KEY ENERGY SERVICES INC
Form 10-KT
March 31, 2003

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended _____________

or

ý **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	**04-2648081**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
6 Desta Drive, Midland, Texas	**79705**
(Address of principal executive offices)	(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

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 ý No o

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. ý

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

The aggregate market value of the Common Shares held by nonaffiliates of the Registrant as of March 28, 2003 was approximately $1,172,722,379.

Common Shares outstanding at March 28, 2003: 128,467,756

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 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 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 $839,270 and 87.5%, respectively, to $484,521 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 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; (iv) 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

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.

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 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.

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 lease in Midland, Texas for approximately $42,000 per month and 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.

WELL SERVICING AND CONTRACT DRILLING

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
Domestic:			
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**
International:			
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.

	High	Low
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	287,011	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
General and administrative	50,155	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				

			Year Ended June 30,			
Debt issuance costs					6,307	
Restructuring charge					4,504	
Income (loss) before income taxes, minority interest, and cumulative effect	(2,022)	65,257	99,283	(27,976)	(78,933)	38,805
Net income (loss)	(4,376)	38,146	62,710	(18,959)	(53,258)	24,175
Income (loss) per common share:						
Basic	$ (0.03)	$ 0.36	$ 0.63	$ (0.23)	$ (1.94)	$ 1.41
Diluted	$ (0.03)	$ 0.35	$ 0.61	$ (0.23)	$ (1.94)	$ 1.23
Average common shares outstanding:						
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).