordinated Notes Due 2004.

Senior Credit Facility

On July 15, 2002, the Company entered into a Third Amended and Restated Credit Agreement, as amended by the First Amendment to the Third Amended and Restated Credit Agreement (the "Senior Credit Facility"). The Senior Credit Facility consists of a \$150,000,000 revolving loan facility with a \$75,000,000 sublimit for letters of credit. The loans are secured by most of the tangible and intangible assets of the Company. The revolving loan commitment will terminate on July 15, 2005 and all revolving loans must be paid on or before that date. The revolving loans bear interest based upon, at the Company's option, the prime rate plus a variable margin of 0.00% to 1.00% or a Eurodollar rate plus a variable margin of 1.75% to 3.00%. The Senior Credit Facility has customary affirmative and negative covenants including a maximum leverage ratio, a minimum fixed charge coverage ratio and a minimum net worth, as well as limitations on liens and indebtedness and restrictions on dividends, acquisitions and dispositions. As of December 31, 2002, the Company was in compliance with all covenants contained in the Senior Credit Facility.

As of December 31, 2002, approximately \$52,000,000 was outstanding under the revolving loan facility and approximately \$34,963,000 of letters of credit related to workers' compensation insurance were outstanding. The Company drew down approximately \$53 million on July 19, 2002 in connection with the acquisition of QSI.

8³/₈% Senior Notes

On March 6, 2001, the Company completed a private placement of \$175,000,000 of 8³/₈% Senior Notes due 2008 (the "8³/₈% Senior Notes"). The net cash proceeds from the private placement were used to repay all of the remaining balance of the original term loans under the Company's then outstanding senior credit facility (the "Prior Senior Credit Facility"), and a portion of the revolving loan facility under the Prior Senior Credit Facility then outstanding. On March 1, 2002, the Company completed a public offering of an additional \$100,000,000 of 8³/₈% Senior Notes due 2008. The net cash proceeds from the public offering were used to repay all of the remaining balance of the revolving loan facility under the Prior Senior Credit Facility. The 8³/₈% Senior Notes are senior unsecured obligations and are fully and unconditionally guaranteed by all of the Company's significant subsidiaries. The 8³/₈% Senior Notes are

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effectively subordinated to Key's secured indebtedness, which includes borrowings under the Senior Credit Facility.

On and after March 1, 2005, the Company may redeem some or all of the 8³/₈% Senior Notes at any time at varying redemption prices in excess of par, plus accrued interest. In addition, before March 1, 2004, the Company may redeem up to 35% of the aggregate principal amount of the 8³/₈% Senior Notes with the proceeds of certain sales of equity at 108.375% of par plus accrued interest.

At December 31, 2002, \$275,000,000 principal amount of the 8³/₈% Senior Notes remained outstanding. The 8³/₈% Senior Notes require semi-annual interest payments on March 1 and September 1 of each year. Interest of approximately \$11,516,000 was paid on September 1, 2002. As of December 31, 2002, the Company was in compliance with all covenants contained in the 8³/₈% Senior Notes.

14% Senior Subordinated Notes

On January 22, 1999, the Company completed the private placement of 150,000 units (the "Units") consisting of \$150,000,000 of 14% Senior Subordinated Notes due 2009 (the "14% Senior Subordinated Notes") and 150,000 warrants to purchase 2,173,433 shares of the Company's common stock at an exercise price of \$4.88125 per share (the "Unit Warrants"). The net cash proceeds from the private placement were used to repay substantially all of the remaining \$148,600,000 principal amount (plus accrued interest) owed under the Company's bridge loan facility arranged in connection with the acquisition of Dawson Production Services, Inc. ("Dawson").

On and after January 15, 2004, the Company may redeem some or all of the 14% Senior Subordinated Notes at any time at varying redemption prices in excess of par, plus accrued interest. In addition, before January 15, 2002, the Company was allowed to redeem up to 35%

of the aggregate principal amount of the 14% Senior Subordinated Notes at 114% of par plus accrued interest with the proceeds of certain sales of equity. During the year ended June 30, 2001, the Company exercised its right of redemption for \$10,313,000 principal amount of the 14% Senior Subordinated Notes at a price of 114% of the principal amount plus accrued interest. This transaction resulted in a loss before taxes of approximately \$2,561,000. On January 14, 2002, the Company exercised its right of redemption for \$35,403,000 principal amount of the 14% Senior Subordinated Notes at a price of 114% of the principal amount plus accrued interest. This transaction resulted in a loss before taxes of approximately \$8,468,000. Also, during the year ended June 30, 2002, the Company purchased and canceled \$6,784,000 principal amount of the 14% Senior Subordinated Notes at a price of 116% of the principal amount plus accrued interest. These transactions resulted in a loss before taxes of approximately \$1,821,000.

The Unit Warrants have separated from the 14% Senior Subordinated Notes and became exercisable on January 25, 2000. On the date of issuance, the value of the Unit Warrants was estimated at \$7,434,000 and is classified as a discount to the 14% Senior Subordinated Notes on the Company's consolidated balance sheet. The discount is being amortized to interest expense over the term of the 14% Senior Subordinated Notes. The 14% Senior Subordinated Notes mature and the Unit Warrants expire on January 15, 2009. The 14% Senior Subordinated Notes are subordinate to the Company's senior indebtedness, which includes borrowings under the Senior Credit Facility and the 8³/₈% Senior Notes. The Senior Subordinated Notes are fully and unconditionally guaranteed by the Company's significant subsidiaries.

At December 31, 2002, \$97,500,000 principal amount of the 14% Senior Subordinated Notes remained outstanding. The 14% Senior Subordinated Notes pay interest semi-annually on January 15 and July 15 of each year. Interest of approximately \$6,825,000 was paid on July 15, 2002. As of December 31, 2002, 63,500 Unit Warrants had been exercised, producing approximately \$4,173,000 of proceeds to the Company and leaving 86,500 Unit Warrants outstanding. As of December 31, 2002, the Company was in compliance with all covenants contained in the 14% Senior Subordinated Notes.

5% Convertible Subordinated Notes

In 1997, the Company completed a private placement of \$216,000,000 of 5% Convertible Subordinated Notes due 2004 (the "5% Convertible Subordinated Notes"). The 5% Convertible Subordinated Notes are subordinate to the Company's senior indebtedness which includes borrowings under the Senior Credit Facility, the 14% Senior Subordinated Notes and the 8³/₈% Senior Notes. The 5% Convertible Subordinated Notes are convertible, at the holder's option, into shares of the Company's common stock at a conversion price of \$38.50 per share, subject to certain adjustments. The 5% Convertible Subordinated Notes are redeemable, at the Company's option, on and after September 15, 2000, in whole or part, together with accrued and unpaid interest. The initial redemption price is 102.86% for the year beginning September 15, 2000 and declines ratably thereafter on an annual basis.

During the year ended June 30, 2001, the Company repurchased (and canceled) \$47,384,000 principal amount of the 5% Convertible Subordinated Notes. These repurchases resulted in gains of approximately \$4,564,000. During the year ended June 30, 2002, the Company repurchased (and canceled) \$108,475,000 principal amount of the 5% Convertible Subordinated Notes, leaving \$49,951,000 principal amount of the 5% Convertible Subordinated Notes outstanding at June 30, 2002. These repurchases resulted in gains of approximately \$5,633,000. During the six months ended December 31, 2002, the Company has repurchased (and canceled) an additional \$397,000 principal amount of the 5% Convertible Subordinated Notes, leaving \$49,554,000 outstanding as of December 31, 2002. These repurchases resulted in a gain of approximately \$18,000. Interest on the 5% Convertible Subordinated Notes is payable on March 15 and September 15 of each year. Interest of approximately \$1,244,000 was paid on September 15, 2002. As of December 31, 2002, the Company was in compliance with all covenants contained in the 5% Convertible Subordinated Notes.

CRITICAL ACCOUNTING POLICIES

The Company prepares its consolidated financial statements in accordance with accounting principles generally accepted in the U.S. and follows certain significant accounting policies when preparing its consolidated financial statements. A complete summary of these policies is included in Note 1 to the consolidated financial statements included herein.

Certain of the policies require management to make significant and subjective estimates, judgments and assumptions that it believes are reasonable based upon the information available. These estimates and assumptions affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the periods presented. In particular, management makes estimates regarding the fair value of the Company's reporting units in assessing potential impairment of goodwill. In addition, the Company makes estimates regarding future undiscounted cash flows from the future use of long-lived assets whenever events or changes in circumstances indicate that the carrying amount of a long-lived asset may not be recoverable.

In assessing impairment of goodwill, the Company has used estimates and assumptions in estimating the fair value of its reporting units. Actual future results could be different than the estimates and assumptions used. Events or circumstances which might lead to an indication of impairment of goodwill would include, but might not be limited to, prolonged decreases in expectations of long-term well servicing and/or drilling activity or rates brought about by prolonged decreases in oil or natural gas prices, changes in government regulation of the oil and natural gas industry or other events which could affect the level of activity of exploration and production companies.

In assessing impairment of long-lived assets other than goodwill where there has been a change in circumstances indicating that the carrying amount of a long-lived asset may not be recoverable, the Company has estimated future undiscounted net cash flows from use of the asset based on actual historical results and expectations about future economic circumstances including oil and natural gas prices and operating costs. The estimate of future net cash flows from use of the asset could change if actual prices and costs differ due to industry conditions or other factors affecting the Company's performance.

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RECENTLY ISSUED FINANCIAL ACCOUNTING STANDARDS

In June 2002, the FASB issued Statement of Financial Accounting Standards No. 146, Accounting for Costs Associated with Exit or Disposal Activities ("SFAS 146"). SFAS 146 establishes requirements for financial accounting and reporting for costs associated with exit or disposal activities. SFAS 146 is effective for exit or disposal activities initiated after June 30, 2002. The adoption of SFAS 146 did not have a material impact on the Company.

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In November 2002, the FASB issued Interpretation No. 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness to Others, an interpretation of FASB Statements No. 5, 57 and 107 and a rescission of FASB Interpretation No. 34 ("FIN 45"). FIN 45 elaborates on the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under guarantees issued. FIN 45 also clarifies that a guarantor is required to recognize, at inception of a guarantee, a liability for the fair value of the obligation undertaken. The initial recognition and measurement provisions of the FIN 45 are applicable to guarantees issued or modified after December 31, 2002 and are not expected to have a material effect on the Company's financial statements. The disclosure requirements are effective for financial statements of interim or annual periods ending after December 15, 2002 and have been adopted.

In December 2002, the FASB issued Statement of Financial Accounting Standards No. 148, Accounting for Stock-Based Compensation Transition and Disclosure, an amendment of FASB Statement No. 123 ("SFAS 148"). SFAS 148 amends FASB Statement No. 123, Accounting for Stock-Based Compensation, to provide alternative methods of transition for a voluntary change to the fair value method of accounting for stock-based employee compensation. In addition, this Statement amends the disclosure requirements of Statement No. 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock based employee compensation and the effect of the method used on reported results. Certain of the disclosure modifications are required for fiscal years ending after December 15, 2002 and are included in the notes to these consolidated financial statements.

In January 2003, the FASB issued Interpretation No. 46, Consolidation of Variable Interest Entities, an interpretation of ARB No. 51 ("FIN 46"). FIN 46 addresses the consolidation by business enterprises of variable interest entities as defined in FIN 46. FIN 46 applies immediately to variable interests in variable interest entities created after January 31, 2003, and to variable interests in variable interest entities obtained after January 31, 2003. The application of FIN 46 is not expected to have a material effect on the Company's financial statements. FIN 46 requires certain disclosures in financial statements issued after January 31, 2003 if it is reasonably possible that the Company will consolidate or disclose information about variable interest entities when FIN 46 becomes effective.

IMPACT OF INFLATION ON OPERATIONS

Management is of the opinion that inflation has not had a significant impact on Key's business.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

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Special Note: Certain statements set forth below under this caption constitute "forward-looking statements". See "Special Note Regarding Forward-Looking Statements" for additional factors relating to such statements.

The primary objective of the following information is to provide forward-looking quantitative and qualitative information about Key's potential exposure to market risks. The term "market risk" refers to the risk of loss arising from adverse changes in foreign currency exchange risk, interest rates and oil and natural gas prices. The disclosures are not meant to be precise indicators of expected future losses, but rather indicators of reasonably possible losses. This forward-looking information provides indicators of how Key views and manages its ongoing market risk exposures.

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INTEREST RATE RISK

At December 31, 2002, Key had long-term debt outstanding of \$493,565,000. Of this amount, \$420,401,000 or 85.18%, bears interest at fixed rates as follows:

	Balance at December 31, 2002
	(thousands)
8 ³ / ₈ % Senior Notes Due 2008	\$ 276,331
14% Senior Subordinated Notes Due 2009	94,411
5% Convertible Subordinated Notes Due 2004	49,554
Other (at approximately 8%)	105
	\$ 420,401

The remaining \$73,164,000 debt outstanding as of December 31, 2002 bears interest at floating rates, which averaged approximately 4.57% at December 31, 2002. A 10% increase in short-term interest rates on the floating-rate debt outstanding at December 31, 2002 would equal approximately 46 basis points. Such an increase in interest rates would increase Key's annual interest expense by approximately \$300,000 assuming borrowed amounts remain outstanding.

The above sensitivity analysis for interest rate risk excludes accounts receivable, accounts payable and accrued liabilities because of the short-term maturity of such instruments.

FOREIGN CURRENCY RISK

During the year ended June 30, 2002, the Argentine government suspended the law tying the Argentine peso to the U.S. dollar at the conversion ratio of 1:1 and created a dual currency system in Argentina. Key's net assets of its Argentina subsidiaries are based on the U.S. dollar equivalent of such amounts measured in Argentine pesos as of December 31, 2002 and June 30, 2002. Assets and liabilities of the Argentine operations were translated to U.S. dollars at December 31, 2002 and June 30, 2002 using the applicable free market conversion ratio of 3.4:1 and 3.9:1, respectively, and will be translated at future dates using the applicable free market conversion ratio on such dates. Key's net earnings and cash flows from its Argentina subsidiaries were tied to the U.S. dollar for the six months ended December 31, 2001 and are based on the U.S. dollar equivalent of such amounts measured in Argentine pesos for periods after December 31, 2001. Revenues, expenses and cash flow will be translated using the average exchange rates during the periods after December 31, 2001. See Note 18 to the consolidated financial statements.

The change in the Argentine peso to the U.S. dollar exchange rate since December 31, 2001 has reduced stockholders' equity by \$44,547,000, through a charge to other comprehensive loss through December 31, 2002.

Key's net assets, net earnings and cash flows from its Canadian subsidiary are based on the U.S. dollar equivalent of such amounts measured in Canadian dollars. Assets and liabilities of the Canadian operations are translated to U.S. dollars using the applicable exchange rate

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as of the end of a reporting period. Revenues and expenses are translated using the average exchange rate during the reporting period.

A 10% change in the Canadian-to-U.S. Dollar exchange rate would not be material to the net assets, net earnings or cash flows of the Company. See discussion regarding foreign operations in Note 13 to the consolidated financial statements.

COMMODITY PRICE RISK

Key's major market risk exposure for its oil and natural gas production operations is in the pricing applicable to its oil and natural gas sales. Realized pricing is primarily driven by the prevailing worldwide

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price for crude oil and spot market prices for natural gas. Pricing for oil and natural gas production has been volatile and unpredictable for several years.

The Company periodically hedges a portion of its oil and natural gas production through collar and option agreements. The purpose of the hedges is to provide a measure of stability in the volatile environment of oil and natural gas prices and to manage exposure to commodity price risk under existing sales commitments. The Company's risk management objective is to lock in a range of pricing for expected production volumes. This allows the Company to forecast future earnings within a predictable range. The Company meets this objective by entering into collar and option arrangements which allow for acceptable cap and floor prices.

As of December 31, 2002, Key had oil and natural gas price collars and put options in place, as detailed in the following table. Hedged oil and natural gas volumes as a percentage of actual production were 43% and 51%, respectively, for the six months ended December 31, 2002. A 10% variation in the market price of oil or natural gas from their levels at December 31, 2002 would have no material impact on the Company's net assets, net earnings or cash flows (as derived from commodity option contracts).

The following table sets forth the future volumes hedged by year and the weighted-average strike price of the option contracts at December 31, 2002 and June 30, 2002 and 2001:

	Monthly Income		Term	Strike Price Per Bbl/MMbtu		Fair Value
	Oil (Bbls)	Gas (MMbtu)		Floor	Cap	
At December 31, 2002						
Oil Put	5,000		Mar 2002-Feb 2003	\$ 22.00		
Oil Put	4,000		Mar 2003-Feb 2004	\$ 21.00		\$ 34,000
Gas Put		75,000	Mar 2002-Feb 2003	\$ 3.00		
At June 30, 2002						
Oil Put	5,000		Mar 2002-Feb 2003	\$ 22.00		\$ 24,000
Oil Put	4,000		Mar 2003-Feb 2004	\$ 21.00		\$ 118,000
Gas Put		75,000	Mar 2002-Feb 2003	\$ 3.00		\$ 104,000
At June 30, 2001						
Oil Collar	5,000		Mar 2001-Feb 2002	\$ 19.70	\$ 23.70	\$ (115,000)
Oil Put	5,000		Mar 2002-Feb 2003	\$ 22.00		\$ 141,000
Gas Collar		40,000	Mar 2001-Feb 2002	\$ 2.40	\$ 2.91	\$ (229,000)
Gas Put		75,000	Mar 2002-Feb 2003	\$ 3.00		\$ 894,000

(The strike prices for the oil collars and puts are based on the NYMEX spot price for West Texas Intermediate; the strike prices for the natural gas collars are based on the Inside FERC-West Texas Waha spot price; the strike price for the natural gas put is based on the Inside FERC-El Paso Permian spot price.)

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ITEM 8. CONSOLIDATED FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.

Presented herein are the consolidated financial statements of Key Energy Services, Inc. as of December 31, 2002, June 30, 2002 and 2001, the six months ended December 31, 2002, and the years ended June 30, 2002, 2001 and 2000.

Also included is the report of KPMG LLP, independent certified public accountants, on such consolidated financial statements as of December 31, 2002, June 30, 2002 and 2001, the six months ended December 31, 2002, and the years ended June 30, 2002, 2001 and 2000.

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

Consolidated Balance Sheets
Consolidated Statements of Operations
Consolidated Statements of Comprehensive Income
Consolidated Statements of Cash Flows
Consolidated Statements of Stockholders' Equity
Notes to Consolidated Financial Statements
Independent Auditors' Report

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Key Energy Services, Inc.**Consolidated Balance Sheets**

	December 31, 2002	June 30, 2002	June 30, 2001
	(Thousands, except share data)		
ASSETS			
Current assets:			
Cash and cash equivalents	\$ 9,044	\$ 54,147	\$ 2,098
Accounts receivable, net of allowance for doubtful accounts, \$4,439, \$3,969 and \$4,082, at December 31, 2002 and June 30, 2002 and 2001, respectively	141,958	117,907	177,016
Inventories	10,243	7,776	16,547
Prepaid expenses and other current assets	14,329	12,243	10,489
Total current assets	175,574	192,073	206,150
Property and equipment:			
Well servicing equipment	935,911	776,271	723,724
Contract drilling equipment	128,199	124,191	119,122
Motor vehicles	79,110	68,977	64,907
Oil and gas properties and other related equipment, successful efforts method	48,362	44,439	44,245
Furniture and equipment	51,349	38,979	24,865
Buildings and land	48,922	40,247	37,812

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	December 31, 2002	June 30, 2002	June 30, 2001
Total property and equipment	1,291,853	1,093,104	1,014,675
Accumulated depreciation & depletion	(335,348)	(284,204)	(220,959)
Net property and equipment	956,505	808,900	793,716
Goodwill, net of accumulated amortization, \$27,876, \$27,856 and \$28,168 at December 31, 2002 and June 30, 2002 and 2001, respectively	322,270	201,069	189,875
Deferred costs, net	13,503	12,580	17,624
Notes receivable - related parties	251	274	6,050
Other assets	33,899	28,099	14,869
Total assets	\$ 1,502,002	\$ 1,242,995	\$ 1,228,284
LIABILITIES AND STOCKHOLDERS' EQUITY			
Current liabilities:			
Accounts payable	\$ 28,818	\$ 24,625	\$ 42,544
Other accrued liabilities	57,823	49,465	48,923
Accrued interest	15,226	14,864	16,140
Current portion of long-term debt	7,008	7,674	7,946
Total current liabilities	108,875	96,628	115,553
Long-term debt, less current portion	472,336	420,717	470,578
Capital lease obligations, less current portion	14,221	15,219	15,383
Deferred revenue	8,460	10,001	14,104
Non-current accrued expenses	40,477	13,574	8,388
Deferred tax liability	161,265	149,990	127,400
Commitments and contingencies			
Stockholders' equity:			
Common stock, \$0.10 par value; 200,000,000 shares authorized, 128,757,693, 110,308,463 and 101,440,166 shares issued, at December 31, 2002 and June 30, 2002 and 2001, respectively	12,876	11,031	10,144
Additional paid-in capital	673,249	514,752	444,768
Treasury stock, at cost; 416,666 shares at December 31, 2002 and June 30, 2002 and 2001	(9,682)	(9,682)	(9,682)
Accumulated other comprehensive income (loss)	(45,431)	(48,967)	62
Retained earnings	65,356	69,732	31,586
Total stockholders' equity	696,368	536,866	476,878
Total liabilities and stockholders' equity	\$ 1,502,002	\$ 1,242,995	\$ 1,228,284

See the accompanying notes which are an integral part of these consolidated financial statements.

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	Year Ended June 30,			
	Six Months Ended December 31, 2002	2001		2000
		2002		
(Thousands, except per share data)				
REVENUES:				
Well servicing	\$ 370,871	\$ 706,629	\$ 758,273	\$ 559,492
Contract drilling	33,632	87,077	107,639	68,428
Other	4,495	8,858	7,350	9,812
Total revenues	408,998	802,564	873,262	637,732
COSTS AND EXPENSES:				
Well servicing	263,595	489,681	500,324	408,723
Contract drilling	23,416	60,561	77,366	58,299
Depreciation, depletion and amortization	51,111	78,265	75,147	70,972
General and administrative	48,239	59,494	60,118	51,637
Interest	22,743	43,332	56,560	71,930
Other expenses	1,934	4,531	4,464	4,147
Foreign currency transaction loss, Argentina		1,443		
(Gain) loss on retirement of debt	(18)	4,812	(684)	(2,191)
Total costs and expenses	411,020	742,119	773,295	663,517
Income (loss) before income taxes	(2,022)	60,445	99,967	(25,785)
Income tax benefit (expense)	519	(22,299)	(37,257)	6,826
INCOME (LOSS) before cumulative effect	(1,503)	38,146	62,710	(18,959)
Cumulative effect on prior years of change in accounting principle, net of tax (See Note 1)	(2,873)			
NET INCOME (LOSS)	\$ (4,376)	\$ 38,146	\$ 62,710	\$ (18,959)
EARNINGS (LOSS) PER SHARE:				
Basic before cumulative effect	\$ (0.01)	\$ 0.36	\$ 0.64	\$ (0.23)
Cumulative effect, net of tax	(0.02)			
Basic after cumulative effect	\$ (0.03)	\$ 0.36	\$ 0.64	\$ (0.23)
Diluted before cumulative effect	\$ (0.01)	\$ 0.35	\$ 0.61	\$ (0.23)
Cumulative effect, net of tax	(0.02)			
Diluted after cumulative effect	\$ (0.03)	\$ 0.35	\$ 0.61	\$ (0.23)

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	Year Ended June 30,			
Amortization of deferred debt issuance costs, discount and premium	2,154	3,005	4,947	5,919
Deferred income taxes	(552)	21,385	34,953	(1,238)
(Gain) loss on sale of assets	477	(668)	173	25
Foreign currency transaction loss, Argentina		1,443		
(Gain) loss on retirement of debt	(18)	4,812	(684)	(2,191)
Cumulative effect of a change in accounting principle, net of tax	2,873			
<i>Change in assets and liabilities net of effects from the acquisitions:</i>				
(Increase) decrease in accounts receivable	(4,951)	48,907	(53,813)	(31,205)
(Increase) decrease in other current assets	7,655	(4,410)	(4,485)	(5,483)
Increase (decrease) in accounts payable, accrued interest and accrued expenses	(3,562)	(12,180)	29,414	18,875
Other assets and liabilities	6,783	11	(5,015)	(1,855)
	<u>57,594</u>	<u>178,716</u>	<u>143,347</u>	<u>34,860</u>
Net cash provided by operating activities				
CASH FLOWS FROM INVESTING ACTIVITIES:				
Capital expenditures well servicing	(27,422)	(57,857)	(51,064)	(26,469)
Capital expenditures contract drilling	(3,894)	(19,861)	(15,884)	(8,282)
Capital expenditures other	(10,180)	(15,979)	(15,802)	(3,422)
Proceeds from sale of fixed assets	788	4,258	3,415	2,722
Notes receivable from related parties			(1,500)	(2,315)
Acquisitions well servicing	(105,365)	(17,273)	(2,345)	
Acquisitions contract drilling		(2,037)	(800)	
	<u>(146,073)</u>	<u>(108,749)</u>	<u>(83,980)</u>	<u>(37,766)</u>
Net cash used in investing activities				
CASH FLOWS FROM FINANCING ACTIVITIES:				
Repayment of long-term debt	(16,413)	(309,559)	(373,998)	(39,438)
Repayment of capital lease obligations	(4,902)	(10,182)	(8,542)	(11,639)
Borrowings under line of credit	68,000			
Proceeds from equity offerings, net of expenses		42,590		100,571
Proceeds from long-term debt		258,500	205,210	12,000
Debt issuance costs	(3,026)	(1,585)	(4,958)	
Proceeds from forward sale, net of expenses				18,236
Proceeds from exercise of warrants			847	8,473
Proceeds from exercise of stock options	433	3,219	14,617	1,098
Other	(38)	(298)	(318)	
	<u>44,054</u>	<u>(17,315)</u>	<u>(167,142)</u>	<u>89,301</u>
Net cash provided by (used in) financing activities				
Effect of exchange rates on cash	(678)	(603)		
Net increase (decrease) in cash	(45,103)	52,049	(107,775)	86,395
Cash and cash equivalents at beginning of period	54,147	2,098	109,873	23,478
	<u>\$ 9,044</u>	<u>\$ 54,147</u>	<u>\$ 2,098</u>	<u>\$ 109,873</u>
Cash and cash equivalents at end of period				

See the accompanying notes which are an integral part of these consolidated financial statements.

Key Energy Services Inc.

Consolidated Statements of Stockholders' Equity

(Thousands)

	Common Stock			Treasury Stock	Accumulated Other Comprehensive Income	Retained Earnings	Total
	Number of Shares	Amount at par	Additional Paid-in Capital				
BALANCE AT JUNE 30, 1999	83,155	\$ 8,317	\$ 301,615	\$ (9,682)	\$ 9	\$ (12,165)	\$ 288,094
Foreign currency transition adjustment, net of tax					(1)		(1)
Exercise of warrants	2,431	243	8,230				8,473
Exercise of options	241	24	1,074				1,098
Conversion of 7% Debentures	380	38	3,568				3,606
Issuance of common stock in equity offering, net of offering costs	11,000	1,100	99,471				100,571
Other	3	1	4				5
Net loss						(18,959)	(18,959)
BALANCE AT JUNE 30, 2000	97,210	\$ 9,723	\$ 413,962	\$ (9,682)	\$ 8	\$ (31,124)	\$ 382,887
Derivative transition adjustment (see Note 6)					(778)		(778)
Oil and natural gas derivatives adjustment, net of tax (See Note 6)					306		306
Amortization of oil and natural gas derivatives (see Note 6)					558		558
Foreign currency translation adjustment, net of tax					(32)		(32)
Exercise of warrants	185	19	828				847
Exercise of options	3,106	308	14,309				14,617
Conversion of 7% Debentures	101	10	947				957
Issuance of common stock for acquisitions	838	84	8,036				8,120
Deferred tax benefit compensation expense			7,004				7,004
Other			(318)				(318)
Net income						62,710	62,710
BALANCE AT JUNE 30, 2001	101,440	\$ 10,144	\$ 444,768	\$ (9,682)	\$ 62	\$ 31,586	\$ 476,878
Oil and natural gas derivatives adjustment, net of tax (See Note 6)					(279)		(279)
Amortization of oil and natural gas derivatives (see Note 6)					(367)		(367)
Foreign currency translation adjustment, net of tax					(48,383)		(48,383)
Exercise of warrants	7	1	(1)				
Exercise of options	659	66	3,153				3,219
Issuance of common stock for acquisitions	2,801	280	24,787				25,067
Issuance of common stock in equity offering, net of offering costs	5,400	540	42,050				42,590
Other	1		(5)				(5)
Net income						38,146	38,146
BALANCE AT JUNE 30, 2002	110,308	\$ 11,031	\$ 514,752	\$ (9,682)	\$ (48,967)	\$ 69,732	\$ 536,866

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Common Stock							
Oil and natural gas derivatives adjustment, net of tax (See Note 6)						(775)	(775)
Amortization of oil and natural gas derivatives (see Note 6)						609	609
Foreign currency translation adjustment, net of tax						3,702	3,702
Exercise of options	139	14	419				433
Issuance of common stock for acquisitions	18,311	1,831	158,115				159,946
Other			(37)				(37)
Net loss							(4,376)
							(4,376)
BALANCE AT DECEMBER 31, 2002	128,758	\$ 12,876	\$ 673,249	\$ (9,682)	\$ (45,431)	\$ 65,356	696,368

See the accompanying notes which are an integral part of these consolidated financial statements.

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Key Energy Services Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2002, June 30, 2002, 2001 and 2000

1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The Company

Based on the number of rigs owned and available industry data, Key Energy Services, Inc. (the "Company" or "Key"), is the largest onshore, rig-based well servicing contractor in the world, with approximately 1,489 well service rigs and 2,295 oilfield service vehicles as of December 31, 2002. The Company provides a complete range of well services to major oil companies and independent oil and natural gas production companies, including: rig-based well maintenance, workover, completion, and recompletion services (including horizontal recompletions); oilfield trucking services; well intervention services; and ancillary oilfield services. Key conducts well servicing operations onshore in the continental United States in the following regions: Gulf Coast (including South Texas, Central Gulf Coast of Texas, and South Louisiana), Permian Basin of West Texas and Eastern New Mexico, Mid-Continent (including the Anadarko, Hugoton and Arkoma Basins, Forth Worth Basin and the ArkLaTex region), Four Corners (including the San Juan, Piceance, Uint