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KEY ENERGY SERVICES INC

Form 10-K/A

October 29, 2001

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K/A

(MARK ONE)

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

FOR THE FISCAL YEAR ENDED JUNE 30, 2001  
OR

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

FOR THE TRANSITION PERIOD FROM \_\_\_\_\_ TO \_\_\_\_\_

COMMISSION FILE NUMBER 1-8038

KEY ENERGY SERVICES, INC.

(Exact name of registrant as specified in its charter)

MARYLAND  
(State or other jurisdiction of  
incorporation or organization)  
6 DESTA DRIVE, MIDLAND, TEXAS  
(Address of principal executive offices)

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

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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 /X/ 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. /X/

The aggregate market value of the Common Stock held by nonaffiliates of the Registrant as of October 25, 2001 was approximately \$854,169,893.

Common Stock outstanding at October 25, 2001: 102,357,547

DOCUMENTS INCORPORATED BY REFERENCE: None

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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."

## PART I

### ITEM 1. BUSINESS.

#### THE COMPANY

Key Energy Services, Inc. (the "Company" or "Key"), is the largest onshore, rig-based well servicing contractor in the world, with approximately 1,477 well service rigs and 1,455 oilfield service vehicles as of June 30, 2001. 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 (including

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horizontal recompletions); 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 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 and Ontario, Canada. Key is also a leading onshore drilling contractor, with 79 land drilling rigs as of June 30, 2001. Key conducts land drilling operations in a number of major domestic producing basins, as well as in Argentina and in Ontario, Canada. 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 website address is [www.keyenergy.com](http://www.keyenergy.com).

### BUSINESS STRATEGY

Key has built its leadership position through the consolidation of smaller, less viable competitors. This consolidation, 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

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capitalize on improved market conditions which existed during fiscal 2001. 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.** Over the past fiscal year, Key has significantly reduced debt and strengthened its balance sheet. At June 30, 2001, Key's long-term funded debt net of cash and capitalized leases ("net funded debt") was approximately \$468,845,000 and its net funded debt to capitalization ratio was approximately 50% as compared to approximately \$534,816,000 and 58%, respectively, at June 30, 2000. Key expects to be able to continue to reduce debt from available cash flow from operations and from anticipated interest savings resulting from prior and future debt reductions and future debt refinancings.

**BUILDING STRONG CUSTOMER ALLIANCES.** Key seeks to maximize customer satisfaction by offering a broad range of equipment and services in conjunction with highly trained and motivated employees. 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.

**REFURBISHING RIGS AND RELATED EQUIPMENT.** Key intends to continue actively refurbishing its rigs and related equipment to maximize the utilization of its rig fleet. The increase in Key's cash flow, both from operations and from anticipated interest savings from reduced levels of debt, combined with Key's borrowing availability under its revolving credit facility, has provided ample liquidity and resources necessary to make the capital expenditures to refurbish such equipment.

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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 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, safe personnel to provide quality service to its customers.

### MAJOR DEVELOPMENTS DURING FISCAL 2001

#### FAVORABLE INDUSTRY CONDITIONS

Operating conditions improved significantly during fiscal 2001 as capital spending by oil and natural gas producers for well servicing and contract drilling services increased over prior year levels. The increased spending was primarily due to higher commodity prices with WTI Cushing prices for light sweet crude averaging approximately \$26.97 per barrel and Nymex Henry Hub natural gas prices averaging approximately \$5.09 per MMBtu during fiscal 2001, as compared to an average WTI Cushing price for light sweet crude of \$25.97 per barrel and an average Nymex Henry Hub natural gas price of \$3.04 per MMBtu during fiscal 2000.

This increase in commodity prices during fiscal 2001 led to a steady, sequential increase in the demand for Key's services and equipment during fiscal 2001 as Key's customers increased their exploration and development activity in Key's primary market areas, enabling Key to increase the rates it charges for its services. This increase in demand and rates resulted in sequential increases in revenues, cash flow and net income in each quarter of fiscal 2001 over the same quarter of fiscal 2000. Key expects demand for its services to remain at or above current levels as long as capital spending by Key's customers remains at or near their current levels.

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During fiscal 2001, crude oil prices continued to trade at healthy levels due largely to the ability of the Organization of Petroleum Exporting Countries ("OPEC") to adhere to its production quotas designed to keep crude oil prices in the range of \$22.00 to \$28.00 per barrel. The adherence to the production quotas brought more stability to crude oil prices. Since June 30, 2001, however, both crude oil and natural gas prices have weakened significantly, falling below \$22.00 per barrel and \$2.00 per Mmbtu, respectively. While management believes that many of its customers generally base their capital spending budgets on a crude oil price of \$18.00 to \$22.00 per barrel and a natural gas price of \$2.00 to \$2.75 per MMBtu, there can be no assurances that its customers will not postpone and/or reduce their capital spending plans if crude oil prices and natural gas prices continue to remain at or below their current levels. In addition, the terrorist attacks on the World Trade Center and the Pentagon that occurred on September 11, 2001 threaten to increase the downward pressure on commodity prices as U.S. fuel consumption decreases due to significantly reduced air and other travel, the general demand for energy decreases as consumer anxiety further weakens the U.S. economy, and OPEC faces political pressure to reduce its price targets for crude oil.

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).

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### DEBT REDUCTION

During fiscal 2001, Key significantly reduced its long-term debt and strengthened its balance sheet. At June 30, 2001, Key's net funded debt was approximately \$468,845,000 and its net funded debt to capitalization ratio was approximately 50% as compared to approximately \$534,816,000 and 58%, respectively, at June 30, 2000. Proceeds from the Debt Offering (defined below) and from the exercise of options and warrants, as well as cash flow from operations were used to accomplish this reduction in net funded debt (see Part II-Item 7-Management's Discussion and Analysis of Results of Operations and Financial Condition-Long-Term Debt).

### DEBT OFFERING

On March 6, 2001, Key completed the public offering of \$175,000,000 of 8 3/8% Senior Notes Due 2008 (the "Debt Offering"). Net proceeds from the Debt Offering were approximately \$170.0 million, which was used to immediately repay the term loans in full and to repay a portion of the revolver outstanding under Key's senior credit facility.

### 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 in Argentina and Canada. The following is a description of each of these business segments (for financial information regarding these business segments, see Note 15 to Consolidated Financial Statements-Business Segment Information).

#### WELL SERVICING

Key provides a full range of well services, including rig-based services, oilfield trucking services and 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.

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#### 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 estimates that there are approximately 600,000 producing oil wells and approximately 300,000 producing natural gas wells in the United States. 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 installed. 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

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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 current production of existing wells. Such services include extensions of existing wells to drain new formations either through deepening wellbores to new zones or through drilling of 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 then 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.

The demand for workover services is more sensitive to expectations relating to, and changes in, oil and natural gas prices than the demand for maintenance services. As oil and natural gas prices increase, the level of workover activity tends to increase as operators seek to increase production by enhancing the efficiency of their wells at higher commodity prices with correspondingly higher rates of return.

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**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

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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

Key provides 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. These trucks are also utilized in connection with drilling and workover projects, which tend to produce and use large amounts of various oilfield fluids. Key also owns a number of salt water disposal wells. In addition, Key provides haul/ equipment trucks that are used to move large pieces of equipment from one wellsite to the next. Demand and pricing for these services are generally related to demand for Key's well service and drilling rigs.

### ANCILLARY OILFIELD SERVICES

Key provides ancillary oilfield services, which include among others: hot oiling; wireline; frac tank rentals; well site construction; roustabout services; fishing and other tool rentals; blowout preventers (BOPs); and foam units and air drilling services. 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 Ontario, Canada. 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.

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### FOREIGN OPERATIONS

Key also operates each of its business segments discussed above in Argentina and Ontario, Canada. Key's foreign operations currently own 26 well servicing rigs, 57 oilfield trucks and eight drilling rigs in Argentina and three well servicing rigs, four oilfield trucks and three drilling rigs in Ontario, Canada.

### CUSTOMERS

Key's customers include major oil companies, independent oil and natural gas



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production companies, and foreign national oil and natural gas production companies. No single customer in fiscal 2001 accounted for 10% or more of Key's consolidated revenues.

### COMPETITION AND OTHER EXTERNAL FACTORS

Despite the significant consolidation 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 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 increase as oil and natural gas producers attempt to maximize the producing efficiency of their wells in a higher priced environment.

### EMPLOYEES

As of June 30, 2001, Key employed approximately 9,300 persons (approximately 9,220 in well servicing and contract drilling and 80 in corporate). 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

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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 us 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 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 fiscal years.

### ITEM 2. PROPERTIES.

Key's corporate headquarters are located in Midland, Texas. Key leases office space at this location from an independent third party.

#### 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 June 30, 2001:

| OPERATING DIVISION<br>-----              | WELL SERVICE/<br>WORKOVER RIGS<br>----- | OILFIELD<br>TRUCKS<br>----- | DRILLING<br>RIGS<br>----- |
|------------------------------------------|-----------------------------------------|-----------------------------|---------------------------|
| DOMESTIC:                                |                                         |                             |                           |
| Permian Basin (well servicing).....      | 466                                     | 357                         | 0                         |
| Gulf Coast.....                          | 244                                     | 338                         | 0                         |
| Mid-Continent.....                       | 313                                     | 285                         | 0                         |
| Four Corners.....                        | 61                                      | 79                          | 17                        |
| Eastern.....                             | 95                                      | 208                         | 3                         |
| Rocky Mountains.....                     | 134                                     | 54                          | 12                        |
| California.....                          | 135                                     | 24                          | 0                         |
| Key Energy Drilling (Permian Basin)..... | 0                                       | 48                          | 36                        |
| DOMESTIC SUBTOTAL.....                   | 1,448                                   | 1,393                       | 68                        |
| INTERNATIONAL:                           |                                         |                             |                           |
| Argentina.....                           | 26                                      | 57                          | 8                         |
| Canada.....                              | 3                                       | 5                           | 3                         |
| TOTALS.....                              | 1,477                                   | 1,455                       | 79                        |

The Permian Basin Well Servicing division owns 35 and leases six office and yard locations. The Gulf Coast division owns 16 and leases 18 office and yard locations. The Mid-Continent division owns 28 and leases 20 office and yard locations. The Four Corners division owns eight and leases two office and yard locations. The Eastern division owns three and leases ten office and yard

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locations. The Rocky Mountain division owns 17 and leases three office and yard locations. The California division owns one and leases one office and yard locations. The Permian Basin Drilling division owns two and leases two office and yard locations. The Argentina division owns two and leases one office and yard locations. The Canadian operation owns one yard location. Odessa Exploration owns interests in 515 gross (348 proved developed) oil properties and 53 gross (45 proved developed) gas properties. The corporate division leases two office locations in addition to its headquarters.

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

### ITEM 3. LEGAL PROCEEDINGS AND OTHER ACTIONS.

See Note 4 to Consolidated Financial Statements--Commitments and Contingencies.

### 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 June 30, 2001, there were 669 registered holders of 101,440,166 issued and outstanding shares of common stock, including 416,666 shares of common stock held in treasury (101,023,500 net of treasury shares).

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 fiscal 2001 and fiscal 2000, as derived from published sources.

|                          | HIGH     | LOW       |
|--------------------------|----------|-----------|
|                          | -----    | -----     |
| Fiscal Year Ending 2001: |          |           |
| Fourth Quarter.....      | \$15 1/3 | \$9 11/20 |
| Third Quarter.....       | 13 13/25 | 8 1/8     |
| Second Quarter.....      | 10 1/2   | 6 13/16   |
| First Quarter.....       | 11 11/25 | 7 1/16    |
| Fiscal Year Ending 2000: |          |           |
| Fourth Quarter.....      | \$11 7/8 | \$8 1/16  |
| Third Quarter.....       | 12 1/4   | 5         |
| Second Quarter.....      | 5 7/8    | 3 1/8     |
| First Quarter.....       | 5 13/16  | 3 3/8     |

There were no dividends paid on Key's common stock during the fiscal years ended June 30, 2001, 2000 or 1999. Key does not intend, for the foreseeable future, to pay dividends on its common stock. In addition, Key is contractually restricted from paying dividends under the terms of its existing credit facilities.

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Key did not make any unregistered sales of its securities during the twelve months ended June 30, 2001 that were not previously included in its Quarterly Reports filed for such period.

### ITEM 6. SELECTED FINANCIAL DATA.

|                                                                                       | FISCAL YEAR ENDED JUNE 30,               |            |            |            |
|---------------------------------------------------------------------------------------|------------------------------------------|------------|------------|------------|
|                                                                                       | 2001                                     | 2000       | 1999 (1)   | 1998       |
|                                                                                       | (IN THOUSANDS, EXCEPT PER SHARE AMOUNTS) |            |            |            |
| OPERATING DATA:                                                                       |                                          |            |            |            |
| Revenues.....                                                                         | \$ 873,262                               | \$ 637,732 | \$ 491,817 | \$ 424,543 |
| Operating costs:                                                                      |                                          |            |            |            |
| Direct costs.....                                                                     | 574,938                                  | 462,386    | 371,428    | 293,448    |
| Depreciation, depletion and<br>amortization.....                                      | 75,147                                   | 70,972     | 62,074     | 31,001     |
| General and administrative.....                                                       | 66,071                                   | 58,772     | 53,108     | 38,987     |
| Bad debt expense.....                                                                 | 1,263                                    | 1,648      | 5,928      | 826        |
| Debt issuance costs.....                                                              | --                                       | --         | 6,307      | --         |
| Restructuring charge.....                                                             | --                                       | --         | 4,504      | --         |
| Interest.....                                                                         | 56,560                                   | 71,930     | 67,401     | 21,476     |
| Income (loss) before income taxes, minority<br>interest, and extraordinary items..... | 99,283                                   | (27,976)   | (78,933)   | 38,805     |
| Net income (loss).....                                                                | 62,710                                   | (18,959)   | (53,258)   | 24,175     |
| Income (loss) per common share:                                                       |                                          |            |            |            |
| Basic.....                                                                            | \$ 0.63                                  | \$ (0.23)  | \$ (1.94)  | \$ 1.41    |
| Diluted.....                                                                          | \$ 0.61                                  | \$ (0.23)  | \$ (1.94)  | \$ 1.23    |
| Average common shares outstanding:                                                    |                                          |            |            |            |
| Basic.....                                                                            | 98,195                                   | 83,815     | 27,501     | 17,153     |
| Assuming full dilution.....                                                           | 102,271                                  | 83,815     | 27,501     | 24,024     |
| Common shares issued at period end.....                                               | 101,440                                  | 97,210     | 82,738     | 18,267     |
| Market price per common share at period<br>end.....                                   | \$ 10.84                                 | \$ 9.64    | \$ 3.56    | \$ 13.12   |
| Cash dividends paid on common shares.....                                             | --                                       | --         | --         | --         |
| BALANCE SHEET DATA:                                                                   |                                          |            |            |            |
| Cash.....                                                                             | \$ 2,098                                 | \$ 109,873 | \$ 23,478  | \$ 25,265  |
| Current assets.....                                                                   | 206,150                                  | 253,589    | 132,543    | 127,557    |
| Property and equipment.....                                                           | 1,014,675                                | 920,437    | 871,940    | 547,537    |
| Property and equipment, net.....                                                      | 793,716                                  | 760,561    | 769,562    | 499,152    |
| Total assets.....                                                                     | 1,228,284                                | 1,246,265  | 1,148,138  | 698,640    |
| Current liabilities.....                                                              | 115,553                                  | 92,848     | 73,151     | 48,029     |
| Long-term debt, including current portion...                                          | 493,907                                  | 666,600    | 699,978    | 399,779    |
| Stockholders' equity.....                                                             | 476,878                                  | 382,887    | 288,094    | 154,928    |
| OTHER DATA:                                                                           |                                          |            |            |            |
| Adjusted EBITDA(2).....                                                               | \$ 232,253                               | \$ 116,574 | \$ 67,281  | \$ 92,108  |
| Net cash provided by (used in):                                                       |                                          |            |            |            |
| Operating activities.....                                                             | 142,717                                  | 34,860     | (13,427)   | 40,925     |
| Investing activities.....                                                             | (83,350)                                 | (37,766)   | (294,654)  | (306,339)  |
| Financing activities.....                                                             | (167,142)                                | 89,301     | 306,294    | 248,975    |
| Working capital.....                                                                  | 90,597                                   | 160,741    | 59,392     | 79,528     |
| Book value per common share(3).....                                                   | \$ 4.70                                  | \$ 3.94    | \$ 3.47    | \$ 8.48    |

(1) 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.

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- (2) ADJUSTED EBITDA IS NET INCOME BEFORE INTEREST EXPENSE, INCOME TAXES, DEPRECIATION, DEPLETION AND AMORTIZATION, BAD DEBT EXPENSE, DEBT ISSUANCE COSTS CHARGED TO EARNINGS, RESTRUCTURING CHARGE AND EXTRAORDINARY ITEMS. ADJUSTED EBITDA IS PRESENTED BECAUSE OF ITS ACCEPTANCE AS A COMPONENT OF A COMPANY'S POTENTIAL VALUATION IN COMPARISON TO COMPANIES

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IN THE SAME INDUSTRY AND OF A COMPANY'S ABILITY TO SERVICE OR INCUR DEBT. MANAGEMENT INTERPRETS TRENDS INDICATED BY CHANGES IN ADJUSTED EBITDA AS AN INDICATOR OF THE EFFECTIVENESS OF ITS STRATEGIES IN ACHIEVING REVENUE GROWTH AND CONTROLLING DIRECT AND INDIRECT COSTS OF SERVICES PROVIDED. INVESTORS SHOULD CONSIDER THAT THIS MEASURE DOES NOT TAKE INTO CONSIDERATION DEBT SERVICE, INTEREST EXPENSES, COSTS OF CAPITAL, IMPAIRMENTS OF LONG LIVED ASSETS, DEPRECIATION OF PROPERTY, THE COST OF REPLACING EQUIPMENT OR INCOME TAXES. ADJUSTED EBITDA SHOULD NOT BE CONSIDERED AS AN ALTERNATIVE TO NET INCOME, INCOME BEFORE TAXES, CASH FLOWS FROM OPERATING ACTIVITIES OR ANY OTHER MEASURE OF FINANCIAL PERFORMANCE PRESENTED IN ACCORDANCE WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES AND IS NOT INTENDED TO REPRESENT CASH FLOW. ADJUSTED EBITDA MAY NOT BE COMPARABLE TO SIMILARLY TITLED MEASURES OF OTHER COMPANIES.

- (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 Reform Act. 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. Please note that certain reclassifications have been made to the fiscal 2000 and 1999 financial data presented below to conform to the fiscal 2001 presentation. The reclassifications consist primarily of reclassifying oil and natural gas production revenues and expenses. Oil and natural gas production revenues and related expenses have been reclassified to other revenues and other expenses because the Company does not believe this business segment is material to the Company's consolidated financial statements.

#### RESULTS OF OPERATIONS

##### FISCAL YEAR ENDED JUNE 30, 2001 VERSUS FISCAL 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 fiscal 2001 (see Part I--Item--Major Developments During Fiscal 2001--Favorable Industry Conditions). 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 in fiscal 2000, while net income for fiscal

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2001 increased \$81,669,000 to \$62,710,000 from a net loss of \$18,959,000 in fiscal 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.

### 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 in fiscal 2000. The increase was due to increased demand for the Company's well servicing equipment and services and higher pricing.

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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 in fiscal 2000. The increase was due to increased demand for the Company's contract drilling equipment and services and higher pricing.

### OPERATING EXPENSES

WELL SERVICING. Well servicing expenses for the year ended June 30, 2001 increased \$93,168,000, or 23.3%, to \$493,108,000 from \$399,940,000 in fiscal 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 71.5% for fiscal 2000 to 65% for fiscal 2001. The margin 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 in fiscal 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% in fiscal 2000 to 71.9% in fiscal 2001. The margin 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 in fiscal 2000. The increase is due to higher capital expenditures incurred during fiscal 2001 as the Company refurbished equipment and increased utilization of its contract drilling equipment (which it depreciates partially based on utilization).

### GENERAL AND ADMINISTRATIVE EXPENSES

The Company's general and administrative expenses for the year ended June 30, 2001 increased \$7,299,000, or 12.4%, to \$66,071,000 from \$58,772,000 in fiscal 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 9.2% in fiscal 2000 to 7.6% in fiscal 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 in fiscal 2000. The

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decrease was primarily due to the impact of the long-term debt reduction during fiscal 2001 and, to a lesser extent, lower short-term interest rates and borrowing margins on floating rate debt.

### BAD DEBT EXPENSE

The Company's bad debt expense for the year ended June 30, 2001 decreased \$385,000, or 23.4%, to \$1,263,000 from \$1,648,000 in fiscal 2000. The decrease was primarily due to improved industry conditions for Key's customers and, to a lesser extent, the centralization of the Company's internal credit approval process.

### EXTRAORDINARY GAIN

During fiscal 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 issuance costs, all of which resulted in an after-tax extraordinary gain of \$429,000.

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### INCOME TAXES

The Company's income tax expense for the year ended June 30, 2001 increased \$44,408,000 to \$37,002,000 from a benefit of \$7,406,000 in fiscal 2000. The increase in income tax expense is due to increased pre-tax income. The Company's effective tax rate for fiscal 2001 and 2000 was 37.2% and 26.5%, respectively. The effective tax rates vary from the statutory 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 \$107,857,000 to \$142,717,000 from \$34,860,000 in fiscal 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 \$45,584,000 to \$83,350,000 from \$37,766,000 in fiscal 2000. The increase is due primarily to higher capital expenditures.

The Company's net cash used by 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 in fiscal 2000. The increase is primarily the result of significant debt reduction during fiscal 2001, partially offset by proceeds from the Debt Offering and the exercise of stock options and warrants.

### FISCAL YEAR ENDED JUNE 30, 2000 VERSUS FISCAL YEAR ENDED JUNE 30, 1999

The Company's results of operations for the year ended June 30, 2000 reflect the impact of the industry recovery during such period resulting from increased commodity prices which in turn caused increased demand for the Company's equipment and services during fiscal 2000. 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

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Revenues for the year ended June 30, 2000 increased \$145,915,000, or 29.7%, to \$637,732,000 from \$491,817,000 in fiscal 1999, while net income for fiscal 2000 increased \$34,299,000 to a net loss of \$18,959,000 from a net loss of \$53,258,000 in fiscal 1999. The increase in revenues is due to improved operating conditions and higher rig hours, the full year effect of the acquisitions completed during the early portion of fiscal 1999 and, to a lesser extent, higher pricing. The decrease in net loss is the result of improved operating conditions, higher pricing, and cost reduction initiatives. In addition, fiscal 1999 included non-recurring charges for debt issuance costs and restructuring initiatives as well as higher bad debt expense.

### OPERATING REVENUES

**WELL SERVICING.** Well servicing revenues for the year ended June 30, 2000 increased \$125,835,000 or 29%, to \$559,492,000 from \$433,657,000 in fiscal 1999. The increase was due to increased demand for the Company's well servicing equipment and services, the full year effect of the acquisitions completed during the early portion of fiscal 1999 and, to a lesser extent, higher pricing.

**CONTRACT DRILLING.** Contract drilling revenues for the year ended June 30, 2000 increased \$17,815,000, or 35.2%, to \$68,428,000 from \$50,613,000 in fiscal 1999. The increase was due to increased demand for the Company's contract drilling equipment and services, the full year effect of the acquisition completed during the early portion of fiscal 1999 and, to a lesser extent, higher pricing.

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### OPERATING EXPENSES

**WELL SERVICING.** Well servicing expenses for the year ended June 30, 2000 increased \$74,975,000, or 23.1%, to \$399,940,000 from \$324,965,000 in fiscal 1999. 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 percent of well servicing revenues decreased from 74.9% for fiscal 1999 to 71.5% for fiscal 2000. The margin improvement is due to improved operating efficiencies and the effects of higher pricing.

**CONTRACT DRILLING.** Contract drilling expenses for the year ended June 30, 2000, increased \$14,743,000, or 33.8%, to \$58,299,000 from \$43,556,000 in fiscal 1999. 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 86.1% in fiscal 1999 to 85.2% in fiscal 2000. The margin 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, 2000 increased \$8,898,000, or 14.3%, to \$70,972,000 from \$62,074,000 in fiscal 1999. The increase is due to higher capital expenditures incurred during fiscal 2000 as the Company refurbished equipment and increased utilization of its contract drilling equipment (which it depreciates partially based on utilization).

### GENERAL AND ADMINISTRATIVE EXPENSES

The Company's general and administrative expenses for the year ended June 30, 2000 increased \$5,664,000, or 10.7%, from \$53,108,000 to \$58,772,000 in fiscal 2000. The increase was due to higher administrative costs necessitated by



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the growth of the Company's operations as a result of the fiscal 1999 acquisitions and improved industry conditions. Despite the increased costs, general and administrative expenses as a percentage of total revenues declined from 10.8% in fiscal 1999 to 9.2% in fiscal 2000.

### INTEREST EXPENSE

The Company's interest expense for the year ended June 30, 2000 increased \$4,529,000, or 6.7%, to \$71,930,000 from \$67,401,000 in fiscal 1999. The increase was primarily due to the full year effect of the debt incurred in connection with the acquisitions completed during the early portion of fiscal 1999, and, to a lesser extent, higher interest rates during fiscal 2000 partially offset by the impact of the long-term debt reduction during fiscal 2000.

### BAD DEBT EXPENSE

The Company's bad debt expense for the year ended June 30, 2000 decreased \$4,280,000, or 72.2%, to \$1,648,000 from \$5,928,000 in fiscal 1999. The decrease was primarily due to improved industry conditions for Key's customers and, to a lesser extent, the centralization of the Company's internal credit approval process.

### EXTRAORDINARY GAIN

During the fourth quarter of fiscal 2000, the Company repurchased \$10,190,000 of its 5% Convertible Subordinated Notes which resulted in an after-tax gain of \$1,611,000.

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### INCOME TAXES

The Company's income tax benefit for the year ended June 30, 2000 decreased \$18,269,000 to \$7,406,000 from \$25,675,000 in fiscal 1999. The decrease in income tax benefit is due to the decrease in pretax loss. The Company's effective tax benefit rate for fiscal 2000 and 1999 was 26.5% and 32.5%, respectively. The fiscal 2000 effective tax benefit rate is different from the statutory rate of 35% principally because of certain non-deductible goodwill amortization, other non-deductible expenses and state and local taxes. The decrease in the fiscal 2000 effective tax benefit rate was due to an increase in the amount of non-deductible expenses, primarily as a result of the full year effect of the goodwill amortization of the acquisitions completed during the early portion of fiscal 1999.

### CASH FLOW

The Company's net cash provided by operating activities for the year ended June 30, 2000 increased \$48,287,000 to a \$34,860,000 from a use of \$13,427,000 in fiscal 1999. The increase is due to higher revenues resulting from increased demand for the Company's equipment and services, the full year effect of the acquisitions completed during the early portion of fiscal 1999 and, to a lesser extent, 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, 2000 decreased \$256,888,000, or 87.2%, to \$37,766,000 from \$294,654,000 in fiscal 1999. The decrease is due to no acquisitions having occurred during fiscal 2000 partially offset by higher capital expenditures.

The Company's net cash provided by financing activities for the year ended June 30, 2000 decreased \$216,993,000, or 70.8%, to \$89,301,000 from \$306,294,000

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in fiscal 1999. The decrease is primarily the result of significantly decreased borrowings during fiscal 2000 and, to a lesser extent, the repayment of long-term debt partially offset by proceeds from the equity offering and the volumetric production payment completed in fiscal 2000.

### 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.

The Company's cash and cash equivalents decreased \$107.8 million to \$2.1 million as of June 30, 2001 from \$109.9 million as of June 30, 2000, which included \$100.6 million in net proceeds from the Company's equity offering which closed on June 30, 2000 and had not yet been applied to debt reduction.

The Company projects approximately \$65 million for capital expenditures for fiscal 2002 as compared to \$82 million and \$38 million in fiscal 2001 and 2000, respectively. The Company expects to finance its capital expenditures using net cash provided by operating activities and available credit. The Company believes that its cash flow and, to the extent required, borrowings under its current and future credit facilities, will be sufficient to fund such expenditures.

As of June 30, 2001 the Company had working capital (excluding the current portion of long-term debt) of approximately \$98,543,000, which includes cash and cash equivalents of approximately \$2,098,000, as compared to working capital (excluding the current portion of long-term debt) of approximately \$175,396,000, which includes cash and cash equivalents of approximately \$109,873,000, as of June 30, 2000. The decrease in working capital is primarily due to the use of the net cash proceeds of \$100,571,000 from the June 30, 2000 equity offering to repay long-term debt during the fiscal year ended June 30, 2001. Working capital at June 30, 2001, excluding the change in cash, increased from June 30, 2000 due to

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continuing improvement in operating results and timing differences related to cash receipts and disbursements.

### LONG-TERM DEBT

Other than capital lease obligations and miscellaneous notes payable, as of June 30, 2001, the Company's long-term debt was comprised of (i) a senior credit facility, (ii) a series of 8 3/8% Senior Notes Due 2008, (iii) a series of 14% Senior Subordinated Notes Due 2009, (iv) a series of 5% Convertible Subordinated Notes Due 2004, and (v) a series of 9 3/8% Senior Notes Due 2007.

### SENIOR CREDIT FACILITY

As of June 30, 2001, the Company had a senior credit facility with PNC Bank, National Association, as Administrative Agent, Norwest Bank Texas, N.A., as Collateral Agent, PNC Capital Markets, Inc., as Arranger, and the other lenders named from time to time parties thereto (as subsequently amended, the "Senior Credit Facility"), which consisted of a \$125 million revolving loan facility. In addition, up to \$20 million of letters of credit can be issued under the Senior Credit Facility, but any outstanding letters of credit reduce borrowing availability under the revolving loan facility. The commitment to make revolving loans was reduced to \$100 million on September 14, 2001 and will reduce to

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\$75 million on September 14, 2002. The revolving commitment will terminate on September 14, 2003, and all the revolving loans must be paid on or before that date. The revolving loan bears interest at rates based upon, at the Company's option, either the prime rate plus a margin ranging from 0.75% to 2.00% or a Eurodollar rate plus a margin ranging from 2.25% to 3.50%, in each case depending upon the ratio of the Company's total debt (less cash on hand over \$5 million) to the Company's trailing 12-month EBITDA, as adjusted.

During fiscal 2001, the Company repaid in full approximately \$198.9 million under the term loans which were originally included in the Senior Credit Facility while decreasing net borrowings under the revolver by \$91 million. As a result, at June 30, 2001 the principal amounts outstanding under (i) the original term loans were fully repaid and (ii) the revolver was approximately \$2.0 million. Additionally, at June 30, 2001, the Company had outstanding letters of credit totaling approximately \$12.0 million related to its workers compensation insurance program. Since June 30, 2001 the principal amount outstanding under the revolver has increased to \$38.0 million as of September 25, 2001. These funds were used to repurchase certain long-term debt of the Company.

See Note 5 to Consolidated Financial Statements-Long Term Debt for further discussion of the Senior Credit Facility.

### 8 3/8% SENIOR NOTES

On March 6, 2001, the Company completed a private placement of \$175,000,000 of 8 3/8% Senior Notes due 2008 (the "8 3/8% 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 Senior Credit Facility and a portion of the revolving loans under the Senior Credit Facility. The 8 3/8% Senior Notes are senior unsecured obligations, ranking equally with the Company's other senior unsecured indebtedness. The 8 3/8% Senior Notes are effectively subordinated to Key's secured indebtedness which includes borrowings under the Senior Credit Facility and the Dawson 9 3/8% Senior Notes.

On and after March 1, 2005 the Company may redeem some or all of the 8 3/8% 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 8 3/8% Senior Notes with the proceeds of certain sales of equity at 108.375% of par plus accrued interest.

At June 30, 2001, \$175,000,000 principal amount of the 8 3/8% Senior Notes remained outstanding. The 8 3/8% Senior Notes pay interest semi-annually on March 1 and September 1 of each year.

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### 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 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 \$148.6 million 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 may redeem up to 35% of the aggregate principal amount of the 14% Senior

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Subordinated Notes with the proceeds of certain sales of equity at 114% of par plus accrued interest. On June 11, 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, leaving \$139,687,000 principal amount outstanding as of June 30, 2001.

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, the Dawson 9 3/8% Senior Notes and the 8 3/8% Senior Notes.

At June 30, 2001, \$139,687,000 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 payments of approximately \$10,500,000 were made on July 15, 2000 and January 15, 2001, respectively. As of June 30, 2001, 62,500 Unit Warrants had been exercised, producing approximately \$4,173,000 of proceeds to the Company and leaving 87,500 Unit Warrants outstanding. Since June 30, 2001, the Company repurchased (and canceled) an additional \$6,784,000 principal amount of the 14% Senior Subordinated Notes, leaving \$132,903,000 outstanding as of September 25, 2001.

### 5% CONVERTIBLE SUBORDINATED NOTES

In late September and early October 1997, the Company completed a private placement of \$216 million 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, the Dawson 9 3/8% Senior Notes and the 8 3/8% 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 fiscal 2001, the Company repurchased (and canceled) \$47,384,000 principal amount of the 5% Convertible Subordinated Notes, leaving \$158,426,000 principal amount of the 5% Convertible Subordinated Notes outstanding at June 30, 2001. Since June 30, 2001, the Company repurchased (and

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canceled) an additional \$46,493,000 principal amount of the 5% Convertible Subordinated Notes, leaving \$111,933,000 outstanding as of September 25, 2001.

Interest on the 5% Convertible Subordinated Notes is payable on March 15 and September 15. Interest of approximately \$4,890,000 and \$4,815,000 million was paid on September 15, 2000 and March 15, 2001, respectively.

### DAWSON 9 3/8% SENIOR NOTES

As a result of the Dawson acquisition, the Company, its subsidiaries and U.S. Trust Company of Texas, N.A., as trustee ("U.S. Trust"), entered into a

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Supplemental Indenture dated September 21, 1998 (the "Supplemental Indenture"), pursuant to which the Company assumed the obligations of Dawson under the Indenture dated February 20, 1997 (the "Dawson Indenture") between Dawson and U.S. Trust. The senior notes due 2007 (the "Dawson 9 3/8% Senior Notes") issued pursuant to the Dawson Indenture were equally and ratably secured with the obligations under the Senior Credit Facility. As a result of a mandatory tender offer made in connection with the Dawson acquisition and subsequent repurchases, only \$1,106,000 principal amount of Dawson 9 3/8% Senior Notes remained outstanding at June 30, 2000.

During the quarter ended September 30, 2000, the Company repurchased (and canceled) \$800,000 principal amount of Dawson 9 3/8% Senior Notes. During the quarter ended June 30, 2001, the Company repurchased an additional \$60,000 principal amount of the Dawson 9 3/8% Senior Notes, leaving \$246,000 principal amount of the Dawson 9 3/8% Senior Notes outstanding at June 30, 2001. Interest on the Dawson 9 3/8% Senior Notes is payable on February 1 and August 1 of each year. Interest of approximately \$52,000 and \$14,000 was paid on August 1, 2000 and February 1, 2001, respectively.

### 7% CONVERTIBLE SUBORDINATED DEBENTURES

In July 1996, the Company completed a private placement of \$52,000,000 principal amount of 7% Convertible Subordinated Debentures due 2003 (the "7% Convertible Subordinated Debentures"). During the quarter ended September 30, 2000, \$985,000 principal amount of the 7% Convertible Subordinated Debentures were surrendered for conversion by the holders thereof and 101,025 shares of common stock were issued on September 1, 2000 in connection with the conversion. On September 1, 2000, the remaining \$15,000 principal amount of the outstanding 7% Convertible Subordinated Debentures was redeemed at 103% of the principal amount plus accrued interest, leaving none outstanding. Interest on the 7% Convertible Subordinated Debentures is payable on January 1 and July 1 of each year. Interest of approximately \$35,000 was paid on July 1, 2000.

### IMPACT OF RECENTLY ISSUED ACCOUNTING STANDARDS

The FASB recently issued Statements of Financial Accounting Standards No. 141 "Business Combinations", No. 142 "Goodwill and Other Intangible Assets" and No. 143 "Accounting for Asset Retirement Obligations". Statement 141 requires that all business combinations initiated after June 30, 2001 be accounted for under the purchase method. Statement 142 requires that goodwill no longer be amortized to earnings, but instead be reviewed for impairment. The standard is effective for fiscal years beginning after December 15, 2001. Early adoption is permitted for entities with fiscal years beginning after March 15, 2001, provided the first interim financial statements have not previously been issued. Statement 143 establishes requirements for the accounting of removal-type costs associated with asset retirements. The standard is effective for fiscal years beginning after June 15, 2002, with earlier application encouraged. The Company is currently assessing the impact of these statements on its consolidated financial statements and whether to early adopt Statement 142 in the first quarter of fiscal 2002.

### 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.

Special Note: Certain statements set forth below under this caption constitute "forward-looking statements". See "Special Note Regarding

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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.

### INTEREST RATE RISK

At June 30, 2001, Key had long-term debt outstanding of \$493,907,000. Of this amount, \$468,943,000 or 94.9%, bears interest at fixed rates as follows:

|                                                        | BALANCE AT<br>6/30/01<br>-----<br>(THOUSANDS) |
|--------------------------------------------------------|-----------------------------------------------|
| 8 3/8% Senior Notes Due 2008.....                      | \$175,000                                     |
| 5% Convertible Subordinated Notes Due 2004.....        | 158,426                                       |
| 14% Senior Subordinated Notes Due 2009.....            | 134,466                                       |
| Dawson 9 3/8% Senior Notes Due 2007.....               | 246                                           |
| Other (rates generally ranging from 8.0% to 8.5%)..... | 805                                           |
|                                                        | -----                                         |
|                                                        | \$468,943                                     |
|                                                        | =====                                         |

The remaining \$24,964,000 of debt outstanding as of June 30, 2001 bears interest at floating rates which averaged approximately 9.34% at June 30, 2001. A 10% increase in short-term interest rates on the floating-rate debt outstanding at June 30, 2001 would equal approximately 93 basis points. Such an increase in interest rates would increase Key's fiscal 2002 interest expense by approximately \$200,000 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

Key's net assets, net earnings and cash flows from its Argentina subsidiaries are currently not exposed to foreign currency risk, as Argentina's currency is tied to the U.S. dollar. Key's net assets, net earnings and cash flows from its Canadian subsidiary is 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 as of the end of a reporting period. Revenues, expenses and cash flow 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 Key.

### COMMODITY PRICE RISK

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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 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 June 30, 2001, Key had oil and natural gas price collars and put options in place, as detailed in the following table. The total fiscal 2001 hedged oil and natural gas volumes represent approximately 32% and 20%, respectively, of expected calendar year total production. A 10% variation in the market price of oil or natural gas from their levels at June 30, 2001 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 June 30, 2001 and 2000:

|                  | MONTHLY INCOME |                        | TERM                | STRIKE PRICE<br>PER BBL/MMBTU |          |    |
|------------------|----------------|------------------------|---------------------|-------------------------------|----------|----|
|                  | OIL<br>(BBLs)  | NATURAL GAS<br>(MMBTU) |                     | FLOOR                         | CAP      |    |
| At June 30, 2001 |                |                        |                     |                               |          |    |
| Oil Collar.....  | 5,000          | --                     | Mar 2001 - Feb 2002 | \$19.70                       | \$ 23.70 | \$ |
| Oil Put.....     | 5,000          | --                     | Mar 2002 - Feb 2003 | 22.00                         | --       |    |
| Gas Collar.....  | --             | 40,000                 | Mar 2001 - Feb 2002 | 2.40                          | 2.91     |    |
| Gas Put.....     | --             | 75,000                 | Mar 2002 - Feb 2003 | 3.00                          | --       |    |
| At June 30, 2000 |                |                        |                     |                               |          |    |
| Oil Collars..... | 4,000          | --                     | May 2000 - Feb 2001 | \$22.20                       | \$ 26.50 | \$ |
|                  | 5,000          | --                     | Mar 2001 - Feb 2002 | 19.70                         | 23.70    |    |
| Gas Collars..... | --             | 30,000                 | May 2000 - Feb 2001 | 2.60                          | 3.19     |    |
|                  | --             | 40,000                 | Mar 2001 - Feb 2002 | 2.40                          | 2.91     |    |

(The strike prices for the oil collars and put 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.)

### ITEM 8. CONSOLIDATED FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.

Presented herein are the consolidated financial statements of Key Energy Services, Inc. as of June 30, 2001 and 2000 and the years ended June 30, 2001, 2000 and 1999.

Also included is the report of KPMG LLP, independent certified public accountants, on such consolidated financial statements as of June 30, 2001 and 2000 and for the years ended June 30, 2001, 2000 and 1999.

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

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KEY ENERGY SERVICES, INC.

CONSOLIDATED BALANCE SHEETS

|                                                                                                    | JUNE 30, 2001                  | JUNE 30, 2000 |
|----------------------------------------------------------------------------------------------------|--------------------------------|---------------|
|                                                                                                    | -----                          | -----         |
|                                                                                                    | (THOUSANDS, EXCEPT SHARE DATA) |               |
| ASSETS                                                                                             |                                |               |
| Current assets:                                                                                    |                                |               |
| Cash and cash equivalents.....                                                                     | \$ 2,098                       | \$ 109,873    |
| Accounts receivable, net of allowance for doubtful<br>accounts (\$4,082--2001, \$3,189--2000)..... | 177,016                        | 123,203       |
| Inventories.....                                                                                   | 16,547                         | 10,028        |
| Income taxes receivable.....                                                                       | --                             | 5,588         |
| Prepaid expenses and other current assets.....                                                     | 10,489                         | 4,897         |
|                                                                                                    | -----                          | -----         |
| Total current assets.....                                                                          | 206,150                        | 253,589       |
|                                                                                                    | -----                          | -----         |
| Property and equipment:                                                                            |                                |               |
| Well servicing equipment.....                                                                      | 723,724                        | 668,107       |
| Contract drilling equipment.....                                                                   | 119,122                        | 105,454       |
| Motor vehicles.....                                                                                | 64,907                         | 55,042        |
| Oil and gas properties and other related equipment,<br>successful efforts method.....              | 44,245                         | 43,855        |
| Furniture and equipment.....                                                                       | 24,865                         | 11,013        |
| Buildings and land.....                                                                            | 37,812                         | 36,966        |
|                                                                                                    | -----                          | -----         |
| Total property and equipment.....                                                                  | 1,014,675                      | 920,437       |
| Accumulated depreciation & depletion.....                                                          | (220,959)                      | (159,876)     |
|                                                                                                    | -----                          | -----         |
| Net property and equipment.....                                                                    | 793,716                        | 760,561       |



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|                                                                                    |             |             |
|------------------------------------------------------------------------------------|-------------|-------------|
| Goodwill, net of accumulated amortization (\$28,168--2001,<br>\$18,849--2000)..... | 189,875     | 198,633     |
| Deferred costs, net.....                                                           | 17,624      | 18,855      |
| Notes receivable--related parties.....                                             | 6,050       | 5,150       |
| Other assets.....                                                                  | 14,869      | 9,477       |
|                                                                                    | -----       | -----       |
| Total assets.....                                                                  | \$1,228,284 | \$1,246,265 |
|                                                                                    | =====       | =====       |

## LIABILITIES AND STOCKHOLDERS' EQUITY

|                                                                                                                                                                                      |             |             |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------|-------------|
| Current liabilities:                                                                                                                                                                 |             |             |
| Accounts payable.....                                                                                                                                                                | \$ 42,544   | \$ 35,801   |
| Other accrued liabilities.....                                                                                                                                                       | 48,923      | 26,398      |
| Accrued interest.....                                                                                                                                                                | 16,140      | 15,994      |
| Current portion of long-term debt.....                                                                                                                                               | 7,946       | 14,655      |
|                                                                                                                                                                                      | -----       | -----       |
| Total current liabilities.....                                                                                                                                                       | 115,553     | 92,848      |
|                                                                                                                                                                                      | -----       | -----       |
| Long-term debt, less current portion.....                                                                                                                                            | 485,961     | 651,945     |
| Deferred revenue.....                                                                                                                                                                | 14,104      | 17,031      |
| Non-current accrued expenses.....                                                                                                                                                    | 8,388       | 1,847       |
| Deferred tax liability.....                                                                                                                                                          | 127,400     | 99,707      |
| Commitments and contingencies.....                                                                                                                                                   | --          | --          |
| Stockholders' equity:                                                                                                                                                                |             |             |
| Common stock, \$0.10 par value; 200,000,000 shares<br>authorized, 101,440,166 and 97,209,504 shares issued,<br>respectively at June 30, 2001 and June 30, 2000,<br>respectively..... | 10,144      | 9,723       |
| Additional paid-in capital.....                                                                                                                                                      | 444,768     | 413,962     |
| Treasury stock, at cost; 416,666 shares at June 30, 2001<br>and June 30, 2000.....                                                                                                   | (9,682)     | (9,682)     |
| Accumulated other comprehensive income.....                                                                                                                                          | 62          | 8           |
| Retained earnings (deficit).....                                                                                                                                                     | 31,586      | (31,124)    |
|                                                                                                                                                                                      | -----       | -----       |
| Total stockholders' equity.....                                                                                                                                                      | 476,878     | 382,887     |
|                                                                                                                                                                                      | -----       | -----       |
| Total liabilities and stockholders' equity.....                                                                                                                                      | \$1,228,284 | \$1,246,265 |
|                                                                                                                                                                                      | =====       | =====       |

SEE THE ACCOMPANYING NOTES WHICH ARE AN INTEGRAL PART OF THESE CONSOLIDATED  
FINANCIAL STATEMENTS.

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KEY ENERGY SERVICES, INC.

## CONSOLIDATED STATEMENTS OF OPERATIONS

|                        | YEAR ENDED JUNE 30,                |           |           |
|------------------------|------------------------------------|-----------|-----------|
|                        | 2001                               | 2000      | 1999      |
|                        | -----                              | -----     | -----     |
|                        | (THOUSANDS, EXCEPT PER SHARE DATA) |           |           |
| REVENUES:              |                                    |           |           |
| Well servicing.....    | \$758,273                          | \$559,492 | \$433,657 |
| Contract drilling..... | 107,639                            | 68,428    | 50,613    |
| Other.....             | 7,350                              | 9,812     | 7,547     |
|                        | -----                              | -----     | -----     |

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|                                                                                                                      |           |             |             |
|----------------------------------------------------------------------------------------------------------------------|-----------|-------------|-------------|
| Total revenues.....                                                                                                  | 873,262   | 637,732     | 491,817     |
|                                                                                                                      | -----     | -----       | -----       |
| COSTS AND EXPENSES:                                                                                                  |           |             |             |
| Well servicing.....                                                                                                  | 493,108   | 399,940     | 324,965     |
| Contract drilling.....                                                                                               | 77,366    | 58,299      | 43,556      |
| Depreciation, depletion and amortization.....                                                                        | 75,147    | 70,972      | 62,074      |
| General and administrative.....                                                                                      | 66,071    | 58,772      | 53,108      |
| Bad debt expense.....                                                                                                | 1,263     | 1,648       | 5,928       |
| Debt issuance costs.....                                                                                             | --        | --          | 6,307       |
| Interest.....                                                                                                        | 56,560    | 71,930      | 67,401      |
| Other expenses.....                                                                                                  | 4,464     | 4,147       | 2,907       |
| Corporate restructuring.....                                                                                         | --        | --          | 4,504       |
|                                                                                                                      | -----     | -----       | -----       |
| Total costs and expenses.....                                                                                        | 773,979   | 665,708     | 570,750     |
|                                                                                                                      | -----     | -----       | -----       |
| Income (loss) before income taxes.....                                                                               | 99,283    | (27,976)    | (78,933)    |
| Income tax benefit (expense).....                                                                                    | (37,002)  | 7,406       | 25,675      |
|                                                                                                                      | -----     | -----       | -----       |
| INCOME (LOSS) BEFORE EXTRAORDINARY GAIN (LOSS).....                                                                  | \$ 62,281 | \$ (20,570) | \$ (53,258) |
| Extraordinary gain (loss) on retirement of debt, less<br>applicable income taxes of \$255--2001 and \$580--2000..... | 429       | 1,611       | --          |
|                                                                                                                      | -----     | -----       | -----       |
| NET INCOME (LOSS).....                                                                                               | \$ 62,710 | \$ (18,959) | \$ (53,258) |
|                                                                                                                      | =====     | =====       | =====       |
| EARNINGS (LOSS) PER SHARE:                                                                                           |           |             |             |
| Basic--before extraordinary gain (loss).....                                                                         | \$ 0.63   | \$ (0.25)   | \$ (1.94)   |
| Extraordinary gain (loss) on retirement of debt, net of<br>tax.....                                                  | --        | 0.02        | --          |
|                                                                                                                      | -----     | -----       | -----       |
| Basic--after extraordinary gain.....                                                                                 | \$ 0.63   | \$ (0.23)   | \$ (1.94)   |
|                                                                                                                      | =====     | =====       | =====       |
| Diluted--before extraordinary gain.....                                                                              | \$ 0.61   | \$ (0.25)   | \$ (1.94)   |
| Extraordinary gain on retirement of debt, net of tax.....                                                            | --        | 0.02        | --          |
|                                                                                                                      | -----     | -----       | -----       |
| Diluted--after extraordinary gain.....                                                                               | \$ 0.61   | \$ (0.23)   | \$ (1.94)   |
|                                                                                                                      | =====     | =====       | =====       |
| WEIGHTED AVERAGE SHARES OUTSTANDING:                                                                                 |           |             |             |
| Basic.....                                                                                                           | 98,195    | 83,815      | 27,501      |
| Diluted.....                                                                                                         | 102,271   | 83,815      | 27,501      |

SEE THE ACCOMPANYING NOTES WHICH ARE AN INTEGRAL PART OF THESE CONSOLIDATED  
FINANCIAL STATEMENTS.

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KEY ENERGY SERVICES, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

|                                                            | YEAR ENDED JUNE 30, |             |             |
|------------------------------------------------------------|---------------------|-------------|-------------|
|                                                            | 2001                | 2000        | 1999        |
|                                                            | -----               | -----       | -----       |
|                                                            | (THOUSANDS)         |             |             |
| NET INCOME (LOSS).....                                     | \$62,710            | \$ (18,959) | \$ (53,258) |
| OTHER COMPREHENSIVE INCOME (LOSS), NET OF TAX:             |                     |             |             |
| Derivative transition adjustment (See Note 8).....         | (778)               | --          | --          |
| Oil and natural gas derivatives adjustment (See Note 8)... | 306                 | --          | --          |

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|                                                                    |          |             |             |
|--------------------------------------------------------------------|----------|-------------|-------------|
| Amortization of oil and natural gas derivatives (See Note 8).....  | 558      | --          | --          |
| Reversal of unrealized gains on available-for-sale securities..... | --       | --          | (1,525)     |
| Currency translation gain(loss).....                               | (32)     | (1)         | 9           |
|                                                                    | -----    | -----       | -----       |
| COMPREHENSIVE INCOME (LOSS), NET OF TAX.....                       | \$62,764 | \$ (18,960) | \$ (54,774) |
|                                                                    | =====    | =====       | =====       |

SEE THE ACCOMPANYING NOTES WHICH ARE AN INTEGRAL PART OF THESE CONSOLIDATED FINANCIAL STATEMENTS.

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## KEY ENERGY SERVICES, INC.

### CONSOLIDATED STATEMENTS OF CASH FLOWS

|                                                                                               | YEAR ENDED JUNE 30, |             |             |
|-----------------------------------------------------------------------------------------------|---------------------|-------------|-------------|
|                                                                                               | 2001                | 2000        | 1999        |
|                                                                                               | -----               | -----       | -----       |
|                                                                                               | (THOUSANDS)         |             |             |
| CASH FLOWS FROM OPERATING ACTIVITIES:                                                         |                     |             |             |
| Net income (loss).....                                                                        | \$ 62,710           | \$ (18,959) | \$ (53,258) |
| ADJUSTMENTS TO RECONCILE INCOME FROM OPERATIONS TO NET CASH PROVIDED BY (USED IN) OPERATIONS: |                     |             |             |
| Depreciation, depletion and amortization.....                                                 | 75,147              | 70,972      | 62,074      |
| Bad debt expense.....                                                                         | 1,263               | 1,648       | 5,928       |
| Amortization of deferred debt issuance costs.....                                             | 4,317               | 5,919       | 5,216       |
| Restructuring charge.....                                                                     | --                  | --          | 233         |
| Deferred income taxes.....                                                                    | 34,698              | (1,818)     | (25,675)    |
| (Gain) loss on sale of assets.....                                                            | 173                 | 25          | 111         |
| Extraordinary (gain) loss, net of tax.....                                                    | (429)               | (1,611)     | --          |
| Other non-cash items.....                                                                     | --                  | --          | 13          |
| CHANGE IN ASSETS AND LIABILITIES NET OF EFFECTS FROM THE ACQUISITIONS:                        |                     |             |             |
| (Increase) decrease in accounts receivable.....                                               | (55,076)            | (32,853)    | 9,741       |
| (Increase) decrease in other current assets.....                                              | (4,485)             | (5,483)     | (432)       |
| Increase (decrease) in accounts payable, accrued interest and accrued expenses.....           | 29,414              | 18,875      | (17,378)    |
| Other assets and liabilities.....                                                             | (5,015)             | (1,855)     | --          |
|                                                                                               | -----               | -----       | -----       |
| Net cash provided by (used in) operating activities.....                                      | 142,717             | 34,860      | (13,427)    |
|                                                                                               | -----               | -----       | -----       |
| CASH FLOWS FROM INVESTING ACTIVITIES:                                                         |                     |             |             |
| Capital expenditures--well servicing.....                                                     | (50,799)            | (26,469)    | (26,776)    |
| Capital expenditures--contract drilling.....                                                  | (15,884)            | (8,282)     | (1,063)     |
| Capital expenditures--other.....                                                              | (15,437)            | (3,422)     | (3,468)     |
| Proceeds from sale of fixed assets.....                                                       | 3,415               | 2,722       | 7,110       |
| Notes receivable from related parties.....                                                    | (1,500)             | (2,315)     | (2,835)     |
| Cash received in acquisitions.....                                                            | --                  | --          | 27,008      |
| Acquisitions--well servicing.....                                                             | (2,345)             | --          | (292,638)   |
| Acquisitions--contract drilling.....                                                          | (800)               | --          | --          |
| Other assets and liabilities.....                                                             | --                  | --          | (1,992)     |
|                                                                                               | -----               | -----       | -----       |
| Net cash provided by (used in) investing activities.....                                      | (83,350)            | (37,766)    | (294,654)   |
|                                                                                               | -----               | -----       | -----       |

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## CASH FLOWS FROM FINANCING ACTIVITIES:

|                                                                |           |            |           |
|----------------------------------------------------------------|-----------|------------|-----------|
| Repayment of long-term debt and capital lease obligations..... | (382,540) | (51,077)   | (487,376) |
| Borrowings under line-of-credit.....                           | 30,000    | 12,000     | 328,411   |
| Proceeds from equity offerings, net of expenses.....           | --        | 100,571    | 180,441   |
| Proceeds from long-term debt.....                              | 175,210   | --         | 142,566   |
| Proceeds paid for debt issuance costs.....                     | (4,958)   | --         | (15,274)  |
| Proceeds from other long-term debt.....                        | --        | --         | 150,000   |
| Proceeds from forward sale, net of expenses.....               | --        | 18,236     | --        |
| Proceeds from issuance of warrants.....                        | --        | --         | 7,434     |
| Proceeds from exercise of warrants.....                        | 847       | 8,473      | --        |
| Proceeds from exercise of stock options.....                   | 14,617    | 1,098      | 92        |
| Other.....                                                     | (318)     | --         | --        |
| Net cash provided by (used in) financing activities.....       | (167,142) | 89,301     | 306,294   |
| Net increase (decrease) in cash.....                           | (107,775) | 86,395     | (1,787)   |
| Cash and cash equivalents at beginning of period.....          | 109,873   | 23,478     | 25,265    |
| Cash and cash equivalents at end of period.....                | \$ 2,098  | \$ 109,873 | \$ 23,478 |
|                                                                | =====     | =====      | =====     |

SEE THE ACCOMPANYING NOTES WHICH ARE AN INTEGRAL PART OF THESE CONSOLIDATED FINANCIAL STATEMENTS.

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## KEY ENERGY SERVICES INC.

## CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY (THOUSANDS)

|                                                                            | COMMON STOCK        |                  | ADDITIONAL<br>PAID-IN<br>CAPITAL | TREASURY<br>STOCK | RETAINED<br>EARNINGS |
|----------------------------------------------------------------------------|---------------------|------------------|----------------------------------|-------------------|----------------------|
|                                                                            | NUMBER OF<br>SHARES | AMOUNT AT<br>PAR |                                  |                   |                      |
| BALANCE AT JUNE 30, 1998.....                                              | 18,685              | \$ 1,868         | \$119,303                        | \$ (9,682)        | \$41,000             |
| Reversal of unrealized gain on available<br>for sale securities.....       | --                  | --               | --                               | --                | --                   |
| Foreign currency translation adjustment,<br>net of tax.....                | --                  | --               | --                               | --                | --                   |
| Issuance of warrants with 14% Notes.....                                   | --                  | --               | 7,434                            | --                | --                   |
| Issuance of common stock in equity<br>offering, net of offering costs..... | 64,245              | 6,425            | 174,016                          | --                | --                   |
| Issued to lender in lieu of fee.....                                       | 200                 | 20               | 980                              | --                | --                   |
| Exercise of options.....                                                   | 15                  | 2                | 92                               | --                | --                   |
| Other.....                                                                 | 10                  | 2                | (210)                            | --                | --                   |
| Net income (loss).....                                                     | --                  | --               | --                               | --                | (53,200)             |
| BALANCE AT JUNE 30, 1999.....                                              | 83,155              | \$ 8,317         | \$301,615                        | \$ (9,682)        | \$ (12,000)          |
| Foreign currency transition adjustment,<br>net of tax.....                 | --                  | --               | --                               | --                | --                   |
| Exercise of warrants.....                                                  | 2,431               | 243              | 8,230                            | --                | --                   |
| Exercise of options.....                                                   | 241                 | 24               | 1,074                            | --                | --                   |
| Conversion of 7% Debentures.....                                           | 380                 | 38               | 3,568                            | --                | --                   |

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|                                                                         |         |          |           |            |         |
|-------------------------------------------------------------------------|---------|----------|-----------|------------|---------|
| Issuance of common stock in equity offering, net of offering costs..... | 11,000  | 1,100    | 99,471    | --         |         |
| Other.....                                                              | 3       | 1        | 4         | --         |         |
| Net income (loss).....                                                  | --      | --       | --        | --         | (18,9   |
|                                                                         | -----   | -----    | -----     | -----      | -----   |
| BALANCE AT JUNE 30, 2000.....                                           | 97,210  | \$ 9,723 | \$413,962 | \$ (9,682) | \$ (31, |
|                                                                         | -----   | -----    | -----     | -----      | -----   |
| Derivative transition adjustment (see Note 8).....                      | --      | --       | --        | --         |         |
| Oil and natural gas derivatives adjustment, net of tax (See Note 8)...  | --      | --       | --        | --         |         |
| Amortization of oil and natural gas derivatives (see Note 8).....       | --      | --       | --        | --         |         |
| Foreign currency translation adjustment, net of tax.....                | --      | --       | --        | --         |         |
| Exercise of warrants.....                                               | 185     | 19       | 828       | --         |         |
| Exercise of options.....                                                | 3,106   | 308      | 14,309    | --         |         |
| Conversion of 7% Debentures.....                                        | 101     | 10       | 947       | --         |         |
| Issuance of common stock for acquisitions.....                          | 838     | 84       | 8,036     | --         |         |
| Deferred tax benefit--compensation expense.....                         | --      | --       | 7,004     | --         |         |
| Other.....                                                              | --      | --       | (318)     | --         |         |
| Net income (loss).....                                                  | --      | --       | --        | --         | 62,7    |
|                                                                         | -----   | -----    | -----     | -----      | -----   |
| BALANCE AT JUNE 30, 2001.....                                           | 101,440 | \$10,144 | \$444,768 | \$ (9,682) | \$31,5  |
|                                                                         | =====   | =====    | =====     | =====      | =====   |

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

JUNE 30, 2001, 2000 AND 1999

## 1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### THE COMPANY

Key Energy Services, Inc. (the "Company" or "Key"), is the largest onshore, rig-based well servicing contractor in the world, with approximately 1,477 well service rigs and 1,455 oilfield service vehicles as of June 30, 2001. 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; 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, 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 and Ontario, Canada. The Company is also a leading onshore drilling contractor, with 79 land drilling rigs as of June 30, 2001. Key conducts land drilling operations in a number of major

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domestic producing basins, as well as in Argentina and in Ontario, Canada. Key also produces and develops oil and natural gas reserves in the Permian Basin region and Texas Panhandle.

### BASIS OF PRESENTATION

The Company's consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All significant inter-company transactions and balances have been eliminated. The accounting policies presented below have been followed in preparing the accompanying consolidated financial statements.

### ESTIMATES AND UNCERTAINTIES

Preparation of the accompanying consolidated financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amount of assets and liabilities and disclosures of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

### INVENTORIES

Inventories, which consist primarily of oilfield service parts and supplies held for consumption and parts and supplies held for sale at the Company's various retail supply stores, are valued at the lower of average cost or market.

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### KEY ENERGY SERVICES INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

JUNE 30, 2001, 2000 AND 1999

### 1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

#### PROPERTY AND EQUIPMENT

The Company provides for depreciation and amortization of oilfield service and related equipment using the straight-line method, excluding its drilling rigs, over the following estimated useful lives of the assets:

| DESCRIPTION<br>-----                        | YEARS<br>----- |
|---------------------------------------------|----------------|
| Well service rigs.....                      | 25             |
| Motor vehicles.....                         | 5              |
| Furniture and equipment.....                | 3-7            |
| Buildings and improvements.....             | 10-40          |
| Gas processing facilities.....              | 10             |
| Disposal wells.....                         | 15-30          |
| Trucks, trailers and related equipment..... | 7-15           |

The components of a well service rig that generally require replacement during the rig's life are depreciated over their estimated useful lives, which range from three to 15 years. The basic rigs, excluding components, have estimated useful lives from date of original manufacture ranging from 25 to 35 years. Salvage values are assigned to the rigs based on an estimate of 10%.

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Effective July 1, 1998, the Company made certain changes in the estimated useful lives of its well service rigs, increasing the lives from 17 years to 25 years. This change decreased the net loss for the twelve months ended June 30, 1999 by approximately \$3,100,000 (\$0.11 per share-basic). This change was made to better reflect the expected utilization of these assets over time, to better provide matching of revenues and expenses and to better reflect the industry standard in regards to estimated useful lives of workover rigs.

The Company uses the units-of-production method to depreciate its drilling rigs. This method takes into consideration the number of days the rigs are actually in service each month and depreciation is recorded for at least 15 days each month for each rig that is available for service. The Company believes that this method appropriately reflects its financial results by matching revenues with expenses and appropriately reflects how the assets are to be used over time.

The Company uses the successful efforts method of accounting for its oil and gas properties. Under this method, all costs associated with productive wells and nonproductive development wells are capitalized, while nonproductive exploration costs and geological and geophysical costs (if any), are expensed. Capitalized costs relating to proved properties are depleted using the units-of-production method.

The Company follows the provisions of FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of. This statement requires that long-lived assets including certain identifiable intangibles, held and used by the Company, be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. For purposes of applying this statement, the Company groups its long-lived assets, including goodwill, on a yard-by-yard basis and compares the estimated future cash flows of each yard to the yard's net carrying value including allocable goodwill. The Company would record an impairment charge, reducing the yard's net carrying value to an estimated fair value, if the estimated future cash flows

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KEY ENERGY SERVICES INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

JUNE 30, 2001, 2000 AND 1999

1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)  
were less than the yard's net carrying value. Since adoption of this statement no impairment charges have been required.

### HEDGING AND DERIVATIVE FINANCIAL INSTRUMENTS

The Company uses derivative financial instruments, primarily commodity option contracts to reduce the exposure of its oil and gas producing operations to changes in the market price of natural gas and crude oil and to fix the price for natural gas and crude oil independently of the physical sale.

The financial instruments that the Company accounts for as hedging contracts must meet the following criteria: the underlying asset or liability must expose the Company to price risk that is not offset in another asset or liability, the hedging contract must reduce that price risk, and the instrument must be designated as a hedge at the inception of the contract and throughout the contract period. In order to qualify as a hedge, there must be clear correlation between changes in the fair value of the financial instrument and the fair value

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of the underlying asset or liability such that changes in the market value of the financial instrument will be offset by the effect of price rate changes on the exposed items.

Prior to the adoption of SFAS 133, premiums paid for commodity option contracts, which qualify as hedges, are amortized to oil and natural gas sales over the terms of the contracts. Unamortized premiums are included in other assets in the consolidated balance sheet. Amounts receivable under the commodity option contracts are accrued as an increase in oil and natural gas sales for the applicable periods.

Effective July 1, 2000, the Company adopted SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("SFAS 133") as amended by SFAS No. 137 and No. 138 ("SFAS 138"). SFAS 133 establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts and hedging activities. It requires the recognition of all derivative instruments as assets and liabilities in the Company's balance sheet and measurement of those instruments at fair value. The accounting treatment of changes in fair value is dependent upon whether or not a derivative instrument is designated as a hedge and if so, the type of hedge. For derivatives designated as cash flow hedges, changes in fair value are recognized in other comprehensive income until the hedged item is recognized in earnings. See Note 8.

### COMPREHENSIVE INCOME

The Company follows the provisions of Statement of Financial Accounting Standards No. 130, "Reporting Comprehensive Income" ("SFAS 130"). SFAS 130 establishes standards for reporting and presentation of comprehensive income and its components. SFAS 130 requires that all items that are required to be recognized under accounting standards as components of comprehensive income be reported in a financial statement that is displayed with the same prominence as other financial statements. In accordance with the provisions of SFAS 130, the Company has presented the components of comprehensive income in its Consolidated Statements of Comprehensive Income.

### ENVIRONMENTAL

The Company is subject to extensive federal, state and local environmental laws and regulations. These laws, which are constantly changing, regulate the discharge of materials into the environment and may require the Company to remove or mitigate the adverse environmental effects of the disposal or

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KEY ENERGY SERVICES INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

JUNE 30, 2001, 2000 AND 1999

1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)  
release of petroleum or chemical substances at various sites. Environmental expenditures are expensed or capitalized depending on their future economic benefit. Expenditures that relate to an existing condition caused by past operations and that have no future economic benefits are expensed. Liabilities for expenditures of a non-capital nature are recorded when environmental assessment and/or remediation is probable, and the costs can be reasonably estimated.

### GOODWILL



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Net goodwill, totaling \$189.9 million and \$198.6 million at June 30, 2001 and 2000, respectively, represents the cost in excess of fair value of the net tangible and identifiable intangible assets acquired and liabilities assumed in purchase transactions. Goodwill is being amortized on a straight-line basis over periods ranging from ten to 25 years. Amortization of goodwill for fiscal 2001, 2000 and 1999 was approximately \$9,322,000, \$9,840,000 and \$9,202,000, respectively. The carrying amount of unamortized goodwill is reviewed for potential impairment loss whenever events or changes in circumstances indicate that the carrying amount of goodwill may not be recoverable (see Property and Equipment above, for further discussion).

### DEFERRED COSTS

Deferred costs totaling \$31,052,000 and \$30,998,000 at June 30, 2001 and 2000, respectively, represent debt issuance costs and are recorded net of accumulated amortization of \$13,428,000 and \$12,143,000 at June 30, 2001 and 2000, respectively. Deferred costs are amortized to interest expense using the straight-line method over the life of each applicable debt instrument or to extraordinary loss as related debt is retired early. This method approximates the amortization which would be recorded using the effective interest method. Amortization of deferred costs totaled approximately \$3,578,000, \$5,176,000 and \$4,664,000 for fiscal 2001, 2000 and 1999, respectively. Unamortized debt issuance costs included in the determination of the extraordinary gain (loss) on retirement of debt, net of tax, totaled approximately \$1,620,000 for fiscal 2001.

### INCOME TAXES

The Company accounts for income taxes based upon Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes" ("SFAS 109"). Under SFAS 109, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using statutory tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rate is recognized in income in the period that includes the statutory enactment date. A valuation allowance for deferred tax assets is recognized when it is more likely than not that the benefit of deferred tax assets will not be realized.

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KEY ENERGY SERVICES INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

JUNE 30, 2001, 2000 AND 1999

#### 1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

The Company and its eligible subsidiaries file a consolidated U. S. federal income tax return. Certain subsidiaries that are consolidated for financial reporting purposes are not eligible to be included in the consolidated U. S. federal income tax return and separate provisions for income taxes have been determined for these entities or groups of entities.

### EARNINGS PER SHARE

The Company presents earnings per share information in accordance with the provisions of Statement of Financial Accounting Standards No. 128, "Earnings per Share" ("SFAS 128"). Under SFAS 128, basic earnings per common share are

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determined by dividing net earnings applicable to common stock by the weighted average number of common shares actually outstanding during the year. Diluted earnings per common share is based on the increased number of shares that would be outstanding assuming conversion of dilutive outstanding convertible securities using the "as if converted" method.

|                                                                                                         | YEAR ENDED JUNE 30,                |             |             |
|---------------------------------------------------------------------------------------------------------|------------------------------------|-------------|-------------|
|                                                                                                         | 2001                               | 2000        | 1999        |
|                                                                                                         | (THOUSANDS, EXCEPT PER SHARE DATA) |             |             |
| BASIC EPS COMPUTATION:                                                                                  |                                    |             |             |
| NUMERATOR                                                                                               |                                    |             |             |
| Net income (loss) before extraordinary gain (loss).....                                                 | \$ 62,281                          | \$ (20,570) | \$ (53,258) |
| Extraordinary gain (loss), net of tax.....                                                              | 429                                | 1,611       | --          |
|                                                                                                         | -----                              | -----       | -----       |
| Net income (loss).....                                                                                  | \$ 62,710                          | \$ (18,959) | \$ (53,258) |
|                                                                                                         | =====                              | =====       | =====       |
| DENOMINATOR                                                                                             |                                    |             |             |
| Weighted average common shares outstanding.....                                                         | 98,195                             | 83,815      | 27,501      |
|                                                                                                         | -----                              | -----       | -----       |
| BASIC EPS:                                                                                              |                                    |             |             |
| Before extraordinary gain (loss).....                                                                   | \$ 0.63                            | \$ (0.25)   | \$ (1.94)   |
| Extraordinary gain (loss), net of tax.....                                                              | --                                 | 0.02        | --          |
|                                                                                                         | -----                              | -----       | -----       |
| Net income (loss).....                                                                                  | \$ 0.63                            | \$ (0.23)   | \$ (1.94)   |
|                                                                                                         | =====                              | =====       | =====       |
| DILUTED EPS COMPUTATION:                                                                                |                                    |             |             |
| NUMERATOR                                                                                               |                                    |             |             |
| Net income (loss) before extraordinary gain (loss) and effect of dilutive securities, tax effected..... | \$ 62,281                          | \$ (20,570) | \$ (53,258) |
| Convertible securities.....                                                                             | 5                                  | --          | --          |
|                                                                                                         | -----                              | -----       | -----       |
| Net income (loss) before extraordinary gain (loss).....                                                 | \$ 62,286                          | \$ (20,570) | \$ (53,258) |
| Extraordinary gain (loss), net of tax.....                                                              | 429                                | 1,611       | --          |
|                                                                                                         | -----                              | -----       | -----       |
| Net income (loss).....                                                                                  | \$ 62,715                          | \$ (18,959) | \$ (53,258) |
|                                                                                                         | =====                              | =====       | =====       |
| DENOMINATOR                                                                                             |                                    |             |             |
| Weighted average common shares outstanding.....                                                         | 98,195                             | 83,815      | 27,501      |
| Warrants.....                                                                                           | 205                                | --          | --          |
| Stock options.....                                                                                      | 3,853                              | --          | --          |
| 7% Convertible Debentures.....                                                                          | 18                                 | --          | --          |
|                                                                                                         | -----                              | -----       | -----       |
|                                                                                                         | 102,271                            | 83,815      | 27,501      |

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|                                            | YEAR ENDED JUNE 30,                |           |           |
|--------------------------------------------|------------------------------------|-----------|-----------|
|                                            | 2001                               | 2000      | 1999      |
|                                            | (THOUSANDS, EXCEPT PER SHARE DATA) |           |           |
| DILUTED EPS:                               |                                    |           |           |
| Before extraordinary gain (loss).....      | \$ 0.61                            | \$ (0.25) | \$ (1.94) |
| Extraordinary gain (loss), net of tax..... | --                                 | 0.02      | --        |
| Net income (loss).....                     | \$ 0.61                            | \$ (0.23) | \$ (1.94) |
|                                            | =====                              | =====     | =====     |

The diluted earnings per share calculation for the year ended June 30, 2001 excludes the effect of the exercise of 360,000 stock options and the conversion of the Company's 5% Convertible Subordinated Notes because the effects of such instruments on earnings per share would be anti-dilutive.

The diluted earnings per share calculation for the years ended June 30, 2000 and 1999 excludes the effect of the conversion of all of the Company's then outstanding convertible debt and the exercise of all of the Company's then outstanding warrants and stock options because the effects of such instruments on loss per share would be anti-dilutive.

## CONCENTRATION OF CREDIT RISK

Financial instruments, which potentially subject the Company to concentrations of credit risk, consist primarily of temporary cash investments and trade receivables. The Company restricts investment of temporary cash investments to financial institutions with high credit standing and, by policy, limits the amount of credit exposure to any one financial institution. The Company's customer base consists primarily of multi-national and independent oil and natural gas producers. This may affect the Company's overall exposure to credit risk either positively or negatively in as much as its customers are affected by economic conditions in the oil and gas industry, which have historically been cyclical. However, account receivables are well diversified among many customers and a significant portion of the receivables are from major oil companies, which management believes minimizes potential credit risk. Historically, credit losses have been insignificant. Receivables are generally not collateralized, although the Company may generally secure a receivable at any time by filing a mechanic's or material-man's lien on the well serviced. The Company maintains reserves for potential credit losses, and such losses have been within management's expectations.

The Company did not have any one customer who represented 10% or more of consolidated revenues for the fiscal year ended June 30, 2001, 2000 or 1999.

## STOCK-BASED COMPENSATION

The Company accounts for stock option grants to employees using the intrinsic value method of accounting prescribed by APB Opinion No. 25, Accounting for Stock Issued to Employees ("APB 25"). Under the Company's stock incentive plans, the price of the stock on the grant date is the same as the amount an employee must pay to exercise the option to acquire the stock; accordingly, the options have no intrinsic value at grant date, and in accordance with the provisions of APB 25, no compensation cost is recognized.

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

JUNE 30, 2001, 2000 AND 1999

### 1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Statement of Financial Accounting Standards No. 123 ("SFAS 123"), "Accounting for Stock-Based Compensation," sets forth alternative accounting and disclosure requirements for stock-based compensation arrangements. Companies may continue to follow the provisions of APB 25 to measure and recognize employee stock-based compensation; however, SFAS 123 requires disclosure of pro forma net income and earnings per share that would have been reported under the fair value based recognition provisions of SFAS 123. The Company has disclosed in Note 10 the pro forma information required under SFAS 123.

### FOREIGN CURRENCY GAINS AND LOSSES

The local currency is the functional currency for all of the Company's foreign operations (Argentina and Canada). The cumulative translation gains and losses, resulting from translating each foreign subsidiary's financial statements from the functional currency to U.S. dollars, is included in other comprehensive income and accumulated in stockholders' equity until a partial or complete sale or liquidation of the Company's net investment in the foreign entity.

### CASH AND CASH EQUIVALENTS

The Company considers all unrestricted highly liquid investments with less than a three-month maturity when purchased, as cash equivalents.

### RECLASSIFICATIONS

Certain reclassifications have been made to the fiscal 2000 and 1999 consolidated financial statements to conform to the fiscal 2001 presentation. The reclassifications consist primarily of reclassifying oil and natural gas productions revenues and expenses. Oil and natural gas production revenues and related expenses have been reclassified to other revenues and other expenses because the Company does not believe this business segment is material to the Company's consolidated financial statements.

### 2. RESTRUCTURING CHARGE

In response to an industry downturn caused by historically low oil and gas prices and the resulting slowdown in business, on December 7, 1998, the Company announced a company-wide restructuring plan to reduce operating costs beyond those achieved through the Company's consolidation efforts. The plan involved a reduction in the size of management and on-site work force, salary reductions averaging 21% for senior management, the combination of previously separate operating divisions and the elimination of redundant overhead and facilities. The restructuring plan resulted in pretax charges to earnings of approximately \$6.7 million in the second quarter ending December 31, 1998 and \$1.5 million in the third quarter ending March 31, 1999. However, due to an increase in oil and gas prices beginning during the quarter ended March 31, 1999, the Company amended its restructuring plan to decrease the number of planned employee terminations. Increased demand for the Company's services made such terminations unnecessary and would have, in management's opinion, restricted the Company's ability to provide services to its customers. Consequently, the Company did not utilize approximately \$3.7 million of the pretax charges. Essentially all of the unutilized portion of the restructuring charge was reversed in the fourth quarter ending June 30, 1999 resulting in a total pretax charge for the fiscal year ended June 30, 1999 of approximately \$4.5 million. The charges included severance payments and other termination benefits for

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KEY ENERGY SERVICES INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

JUNE 30, 2001, 2000 AND 1999

## 2. RESTRUCTURING CHARGE (CONTINUED)

approximately 97 employees, lease commitments related to closed facilities and environmental studies performed on closed leased yard locations.

The Company completed the plan at June 30, 2000. There remained approximately \$180,000 for COBRA benefits to terminated employees and \$53,000 for contractual payments to an employee at June 30, 1999. The major components of the restructuring charge and costs incurred through June 30, 1999 were as follows:

| DESCRIPTION                   | RESTRUCTURING<br>CHARGE | COST INCURRED<br>THROUGH JUNE 30, 1999 | BALANCE AS OF<br>JUNE 30, 1999 |
|-------------------------------|-------------------------|----------------------------------------|--------------------------------|
| -----                         | -----                   | -----                                  | -----                          |
|                               |                         | (IN THOUSANDS)                         |                                |
| Severance/employee costs..... | \$4,457                 | \$ (4,224)                             | \$233                          |
| Lease commitments.....        | 27                      | (27)                                   | --                             |
| Environmental clean-up.....   | 20                      | (20)                                   | --                             |
|                               | -----                   | -----                                  | ----                           |
| Total.....                    | \$4,504                 | \$ (4,271)                             | \$233                          |
|                               | =====                   | =====                                  | =====                          |

## 3. BUSINESS AND PROPERTY ACQUISITIONS

ACQUISITIONS COMPLETED IN FISCAL 2001 AND 2000

There were no acquisitions completed by the Company during fiscal 2000. During fiscal 2001, the Company completed several small acquisitions for a total consideration of \$11,965,000, which was paid using a combination of cash, notes and shares of the Company's common stock. Through these acquisitions, the Company acquired 34 well service rigs, 8 trucking vehicles, ancillary equipment and five salt water disposal facilities. 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.

DAWSON PRODUCTIONS SERVICES, INC.

In September 1998, the Company completed the acquisition of all of the capital stock of Dawson Production Services, Inc. (Dawson) for an aggregate consideration of approximately \$382.6 million, including approximately \$207.1 million of cash paid for the Dawson stock and for transactional fees and approximately \$175.5 million of net liabilities assumed.

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KEY ENERGY SERVICES INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

JUNE 30, 2001, 2000 AND 1999

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### 3. BUSINESS AND PROPERTY ACQUISITIONS (CONTINUED)

Expenditures for the Dawson acquisition, including acquisition costs, less cash acquired were as follows (in thousands):

|                                                                                                                |           |
|----------------------------------------------------------------------------------------------------------------|-----------|
| Fair value of assets acquired, including goodwill.....                                                         | \$409,722 |
| Liabilities assumed.....                                                                                       | (199,439) |
| Liabilities for employee termination costs and lease termination costs.....                                    | (3,162)   |
|                                                                                                                | -----     |
| Cash paid, including acquisition related expenditures and the cost of Dawson common stock previously held..... | 207,121   |
| Less: Cash acquired.....                                                                                       | (27,008)  |
|                                                                                                                | -----     |
| Net cash used for the acquisition.....                                                                         | \$180,113 |
|                                                                                                                | =====     |

At the time of the closing, Dawson owned approximately 527 well service rigs, 200 oilfield trucks, and 21 production testing units in South Texas and the Gulf Coast, East Texas and Louisiana, the Permian Basin of West Texas and New Mexico, the Anadarko Basin of Texas and Oklahoma, California, and in the inland waters of the Gulf of Mexico.

In connection with the Dawson acquisition, the Company recognized liabilities for the estimated costs to involuntarily terminate employees of Dawson and to exit certain activities of Dawson, primarily Dawson's lease liability for its corporate offices. As of June 30, 1999, the Company had completed its severance plan, terminating 44 former Dawson employees. At June 30, 1999, the Company had \$592,000 accrued, representing the estimated lease termination costs of Dawson's former corporate offices.

#### OTHER FISCAL 1999 ACQUISITIONS

In addition to its acquisition of Dawson, the Company acquired the assets and/or capital stock of six well servicing and contract drilling businesses during fiscal 1999, increasing its rig and truck fleet by a total of approximately 93 well service rigs, 4 drilling rigs and 185 oilfield trucks (and related equipment) for an aggregate purchase price of approximately \$93.7 million in cash. 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.

#### PRO FORMA RESULTS OF OPERATIONS--(UNAUDITED)

The following unaudited pro forma results of operations have been prepared as though the Dawson acquisition had been acquired on July 1, 1998 with adjustments to record specifically identifiable decreases in direct costs and general and administrative expenses related to the termination of individual employees. Pro forma amounts are not necessarily indicative of the results that may be reported in the future.

YEAR ENDED  
JUNE 30, 1999

-----  
(THOUSANDS, EXCEPT PER SHARE DATA)

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|                                      |           |
|--------------------------------------|-----------|
| Revenues.....                        | \$524,924 |
| Net income (loss).....               | (58,211)  |
| Basic earnings (loss) per share..... | (2.12)    |

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## KEY ENERGY SERVICES INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

JUNE 30, 2001, 2000 AND 1999

#### 4. COMMITMENTS AND CONTINGENCIES

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.

In order to retain qualified senior management, the Company enters into employment agreements with its executive officers. These employment agreements run for periods ranging from three to five years, but can be automatically extended on a yearly basis unless terminated by the Company or the executive officer. In addition to providing a base salary for each executive officer, the employment agreements provide for severance payments for each executive officer varying from 1 to 3 years of the executive officer's base salary. At June 30, 2001 the annual base salaries for the executive officers covered under such employment agreements totaled \$1,125,000. The Company also enters into employment agreements with other key employees as it deems necessary in order to retain qualified personnel.

#### 5. LONG-TERM DEBT

The components of the Company's long-term debt are as follows:

|                                                          | JUNE 30,    |           |
|----------------------------------------------------------|-------------|-----------|
|                                                          | 2001        | 2000      |
|                                                          | (THOUSANDS) |           |
| Senior Credit Facility (i)                               |             |           |
| Revolving Loans.....                                     | \$ 2,000    | \$ 93,000 |
| Tranche A Term Loan.....                                 | --          | 22,987    |
| Tranche B Term Loan.....                                 | --          | 175,961   |
| 8 3/8% Senior Notes Due 2008 (ii).....                   | 175,000     | --        |
| 14% Senior Subordinated Notes Due 2009 (iii).....        | 134,466     | 143,650   |
| 5% Convertible Subordinated Notes Due 2004 (iv).....     | 158,426     | 205,810   |
| Dawson 9 3/8% Senior Notes Due 2007 (v).....             | 246         | 1,106     |
| 7% Convertible Subordinated Debentures Due 2003 (vi).... | --          | 1,000     |
| Capital Leases.....                                      | 22,964      | 21,911    |
| Other notes payable.....                                 | 805         | 1,175     |
|                                                          | 493,907     | 666,600   |
| Less current portion.....                                | 7,946       | 14,655    |
| Total long-term debt.....                                | \$485,961   | \$651,945 |
|                                                          | =====       | =====     |

(I) SENIOR CREDIT FACILITY

At June 30, 2001, the Company's senior credit facility (the "Senior Credit Facility") consisted of a \$125 million revolving credit facility. In addition, up to \$20 million of letters of credit can be issued under the Senior Credit Facility, but any outstanding letters of credit reduces borrowing availability under the revolver. The commitment to make revolving loans reduced to \$100 million, on September 14, 2001 and will reduce to \$75 million on September 14, 2002. The revolving commitment will terminate on September 14, 2003, and all the revolving loans must be paid on or before that date.

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KEY ENERGY SERVICES INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

JUNE 30, 2001, 2000 AND 1999

5. LONG-TERM DEBT (CONTINUED)

The revolving loans bear interest at rates based upon, at the Company's option, either the prime rate plus a margin ranging from 0.75% to 2.00% or a Eurodollar rate plus a margin ranging from 2.25% to 3.50%, in each case depending upon the ratio of the Company's total debt (less cash on hand over \$5 million) to the Company's trailing 12-month EBITDA, as adjusted. The Company pays commitment fees on the unused portion of the revolving loan at a varying rate (depending upon the pricing ratio) of between 0.25% and 0.50%.

The Senior Credit Facility contains various financial covenants, including: (i) consolidated debt-to-capitalization ratio at generally decreasing levels varying between 79% and 65%, (ii) consolidated interest coverage ratio at generally increasing levels varying between 2.00-to-1.00 and 3.50-to-1.00, (iii) consolidated senior leverage ratio at generally decreasing levels varying between 2.50-to-1.00 and 2.00-to-1.00, and (iv) trailing 12-month EBITDA, as adjusted, at generally increasing levels varying between \$50 million and \$150 million. In addition, the Company must maintain a consolidated fixed charge coverage ratio at generally decreasing levels varying between 1.25-to-1.00 and 1.00 to 1.00. The covenants for consolidated senior leverage ratio and consolidated interest coverage ratio are not imposed until the quarter ending March 31, 2001, and the covenant levels for consolidated debt-to-capitalization and trailing 12-month EBITDA, as adjusted, will remain fixed at 79% and \$50 million, respectively, for the same period. The Company is also required to maintain a consolidated liquidity level of at least \$30 million.

The Senior Credit Facility subjects the Company to other restrictions, including restrictions upon the Company's ability to incur additional debt, liens and guarantee obligations, to merge or consolidate with other persons, to sell assets, to make dividends, purchases of our stock or subordinated debt, to make capital expenditures in excess of levels ranging from \$37.5 million in fiscal 1999 to \$65 million in fiscal 2004, or to make investments, loans and advances or changes to debt instruments and organizational documents. The Company will not be permitted to make acquisitions unless (i) its consolidated debt to capitalization ratio is not more than 60% or (ii) its consolidated debt to capitalization ratio is not increased and the acquisition is funded solely with capital stock. The Company must also maintain consolidated net worth not less than, \$195 million plus (i) 75% of consolidated net income for each fiscal quarter beginning with the period ending December 31, 1998, (ii) 75% of the net cash proceeds from issuance of capital stock after September 14, 1998 and (iii) 75% of the increase in consolidated net worth resulting from the conversion of the 5% Convertible Subordinated Notes or other convertible debt



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issued after September 14, 1998. All obligations under the Senior Credit Facility are guaranteed by most of the Company's subsidiaries and are secured by substantially all the Company's assets, including the Company's accounts receivable, inventory and equipment.

During fiscal 2001, a portion of the net proceeds from the Equity Offering (see Note 10) was used to repay the entire outstanding balance of the Tranche A term loan then outstanding under the Senior Credit Facility and \$2.3 million of the Tranche B term loan then outstanding under the Senior Credit Facility. In addition, \$65 million of the net proceeds from the Equity Offering were used to reduce the principal amount outstanding under the revolver. The remainder of the net proceeds of the Equity Offering was used to retire other long-term debt. A portion of the proceeds from the Company's 8 3/8% Senior Note offering in fiscal 2001 was used to repay the entire outstanding balance of the Tranche B term loan then outstanding under the Senior Credit Facility and approximately \$59.1 million under the revolver.

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KEY ENERGY SERVICES INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

JUNE 30, 2001, 2000 AND 1999

### 5. LONG-TERM DEBT (CONTINUED)

At June 30, 2001, there was approximately \$2,000,000 outstanding under the revolving loans. Additionally, the Company had outstanding letters of credit of \$11,995,000 and \$15,132,000 as of June 30, 2001 and 2000, respectively, related to its workers compensation insurance.

#### (II) 8 3/8% SENIOR NOTES

On March 6, 2001 the Company completed a private placement of \$175,000,000 of 8 3/8% Senior Notes due 2008 (the "8 3/8% 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 Senior Credit Facility and a portion of the revolving loan facility under the Senior Credit Facility. The 8 3/8% Senior Notes are senior unsecured obligations, ranking equally with the Company's senior unsecured indebtedness. The 8 3/8% Senior Notes are effectively subordinated to Key's secured indebtedness which includes borrowings under the Senior Credit Facility and the Dawson 9 3/8% Senior Notes.

On and after March 1, 2005, the Company may redeem some or all of the 8 3/8% 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 8 3/8% Senior Notes with the proceeds of certain sales of equity at 108.375% of par plus accrued interest.

At June 30, 2001, \$175,000,000 principal amount of the 8 3/8% Senior Notes remained outstanding. The 8 3/8% Senior Notes pay interest semi-annually on March 1 and September 1 of each year.

#### (III) 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 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 \$148.6 million principal amount (plus accrued interest) owed under the Company's bridge loan facility arranged in

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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 may redeem up to 35% of the aggregate principal amount of the 14% Senior Subordinated Notes with the proceeds of certain sales of equity at 114% of par, plus accrued interest. On June 11, 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, leaving \$139,687,000 principal amount outstanding as of June 30, 2001.

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

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KEY ENERGY SERVICES INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

JUNE 30, 2001, 2000 AND 1999

### 5. LONG-TERM DEBT (CONTINUED)

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 Current Senior Credit Facility, the Dawson 9 3/8% Senior Notes and the 8 3/8% Senior Notes.

In the event of a change in control of the Company, as defined in the indenture under which the 14% Senior Subordinated Notes were issued, each holder of 14% Senior Subordinated Notes will have the right, at the holder's option, to require the Company to repurchase all or any part of the holder's 14% Senior Subordinated Notes, within 60 days of such event, at a price equal to 100% of the principal amount thereof, together with accrued and unpaid interest thereon.

During fiscal 2001, the Company repurchased (and cancelled) \$10,313,000 principal amount of the 14% Senior Subordinated Notes and paid a premium of approximately \$1,444,000. At June 30, 2001, \$139,687,000 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, beginning July 15, 1999. Interest of approximately \$10,500,000 was paid on July 15, 2000 and January 15, 2001. As of June 30, 2001, 62,500 Unit Warrants had been exercised, producing approximately \$4,173,000 of proceeds to the Company and leaving 87,500 Unit Warrants outstanding.

### (IV) 5% CONVERTIBLE SUBORDINATED NOTES

In late September and early October 1997, the Company completed a private placement of \$216 million 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, the Dawson 9 3/8% Senior Notes and the 8 3/8% 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

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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 fiscal 2001, the Company repurchased (and cancelled) \$47,384,000 principal amount of the 5% Convertible Subordinated Notes, leaving \$158,426,000 principal amount of the 5% Convertible Subordinated Notes outstanding at June 30, 2001. These repurchases resulted in an after tax gain of approximately \$3.2 million. Interest on the 5% Convertible Subordinated Notes is payable on March 15 and September 15. Interest of approximately \$4,890,000 was paid on September 15, 2000 and \$4,815,000 was paid on March 15, 2001, respectively.

### (V) DAWSON 9 3/8% SENIOR NOTES

As a result of the Dawson acquisition (see Note 3), the Company, its subsidiaries and U.S. Trust Company of Texas, N.A., as trustee ("U.S. Trust"), entered into a Supplemental Indenture dated

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## KEY ENERGY SERVICES INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

JUNE 30, 2001, 2000 AND 1999

#### 5. LONG-TERM DEBT (CONTINUED)

September 21, 1998 (the "Supplemental Indenture"), pursuant to which the Company assumed the obligations of Dawson under the Indenture dated February 20, 1997 (the "Dawson Indenture") between Dawson and U.S. Trust. The senior notes due 2007 (the "Dawson 9 3/8% Senior Notes") issued pursuant to the Dawson Indenture were equally and ratably secured with the obligations under the Senior Credit Facility. As a result of a mandatory tender offer made in connection with the Dawson acquisition and subsequent repurchases, only \$1,106,000 principal amount of Dawson 9 3/8% Senior Notes remained outstanding at June 30, 2000.

During fiscal 2001, the Company repurchased \$860,000 principal amount of the Dawson 9 3/8% Senior Notes, leaving \$246,000 principal amount outstanding as of June 30, 2001. Interest on the Dawson 9 3/8% Senior Notes is payable on February 1 and August 1 of each year. Interest of approximately \$52,000 and approximately \$14,000 was paid on August 1, 2000 and February 1, 2001, respectively.

#### (vi) 7% CONVERTIBLE SUBORDINATED DEBENTURES

In July 1996, the Company completed a private placement of \$52,000,000 principal amount of 7% Convertible Subordinated Debentures due 2003 (the "7% Convertible Subordinated Debentures"). During the quarter ended September 30, 2000, \$985,000 principal amount of the 7% Convertible Subordinated Debentures were surrendered for conversion by the holders thereof and 101,025 shares of common stock were issued on September 1, 2000 in connection with the conversion. On September 1, 2000, the remaining \$15,000 principal amount of the outstanding 7% Convertible Subordinated Debentures was redeemed at 103% of the principal amount plus accrued interest, leaving none outstanding. Interest on the 7% Convertible Subordinated Debentures was payable on January 1 and July 1 of each year. Interest of approximately \$35,000 was paid on July 1, 2000.

#### CAPITALIZED DEBT ISSUANCE COSTS, REPAYMENT SCHEDULE AND INTEREST EXPENSE

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The Company capitalized a total of approximately \$4,958,000 and \$16,370,000 in fees and costs in connection with its various financings during fiscal 2001 and 1999 respectively. The Company did not incur any fees or costs in connection with financing activities in fiscal 2000.

Presented below is a schedule of the repayment requirements of long-term debt for each of the next five years and thereafter as of June 30, 2001:

| FISCAL YEAR ENDED JUNE 30,<br>----- | PRINCIPAL<br>AMOUNT<br>-----<br>(IN THOUSANDS) |
|-------------------------------------|------------------------------------------------|
| 2002.....                           | \$ 7,946                                       |
| 2003.....                           | 7,912                                          |
| 2004.....                           | 9,911                                          |
| 2005.....                           | 158,426                                        |
| 2006.....                           | --                                             |
| Thereafter.....                     | 309,712                                        |
|                                     | -----                                          |
|                                     | \$493,907                                      |
|                                     | =====                                          |

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### KEY ENERGY SERVICES INC.

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

JUNE 30, 2001, 2000 AND 1999

#### 5. LONG-TERM DEBT (CONTINUED)

The Company's interest expense for the years ended June 30, 2001, 2000, and 1999 consisted of the following:

|                                          | 2001<br>-----  | 2000<br>----- | 1999<br>----- |
|------------------------------------------|----------------|---------------|---------------|
|                                          | (IN THOUSANDS) |               |               |
| Cash payments for interest.....          | \$51,524       | \$61,956      | \$52,397      |
| Commitment and agency fees paid.....     | 1,203          | 1,139         | 527           |
| Accretion of discount on notes.....      | 739            | 743           | 552           |
| Amortization of debt issuance costs..... | 3,578          | 5,176         | 4,664         |
| Net change in accrued interest.....      | 146            | 2,916         | 9,261         |
| Other.....                               | (630)          | --            | --            |
|                                          | -----          | -----         | -----         |
|                                          | \$56,560       | \$71,930      | \$67,401      |
|                                          | =====          | =====         | =====         |

#### 6. DEBT ISSUANCE COSTS

During fiscal 1999, the Company recorded an expense item of \$6,307,000 which represented the write-off of debt issuance costs. The debt issuance costs were associated with a bridge loan incurred in connection with the Dawson acquisition, which was subsequently paid primarily with the proceeds from the Company's private placement of 14% Senior Subordinated Notes (see Note 5).

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During fiscal 2000, the Company expensed \$338,000 of debt issuance costs related to the conversion of 7% Convertible Subordinated Debentures and other prepayments of debt.

### 7. FAIR VALUE OF FINANCIAL INSTRUMENTS

The following table presents the carrying amounts and estimated fair values of the Company's financial instruments at June 30, 2001 and 2000. FASB Statement No. 107, "Disclosures about Fair Value of Financial Instruments", defines the fair value of a financial instrument as the amount at which the instrument could be exchanged in a current transaction between willing parties.

|                                                | 2001              |               | 2000              |               |
|------------------------------------------------|-------------------|---------------|-------------------|---------------|
|                                                | CARRYING<br>VALUE | FAIR<br>VALUE | CARRYING<br>VALUE | FAIR<br>VALUE |
| Financial Assets:                              |                   |               |                   |               |
| Cash and cash equivalents.....                 | \$ 2,098          | \$ 2,098      | \$109,873         | \$109,873     |
| Accounts receivable, net.....                  | 177,016           | 177,016       | 123,203           | 123,203       |
| Notes receivable--related parties.....         | 6,050             | 6,600         | 5,150             | 5,150         |
| Commodity option contracts.....                | 1,035             | 1,035         | --                | --            |
| Financial Liabilities:                         |                   |               |                   |               |
| Accounts payable.....                          | 42,544            | 42,544        | 34,091            | 34,091        |
| Commodity option contracts.....                | 344               | 344           | --                | 778           |
| Long-term debt                                 |                   |               |                   |               |
| Senior Credit Facility.....                    | 2,000             | 2,000         | 291,948           | 291,948       |
| 8 3/8% Senior Notes.....                       | 175,000           | 176,094       | --                | --            |
| 5% Convertible Subordinated Notes.....         | 158,426           | 141,989       | 205,810           | 160,532       |
| 7% Convertible Subordinated<br>Debentures..... | --                | --            | 1,000             | 1,130         |
| 14% Senior Subordinated Notes.....             | 134,466           | 153,498       | 143,650           | 162,325       |
| Dawson 9 3/8% Senior Notes.....                | 246               | 246           | 1,106             | 1,029         |
| Capital lease liabilities.....                 | 22,964            | 22,964        | 21,911            | 21,911        |
| Other debt.....                                | 805               | 805           | 1,175             | 1,175         |

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KEY ENERGY SERVICES INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

JUNE 30, 2001, 2000 AND 1999

### 7. FAIR VALUE OF FINANCIAL INSTRUMENTS (CONTINUED)

The following methods and assumptions were used to estimate the fair value of each class of financial instruments:

Cash, trade receivables and trade payables: The carrying amounts approximate fair value because of the short maturity of those instruments.

Commodity option contracts: For fiscal 2001, under SFAS 133, the carrying amount of the commodity option contracts approximate fair value. For fiscal 2000, the carrying value is comprised of the unamortized premiums paid for the option contracts. The fair value of the commodity option contracts is estimated using the discounted forward prices of each options index price, for the term of each option contract.

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Notes receivable-related parties: The amounts reported relate to notes receivable from officers of the Company.

Long-term debt: The fair value of the Company's long-term debt is based upon the quoted market prices for the various notes and debentures at June 30, 2001 and 2000, and the carrying amounts outstanding under the Company's senior credit facility.

### 8. DERIVATIVE FINANCIAL INSTRUMENTS

The Company utilizes derivative financial instruments to manage well defined commodity price risks. The Company is exposed to credit losses in the event of nonperformance by the counter-parties to its commodity hedges. The Company only deals with reputable financial institutions as counter-parties and anticipates that such counter-parties will be able to fully satisfy their obligations under the contracts. The Company does not obtain collateral or other security to support financial instruments subject to credit risk but monitors the credit standing of the counter-parties.

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.

The Company does not enter into derivative instruments for any purpose other than for economic hedging. The Company does not speculate using derivative instruments. The Company has identified the following derivative instruments:

FREESTANDING DERIVATIVES. On March 30, 2000 the Company entered into a collar arrangement for a 22-month period whereby the Company will pay if the specified price is above the cap index and the counter-party will pay if the price should fall below the floor index. The hedge defines a range of cash flows bounded by the cap and floor prices. On May 25, 2001 the Company entered into an option arrangement for a 12-month period beginning March 2002. whereby the counter-party will pay if the price should fall below the floor index. The Company desires a measure of stability to ensure that cash flows do not fall below a certain level.

Prior to the adoption of SFAS 133 as discussed in Note 1, these collars and options were accounted for as cash flow type hedges. Accordingly, the transition adjustment resulted in recording a \$778,000 liability

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KEY ENERGY SERVICES INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

JUNE 30, 2001, 2000 AND 1999

### 8. DERIVATIVE FINANCIAL INSTRUMENTS (CONTINUED)

for the fair value of the collars to accumulated other comprehensive income, of which \$520,000 was recognized in earnings during fiscal 2001. It is estimated that the remaining \$258,000 of this transition adjustment will be recognized in earnings over the next fiscal year. While this arrangement was intended to be an economic hedge, as of July 1, 2000, the Company had not documented the March 30, 2000 oil and natural gas collars as cash flow hedges and therefore

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reported a charge to operations of \$565,000 for the increase in fair value of the liability as of September 30, 2000 in other income. As of October 1, 2000, the Company documented these collars as cash flow hedges. As of May 25, 2001, the Company had not documented the May 25, 2001 oil and natural gas options as cash flow hedges and therefore has included income of \$768,000 for the increase in fair value of the asset as of June 30, 2001 in other income. As of July 1, 2001, the Company documented these options as cash flow hedges. During fiscal 2001, the Company recorded a net increase of \$999,000 in derivative assets, net of derivative liabilities, of which \$132,000 represented ineffectiveness and was credited to earnings.

EMBEDDED DERIVATIVES. The Company is party to a volumetric production payment that meets the definition of an embedded derivative under SFAS 133. Effective July 1, 2000, the Company determined and documented that the volumetric production payment is excluded from the scope of SFAS 133 under the normal purchases/sales exclusion as set forth in SFAS 138.

For fiscal 2000 and 1999, gains and amortization of premiums paid on option contracts are recognized as an adjustment to sales revenue when the related transactions being hedged are finalized.

The net effect of the Company's commodity hedging activities decreased oil and natural gas revenues for the year ended June 30, 2000 by \$822,270 and increased oil and natural gas revenues for the year ended June 30, 1999 by \$158,500.

The following table sets forth the future volumes hedged by year and the weighted-average strike price of the option contracts at June 30, 2001 and 2000:

|                          | MONTHLY INCOME |                        | TERM                | STRIKE PRICE<br>PER BBL/MMBTU |         |
|--------------------------|----------------|------------------------|---------------------|-------------------------------|---------|
|                          | OIL<br>(BBLs)  | NATURAL GAS<br>(MMBTU) |                     | FLOOR                         | CEILING |
| At June 30, 2001         |                |                        |                     |                               |         |
| Oil Collars.....         | 5,000          | --                     | Mar 2001 - Feb 2002 | \$19.70                       | \$23.00 |
| Oil Put.....             | 5,000          | --                     | Mar 2002 - Feb 2003 | 22.00                         |         |
| Natural Gas Collars..... | --             | 40,000                 | Mar 2001 - Feb 2002 | 2.40                          | 2.60    |
| Natural Gas Put.....     | --             | 75,000                 | Mar 2002 - Feb 2003 | 3.00                          |         |
| At June 30, 2000         |                |                        |                     |                               |         |
| Oil Collars.....         | 4,000          | --                     | May 2000 - Feb 2001 | \$22.20                       | \$26.00 |
|                          | 5,000          | --                     | Mar 2001 - Feb 2002 | 19.70                         | 23.00   |
| Natural Gas Collars..... | --             | 30,000                 | May 2000 - Feb 2001 | 2.60                          | 3.00    |
|                          | --             | 40,000                 | Mar 2001 - Feb 2002 | 2.40                          | 2.60    |

(The strike prices for the oil options 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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## 9. OTHER ACCRUED LIABILITIES

Other accrued liabilities consist of the following:

|                                                   | JUNE 30,    |          |
|---------------------------------------------------|-------------|----------|
|                                                   | 2001        | 2000     |
|                                                   | (THOUSANDS) |          |
| Accrued payroll, taxes and employee benefits..... | \$31,242    | \$15,261 |
| State sales, use and other taxes.....             | 5,825       | 2,465    |
| Oil and gas revenue distribution.....             | 1,606       | 1,714    |
| Other.....                                        | 10,250      | 6,958    |
| Total.....                                        | \$48,923    | \$26,398 |
|                                                   | =====       | =====    |

## 10. STOCKHOLDERS' EQUITY

### EQUITY OFFERINGS

On June 30, 2000, the Company closed the public offering of 11,000,000 shares of common stock at \$9.625 per share, or approximately \$106 million (the "Equity Offering"). Net proceeds from the Equity Offering of approximately \$101 million were used to repay a portion of the Company's term loan borrowings and revolving line of credit under its senior credit facility and retire other long-term debt.

On May 7, 1999, the Company closed the public offering of 55,300,000 shares of common stock (300,000 shares of which were sold pursuant to the underwriters' over-allotment option discussed below) at \$3.00 per share, or \$166 million (the "Prior Public Offering"). Concurrently therewith, the Company closed the offering of 3,508,772 shares of common stock at \$2.85 per share, or \$10 million (the "Prior Concurrent Offering" and together with the Prior Public Offering, the "Prior Equity Offerings"). In addition, on June 7, 1999, the underwriters of the Prior Public Offering exercised an over-allotment option to purchase an additional 5,436,000 million shares to cover over-allotments. Net proceeds from the Prior Equity Offerings of approximately \$180.4 million were used to repay a portion of the Company's term loan borrowings under its senior credit facility.

### STOCK INCENTIVE PLANS

On January 13, 1998 the Company's shareholders approved the Key Energy Group, Inc. 1997 Incentive Plan, as amended (the "1997 Incentive Plan"). The 1997 Incentive Plan is an amendment and restatement of the plans formerly known as the "Key Energy Group, Inc. 1995 Stock Option Plan" (the "1995 Option Plan") and the "Key Energy Group, Inc. 1995 Outside Directors Stock Option Plan" (the "1995 Directors Plan") (collectively, the "Prior Plans").

All options previously granted under the Prior Plans and outstanding as of November 17, 1997 (the date on which the Company's board of directors adopted the plan) were assumed and continued, without modification, under the 1997 Incentive Plan.

Under the 1997 Incentive Plan, the Company may grant the following awards to key employees, directors who are not employees ("Outside Directors") and consultants of the Company, its controlled subsidiaries, and its parent



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corporation, if any: (i) incentive stock options ("ISOs") as defined in Section 422 of the Internal Revenue Code of 1986, as amended (the "Code"), (ii) "nonstatutory" stock

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KEY ENERGY SERVICES INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

JUNE 30, 2001, 2000 AND 1999

### 10. STOCKHOLDERS' EQUITY (CONTINUED)

options ("NSOs"), (iii) stock appreciation rights ("SARs"), (iv) shares of the restricted stock, (v) performance shares and performance units, (vi) other stock-based awards and (vii) supplemental tax bonuses (collectively, "Incentive Awards"). ISOs and NSOs are sometimes referred to collectively herein as "Options".

The Company may grant Incentive Awards covering an aggregate of the greater of (i) 3,000,000 shares of the Company's common stock and (ii) 10% of the shares of the Company's common stock issued and outstanding on the last day of each calendar quarter, provided, however, that a decrease in the number of issued and outstanding shares of the Company's common stock from the previous calendar quarter shall not result in a decrease in the number of shares available for issuance under the 1997 Incentive Plan. As a result of the Company's equity offering discussed above, as of June 30, 2001, the number of shares of the Company's common stock that may be covered by Incentive Awards has increased to approximately 10.1 million.

Any shares of the Company's common stock that are issued and are forfeited or are subject to Incentive Awards under the 1997 Incentive Plan that expire or terminate for any reason will remain available for issuance with respect to the granting of Incentive Awards during the term of the 1997 Incentive Plan, except as may otherwise be provided by applicable law. Shares of the Company's common stock issued under the 1997 Incentive Plan may be either newly issued or treasury shares, including shares of the Company's common stock that the Company receives in connection with the exercise of an Incentive Award. The number and kind of securities that may be issued under the 1997 Incentive Plan and pursuant to then outstanding Incentive Awards are subject to adjustments to prevent enlargement or dilution of rights resulting from stock dividends, stock splits, recapitalizations, reorganization or similar transactions.

The maximum number of shares of the Company's common stock subject to Incentive Awards that may be granted or that may vest, as applicable, to any one Covered Employee (defined below) during any calendar year shall be 500,000 shares, subject to adjustment under the provisions of the 1997 Incentive Plan.

The maximum aggregate cash payout subject to Incentive Awards (including SARs, performance units and performance shares payable in cash, or other stock-based awards payable in cash) that may be granted to any one Covered Employee during any calendar year is \$2,500,000. For purposes of the 1997 Incentive Plan, "Covered Employees" means a named executive officer who is one of the group covered employees as defined in Section 162(m) of the Code and the regulation promulgated thereunder (i.e., generally the chief executive officer and the other four most highly compensated executive officers for a given year.)

The 1997 Incentive Plan is administrated by the Compensation Committee appointed by the Board of Directors (the "Committee") consisting of not less than two directors each of whom is (i) an "outside director" under Section 162(m) of the Code and (ii) a "non-employee director" under Rule 16b-3 of the Securities Exchange Act of 1934. In addition, subject to applicable

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shareholder approval requirements, the Company may issue NSOs outside the 1997 Incentive Plan.

The exercise price of options granted under the 1997 Incentive Plan and outside the 1997 Incentive Plan is at or above the fair market value per share on the date the options are granted. The exercise of NSOs results in a U. S. tax deduction to the Company equal to the income tax effect of the difference

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KEY ENERGY SERVICES INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

JUNE 30, 2001, 2000 AND 1999

## 10. STOCKHOLDERS' EQUITY (CONTINUED)

between the exercise price and the market price at the exercise date. The following table summarizes the stock option activity related to the Company's plans (shares in thousands):

|                                            | FISCAL YEAR ENDING JUNE 30, |                                          |        |                                          |        |                                          |
|--------------------------------------------|-----------------------------|------------------------------------------|--------|------------------------------------------|--------|------------------------------------------|
|                                            | 2001                        |                                          | 2000   |                                          | 1999   |                                          |
|                                            | SHARES                      | WEIGHTED<br>AVERAGE<br>EXERCISE<br>PRICE | SHARES | WEIGHTED<br>AVERAGE<br>EXERCISE<br>PRICE | SHARES | WEIGHTED<br>AVERAGE<br>EXERCISE<br>PRICE |
| Outstanding--beginning of fiscal year..... | 9,470                       | \$6.37                                   | 6,920  | \$5.55                                   | 2,292  | \$10.3                                   |
| Granted.....                               | 2,533                       | 8.08                                     | 3,688  | 8.61                                     | 5,443  | 4.3                                      |
| Exercised.....                             | (3,107)                     | 4.70                                     | (241)  | 4.56                                     | (15)   | 6.3                                      |
| Forfeited.....                             | (193)                       | 4.92                                     | (897)  | 9.80                                     | (800)  | 10.8                                     |
| Outstanding--end of fiscal year...         | 8,703                       | 7.49                                     | 9,470  | 6.37                                     | 6,920  | 5.5                                      |
| Exercisable--end of fiscal year...         | 5,820                       |                                          | 4,370  |                                          | 1,020  |                                          |

## STOCK INCENTIVE PLANS

The foregoing stock option activity summary reflects that effective as of September 4, 1998, the Committee authorized the cancellation and reissue of stock options for employees that were not executive officers for the purpose of changing the exercise price and vesting schedule of such options. A total of 473,556 stock options were cancelled, with a weighted average price of approximately \$13.09 per share, and reissued with an exercise price of \$7.125 per share. The vesting of the new options is ratable over a three-year period from the date of grant.

The following table summarizes information about the stock options outstanding at June 30, 2001 (shares in thousands):

OPTIONS OUTSTANDING

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| RANGE OF EXERCISE PRICES | NUMBER OF SHARES<br>OUTSTANDING AT<br>JUNE 30, 2001 | WEIGHTED-AVERAGE<br>REMAINING CONTRACTUAL<br>LIFE | WEIGHTED-<br>AVERAGE<br>EXERCISE PRICE | NUMBER OF<br>OUTSTANDING<br>JUNE 30, 2001 |
|--------------------------|-----------------------------------------------------|---------------------------------------------------|----------------------------------------|-------------------------------------------|
| \$3.00 - \$6.8125        | 1,921                                               | 6.49                                              | \$3.65                                 | 1,844                                     |
| \$7.125 - \$7.4375       | 1,252                                               | 7.82                                              | 7.25                                   | 4,000                                     |
| \$8.125 - \$8.3125       | 2,135                                               | 8.67                                              | 8.25                                   | 1,600                                     |
| \$8.50 - \$13.25         | 3,395                                               | 7.69                                              | 9.27                                   | 1,900                                     |

The Company applies the intrinsic value method of APB 25 in accounting for its employee stock incentive plans. Accordingly, no compensation expense has been recognized for any stock options issued under the employee plans. Had compensation expense for stock options granted to employees been recognized based on the fair value at the grant dates, using the methodology prescribed by SFAS 123, the

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KEY ENERGY SERVICES INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

JUNE 30, 2001, 2000 AND 1999

### 10. STOCKHOLDERS' EQUITY (CONTINUED)

Company's net income (loss) and earnings per share would have been reduced to pro forma amounts indicated below:

|                                             | 2001                                  | 2000        | 1999        |
|---------------------------------------------|---------------------------------------|-------------|-------------|
|                                             | -----                                 | -----       | -----       |
|                                             | (THOUSANDS, EXCEPT PER SHARE AMOUNTS) |             |             |
| Net income (loss):                          |                                       |             |             |
| As reported.....                            | \$62,710                              | \$ (18,959) | \$ (53,258) |
| Pro forma.....                              | 52,338                                | (25,684)    | (57,057)    |
| Basic earnings per share of common stock:   |                                       |             |             |
| As reported.....                            | \$ 0.63                               | \$ (0.23)   | \$ (1.94)   |
| Pro forma.....                              | 0.53                                  | (0.31)      | (2.07)      |
| Diluted earnings per share of common stock: |                                       |             |             |
| As reported.....                            | \$ 0.61                               | \$ (0.23)   | \$ (1.94)   |
| Pro forma.....                              | 0.51                                  | (0.31)      | (2.07)      |

SFAS 123 does not apply to options granted prior to January 1, 1995; therefore, the pro forma effect disclosed above may not be representative of pro forma amounts in future years.

The total fair value of stock options granted during fiscal 2001, 2000 and 1999 was approximately \$11,217,000, \$19,541,000 and \$15,695,000, respectively. The fair value of each stock option grant was estimated on the date of grant using the Black-Sholes option-pricing model, based on the following weighted-average assumptions.

FISCAL YEAR OF GRANT

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|                                                       | 2001    | 2000    | 1999    |
|-------------------------------------------------------|---------|---------|---------|
| Risk-free interest rate.....                          | 4.30%   | 6.40%   | 5.09%   |
| Expected life of options.....                         | 5 years | 5 years | 5 years |
| Expected volatility of the Company's stock price..... | 59%     | 67%     | 98%     |
| Expected dividends.....                               | none    | none    | none    |

## 11. INCOME TAXES

Components of income tax expense (benefit) are as follows:

|                    | FISCAL YEAR ENDED JUNE 30, |            |             |
|--------------------|----------------------------|------------|-------------|
|                    | 2001                       | 2000       | 1999        |
|                    | (THOUSANDS)                |            |             |
| Federal and State: |                            |            |             |
| Current.....       | \$ 2,304                   | \$ (5,588) | \$ --       |
| Deferred           |                            |            |             |
| U.S.....           | 34,698                     | (1,818)    | (25,560)    |
| Foreign.....       | --                         | --         | (115)       |
|                    | -----                      | -----      | -----       |
|                    | \$37,002                   | \$ (7,406) | \$ (25,675) |
|                    | =====                      | =====      | =====       |

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## KEY ENERGY SERVICES INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

JUNE 30, 2001, 2000 AND 1999

## 11. INCOME TAXES (CONTINUED)

No income tax payments were made for fiscal 2001, 2000 or 1999. Additionally a deferred tax benefit of \$7,004,000 has been allocated to stockholders' equity in fiscal 2001 for compensation expense for income tax purposes in excess of amounts recognized for financial reporting purposes.

Income tax expense (benefit) differs from amounts computed by applying the statutory federal rate as follows:

|                                              | FISCAL YEAR ENDED JUNE 30, |         |         |
|----------------------------------------------|----------------------------|---------|---------|
|                                              | 2001                       | 2000    | 1999    |
| Income tax computed at statutory rate.....   | 35.0%                      | (35.0)% | (35.0)% |
| Amortization of goodwill disallowance.....   | 2.2                        | 7.0     | 2.0     |
| State taxes.....                             | 1.4                        | --      | --      |
| Change in valuation allowance and other..... | (1.4)                      | 1.5     | 0.5     |
|                                              | ----                       | -----   | -----   |

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|       |         |         |
|-------|---------|---------|
| 37.2% | (26.5)% | (32.5)% |
| ===== | =====   | =====   |

Deferred tax assets (liabilities) are comprised of the following:

|                                                             | FISCAL YEAR ENDED JUNE 30, |             |
|-------------------------------------------------------------|----------------------------|-------------|
|                                                             | 2001                       | 2000        |
|                                                             | (THOUSANDS)                |             |
| Net operating loss and tax credit carry forwards....        | \$ 69,376                  | \$ 88,491   |
| Property and equipment.....                                 | (182,442)                  | (175,511)   |
| Self insurance reserves.....                                | 405                        | 1,616       |
| Allowance for bad debts.....                                | 1,542                      | 1,129       |
| Acquisition expenses, expensed for tax.....                 | (626)                      | (626)       |
| Other.....                                                  | 148                        | 862         |
|                                                             | -----                      | -----       |
| Net deferred tax liability.....                             | (111,597)                  | (84,039)    |
| Valuation allowance of deferred tax assets.....             | (15,803)                   | (15,668)    |
|                                                             | -----                      | -----       |
| Net deferred tax liability, net of valuation allowance..... | \$ (127,400)               | \$ (99,707) |
|                                                             | =====                      | =====       |

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KEY ENERGY SERVICES INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

JUNE 30, 2001, 2000 AND 1999

### 11. INCOME TAXES (CONTINUED)

A valuation allowance is provided when it is more likely than not that some portion of the deferred tax assets will not be realized. As described below, due to annual limitations on certain net operating loss carryforwards, it does not appear more likely than not that the Company will be able to utilize all available carryforwards prior to their ultimate expiration.

The Company estimates that as of June 30, 2001, the Company will have available approximately \$185,474,305 of net operating loss carryforwards (which will continue to expire in fiscal 2002). Approximately \$53,570,522 of the net operating loss carryforwards are subject to an annual limitation of approximately \$1,012,000, under Sections 382 and 383 of the Internal Revenue Code.

### 12. LEASING ARRANGEMENTS

The Company leases certain property and equipment under non-cancelable operating leases that generally expire at various dates through fiscal 2006. The term of the operating leases generally run from 24 to 60 months with varying payment dates throughout each month.

As of June 30, 2001, the future minimum lease payments under non-cancelable operating leases are as follows (in thousands):

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| FISCAL YEAR ENDING JUNE 30,<br>----- | LEASE<br>PAYMENTS<br>----- |
|--------------------------------------|----------------------------|
| 2002.....                            | \$ 4,689                   |
| 2003.....                            | 4,587                      |
| 2004.....                            | 4,493                      |
| 2005.....                            | 4,426                      |
| 2006.....                            | 2,626                      |
|                                      | -----                      |
|                                      | \$20,821                   |
|                                      | =====                      |

Operating lease expense was approximately \$6,072,000, \$6,460,000 and \$7,313,000 for the fiscal years ended June 30, 2001, 2000 and 1999, respectively.

## 13. EMPLOYEE BENEFIT PLANS

In order to retain quality personnel, the Company maintains 401(k) plans as part of its employee benefits package. From July 1, 1998 through December 31, 1998, the Company matched 100% of employee contributions into its 401(k) plan up to a maximum of \$1,000 per participant per year. From January 1, 1999 through March 31, 2000, the Company elected not to match employee contributions. Commencing April 1, 2000, the Company matches, 100% of employee contributions into its 401(k) plan up to a maximum of \$250 per participant per year. The maximum limit was increased to \$500 effective October 1, 2000, \$750 effective January 1, 2001 and \$1,000 effective July 1, 2001. The Company's matching contributions for fiscal 2001, 2000 and 1999 were approximately \$1,857,000, \$77,000 and \$908,000, respectively.

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KEY ENERGY SERVICES INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

JUNE 30, 2001, 2000 AND 1999

## 14. TRANSACTIONS WITH RELATED PARTIES

In connection with the negotiation of the terms of a five-year employment agreement with Mr. Francis D. John, Chairman of the Board, President and Chief Executive Officer of the Company, and as an inducement to Mr. John to enter into such employment agreement, the Company entered into a separate agreement with Mr. John, dated as of August 2, 1999, which as amended through June 30, 2001, provides that \$6.5 million in loans previously made by the Company to Mr. John, together with the accrued interest payable thereon, will be forgiven, ratably during the ten year period commencing on July 1, 2001 and ending on June 30, 2010. The agreement provides that the foregoing forgiveness of indebtedness is predicated and conditioned upon Mr. John remaining employed by the Company during such period. In addition, in the event that Mr. John is terminated by the Company for Cause (as defined in the agreement), or in the event that Mr. John voluntarily terminates his employment with the Company, the agreement further provides that the entire remaining principal balance of these loans, together with accrued interest payable thereon, will become immediately due and payable by Mr. John. However, in the event that Mr. John's employment is terminated for "Good Reason", or as a result of Mr. John's death or "Disability", or as a result of a "Change in Control" (all as defined in that agreement), the

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agreement stipulates that the remaining principal balance outstanding on the loans, together with accrued interest thereon will be forgiven.

In connection with the negotiation of an employment agreement with Thomas K. Grundman, the Company's Executive Vice President, Chief Financial Officer and Chief Accounting Officer, the Company made a \$240,000 short-term loan and a \$150,000 relocation loan to assist Mr. Grundman's relocation to the Company's executive offices. Interest on these loans accrues at a rate of 6.125% per annum. The short-term loan has been repaid. The relocation loan together with accrued interest will be forgiven in three installments of \$50,000 each on July 1, 2000, 2001 and 2002; provided, however, that if Mr. Grundman's employment is terminated during such period in a way that (i) triggers severance obligations, all amounts owed shall be immediately forgiven or (ii) does not trigger severance obligations, all amounts owed shall be immediately due and payable.

### 15. BUSINESS SEGMENT INFORMATION

The Company's reportable business segments are well servicing and contract drilling. Oil and natural gas production operations previously were presented separately as a reportable business segment and are now included in "corporate/other."

**WELL SERVICING:** the Company's operations provide well servicing (ongoing maintenance of existing oil and natural gas wells), workover (major repairs or modifications necessary to optimize the level of production from existing oil and natural gas wells) and production services (fluid hauling and fluid storage tank rental).

**CONTRACT DRILLING:** the Company provides contract drilling services for major and independent oil companies onshore the continental United States, Argentina and Ontario, Canada.

The Company's management evaluates the performance of its operating segments based on net income and operating profits (revenues less direct operating expenses). Corporate expenses include general corporate expenses associated with managing all reportable operating segments. Corporate assets

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### KEY ENERGY SERVICES INC.

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

JUNE 30, 2001, 2000 AND 1999

### 15. BUSINESS SEGMENT INFORMATION (CONTINUED)

consist principally of cash and cash equivalents, deferred debt financing costs and deferred income tax assets.

|                                               | WELL<br>SERVICING | CONTRACT<br>DRILLING | CORPORATE<br>/OTHER | TOTAL      |
|-----------------------------------------------|-------------------|----------------------|---------------------|------------|
|                                               | -----             | -----                | -----               | -----      |
| TWELVE MONTHS ENDED JUNE 30, 2001             |                   |                      |                     |            |
| Operating revenues.....                       | \$758,273         | \$107,639            | \$ 7,350            | \$ 873,262 |
| Operating profit.....                         | 265,165           | 30,273               | 2,886               | 298,324    |
| Depreciation, depletion and amortization..... | 63,578            | 7,947                | 3,622               | 75,147     |
| Interest expense.....                         | 1,831             | --                   | 54,729              | 56,560     |
| Net income (loss) before extraordinary gain   |                   |                      |                     |            |

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|                                                    |           |           |          |           |
|----------------------------------------------------|-----------|-----------|----------|-----------|
| (loss)*.....                                       | 109,159   | 9,466     | (56,344) | 62,28     |
| Identifiable assets.....                           | 664,611   | 95,473    | 278,325  | 1,038,40  |
| Capital expenditures (excluding acquisitions)..... | 50,799    | 15,884    | 15,437   | 82,12     |
| TWELVE MONTHS ENDED JUNE 30, 2000                  |           |           |          |           |
| Operating revenues.....                            | \$559,492 | \$ 68,428 | \$ 9,812 | \$ 637,73 |
| Operating profit.....                              | 159,552   | 10,129    | 5,665    | 175,34    |
| Depreciation, depletion and amortization.....      | 62,680    | 6,105     | 2,187    | 70,97     |
| Interest expense.....                              | 2,300     | --        | 69,630   | 71,93     |
| Net income (loss) before extraordinary gain (loss) |           |           |          |           |
| *.....                                             | 48,062    | (1,664)   | (56,968) | (20,57    |
| Identifiable assets.....                           | 635,304   | 89,574    | 322,754  | 1,047,63  |
| Capital expenditures (excluding acquisitions)..... | 30,098    | 8,282     | 3,422    | 41,80     |
| TWELVE MONTHS ENDED JUNE 30, 1999                  |           |           |          |           |
| Operating revenues.....                            | \$433,657 | \$ 50,613 | \$ 7,547 | \$ 491,81 |
| Operating profit.....                              | 108,692   | 7,057     | 4,640    | 120,38    |
| Depreciation, depletion and amortization.....      | 52,638    | 6,586     | 2,850    | 62,07     |
| Interest expense.....                              | 1,659     | 18        | 65,724   | 67,40     |
| Net income (loss) before extraordinary gain        |           |           |          |           |
| (loss)*.....                                       | 15,447    | (4,093)   | (64,612) | (53,25    |
| Identifiable assets.....                           | 651,781   | 81,074    | 209,860  | 942,71    |
| Capital expenditures (excluding acquisitions)..... | 26,776    | 1,063     | 3,468    | 31,30     |

\* Net income (loss) before extraordinary gain (loss) for the contract drilling segment includes a portion of well servicing general and administrative expenses allocated on a percentage of revenue basis.

Operating revenues and operating profit for the Company's foreign operations, which includes Argentina and Canada, were \$54.5 million and \$13.4 million, respectively, for the year ended June 30, 2001. Operating revenues and operating profit for the Company's foreign operations, which includes Argentina and Canada, were \$37.7 million and \$7.3 million, respectively, for the year ended June 30, 2000. Operating revenues and operating profit for the Company's foreign operations, which includes Argentina and Canada, were \$26.9 million and \$5.4 million, respectively, for the year ended June 30, 1999.

The Company had \$84.1 million and \$66.9 million of identifiable assets as of June 30, 2001 and 2000, respectively, related to its foreign operations.

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KEY ENERGY SERVICES INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

JUNE 30, 2001, 2000 AND 1999

## 16. SUPPLEMENTAL SCHEDULE OF NONCASH INVESTING AND FINANCING ACTIVITIES

| YEAR ENDED JUNE 30, |      |      |
|---------------------|------|------|
| 2001                | 2000 | 1999 |
| (IN THOUSANDS)      |      |      |



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|                                                                          |         |        |        |    |    |
|--------------------------------------------------------------------------|---------|--------|--------|----|----|
| Fair value of common stock issued in purchase transactions.....          | \$8,120 | \$     | --     | \$ | -- |
| Fair value of common stock issued to lender in lieu of fees.....         | --      | --     | --     | -- | 1  |
| Fair value of common stock issued upon conversion of long-term debt..... | 957     | 3,606  | --     | -- | -- |
| Capital lease obligations.....                                           | 9,595   | 10,758 | 17,120 | -- | -- |

## 17. UNAUDITED SUPPLEMENTARY INFORMATION--QUARTERLY RESULTS OF OPERATIONS

Summarized quarterly financial data for fiscal 2001, 2000 and 1999 are as follows:

|                                                         | FIRST<br>QUARTER                         | SECOND<br>QUARTER | THIRD<br>QUARTER | FOURTH<br>QUARTER |
|---------------------------------------------------------|------------------------------------------|-------------------|------------------|-------------------|
|                                                         | -----                                    | -----             | -----            | -----             |
|                                                         | (IN THOUSANDS, EXCEPT PER SHARE AMOUNTS) |                   |                  |                   |
| 2001                                                    |                                          |                   |                  |                   |
| Revenues.....                                           | \$191,679                                | \$203,911         | \$227,370        | \$250,302         |
| Income (loss) from operations.....                      | 12,229                                   | 18,063            | 27,912           | 41,079            |
| Net income (loss) before extraordinary gain (loss)..... | 7,510                                    | 11,094            | 17,587           | 26,090            |
| Extraordinary gain (loss), net of tax.....              | 1,197                                    | 68                | (167)            | (669)             |
|                                                         | -----                                    | -----             | -----            | -----             |
| Net income (loss).....                                  | 8,707                                    | 11,162            | 17,420           | 25,421            |
|                                                         | =====                                    | =====             | =====            | =====             |
| Earnings (loss) per share:                              |                                          |                   |                  |                   |
| Basic--before extraordinary gain (loss).....            | 0.08                                     | 0.11              | 0.18             | 0.26              |
| Extraordinary gain (loss), net of tax.....              | 0.01                                     | --                | --               | (0.01)            |
|                                                         | -----                                    | -----             | -----            | -----             |
| Basic--after extraordinary gain (loss).....             | 0.09                                     | 0.11              | 0.18             | 0.25              |
|                                                         | =====                                    | =====             | =====            | =====             |
| Diluted--before extraordinary gain (loss).....          | 0.08                                     | 0.11              | 0.17             | 0.25              |
| Extraordinary gain (loss),.....                         | 0.01                                     | --                | --               | (0.01)            |
|                                                         | -----                                    | -----             | -----            | -----             |
| Diluted--after extraordinary gain (loss).....           | 0.09                                     | 0.11              | 0.17             | 0.24              |
|                                                         | =====                                    | =====             | =====            | =====             |
| Weighted average shares outstanding:                    |                                          |                   |                  |                   |
| Basic.....                                              | 96,880                                   | 97,534            | 98,211           | 100,179           |
| Diluted.....                                            | 100,472                                  | 100,534           | 103,524          | 104,401           |
| 2000                                                    |                                          |                   |                  |                   |
| Revenues.....                                           | \$149,892                                | \$159,389         | \$158,551        | \$169,900         |
| Income (loss) from operations.....                      | (13,191)                                 | (7,953)           | (5,730)          | (1,102)           |
| Net income (loss) before extraordinary gain (loss)..... | (9,451)                                  | (5,693)           | (4,150)          | (1,276)           |
| Extraordinary gain (loss), net of tax.....              | --                                       | --                | --               | 1,611             |
|                                                         | -----                                    | -----             | -----            | -----             |
| Net income (loss).....                                  | (9,451)                                  | (5,693)           | (4,150)          | 335               |
|                                                         | =====                                    | =====             | =====            | =====             |

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JUNE 30, 2001, 2000 AND 1999

## 17. UNAUDITED SUPPLEMENTARY INFORMATION--QUARTERLY RESULTS OF OPERATIONS (CONTINUED)

|                                                | FIRST<br>QUARTER                         | SECOND<br>QUARTER | THIRD<br>QUARTER | FOURTH<br>QUARTER |
|------------------------------------------------|------------------------------------------|-------------------|------------------|-------------------|
|                                                | -----                                    | -----             | -----            | -----             |
|                                                | (IN THOUSANDS, EXCEPT PER SHARE AMOUNTS) |                   |                  |                   |
| Earnings (loss) per share:                     |                                          |                   |                  |                   |
| Basic--before extraordinary gain (loss).....   | (0.11)                                   | (0.07)            | (0.05)           | (0.01)            |
| Extraordinary gain (loss), net of tax.....     | --                                       | --                | --               | 0.02              |
|                                                | -----                                    | -----             | -----            | -----             |
| Basic--after extraordinary gain (loss).....    | (0.11)                                   | (0.07)            | (0.05)           | 0.01              |
|                                                | =====                                    | =====             | =====            | =====             |
| Diluted--before extraordinary gain (loss)..... | (0.11)                                   | (0.07)            | (0.05)           | (0.01)            |
| Extraordinary gain (loss), net of tax.....     | --                                       | --                | --               | 0.02              |
|                                                | -----                                    | -----             | -----            | -----             |
| Diluted--after extraordinary gain (loss).....  | (0.11)                                   | (0.07)            | (0.05)           | 0.01              |
|                                                | =====                                    | =====             | =====            | =====             |
| Weighted average shares outstanding:           |                                          |                   |                  |                   |
| Basic.....                                     | 82,738                                   | 82,738            | 84,633           | 85,567            |
| Diluted.....                                   | 82,738                                   | 82,738            | 84,633           | 85,567            |

## 18. VOLUMETRIC PRODUCTION PAYMENT

In March 2000, Key sold a portion of its future oil and natural gas production from Odessa Exploration Incorporated, its wholly owned subsidiary, for gross proceeds of \$20 million pursuant to an agreement under which the purchaser is entitled to receive a share of the production from certain oil and natural gas properties in amounts ranging from 3,500 to 10,000 barrels of oil and 58,800 to 122,100 Mmbtus of natural gas per month over a six year period ending February 2006. The total volume of the forward sale is approximately 486,000 barrels of oil and 6.135 million Mmbtus of natural gas.

## 19. CONDENSED CONSOLIDATING FINANCIAL INFORMATION

The Company's senior notes are guaranteed by all of the Company's subsidiaries (except for the foreign subsidiaries), all of which are wholly-owned. The guarantees are joint and several, full, complete and unconditional. There are currently no restrictions on the ability of the subsidiary guarantors to transfer funds to the parent company.

The accompanying condensed consolidating financial information has been prepared and presented pursuant to SEC Regulation S-X Rule 3-10 "Financial Statements of Guarantors and Issuers of Guaranteed Securities Registered or Being Registered." The information is not intended to present the financial position, results of operations and cash flows of the individual companies or groups of companies in accordance with generally accepted accounting principles.



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|                                                 |           |             |          |              |             |
|-------------------------------------------------|-----------|-------------|----------|--------------|-------------|
| Other long-term liabilities.....                | 1,751     | 17,127      | --       | --           | --          |
| Stockholders' equity.....                       | 174,680   | 198,298     | 9,909    | --           | --          |
|                                                 | -----     | -----       | -----    | -----        | -----       |
| Total liabilities and stockholders' equity..... | \$947,213 | \$1,017,915 | \$69,303 | \$ (788,166) | \$1,017,915 |
|                                                 | =====     | =====       | =====    | =====        | =====       |

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## KEY ENERGY SERVICES INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

JUNE 30, 2001, 2000 AND 1999

#### 19. CONDENSED CONSOLIDATING FINANCIAL INFORMATION (CONTINUED) CONDENSED CONSOLIDATING STATEMENTS OF OPERATIONS

|                                                          | JUNE 30, 2001     |                           |                                   |              |                           |
|----------------------------------------------------------|-------------------|---------------------------|-----------------------------------|--------------|---------------------------|
|                                                          | PARENT<br>COMPANY | GUARANTOR<br>SUBSIDIARIES | NON-<br>GUARANTOR<br>SUBSIDIARIES | ELIMINATIONS | CONDENSED<br>CONSOLIDATED |
|                                                          | -----             | -----                     | -----                             | -----        | -----                     |
|                                                          | (IN THOUSANDS)    |                           |                                   |              |                           |
| Revenues.....                                            | \$ 2,018          | \$816,724                 | \$54,520                          | \$ --        | \$871,252                 |
| Costs and expenses:.....                                 |                   |                           |                                   |              |                           |
| Direct expenses.....                                     | --                | 533,807                   | 41,131                            | --           | 574,938                   |
| Depreciation, depletion and<br>amortization expense..... | 1,353             | 69,714                    | 4,080                             | --           | 1,427                     |
| General and administrative<br>expense.....               | 18,991            | 43,644                    | 3,436                             | --           | 66,071                    |
| Interest.....                                            | 54,464            | 1,275                     | 821                               | --           | 56,560                    |
| Other.....                                               | 318               | 943                       | 2                                 | --           | 1,263                     |
|                                                          | -----             | -----                     | -----                             | -----        | -----                     |
| Total costs and expenses.....                            | 75,126            | 649,383                   | 49,470                            | --           | 724,979                   |
|                                                          | -----             | -----                     | -----                             | -----        | -----                     |
| Income (loss) before income taxes....                    | (73,108)          | 167,341                   | 5,050                             | --           | 89,283                    |
| Income tax (expense) benefit.....                        | 27,247            | (62,367)                  | (1,882)                           | --           | (36,902)                  |
|                                                          | -----             | -----                     | -----                             | -----        | -----                     |
| Net income (loss) before<br>extraordinary items.....     | (45,861)          | 104,974                   | 3,168                             | --           | 62,281                    |
| Extraordinary items, net of tax.....                     | 429               | --                        | --                                | --           | 429                       |
|                                                          | -----             | -----                     | -----                             | -----        | -----                     |
| Net income (loss).....                                   | \$ (45,432)       | \$104,974                 | \$ 3,168                          | \$ --        | \$ 62,713                 |
|                                                          | =====             | =====                     | =====                             | =====        | =====                     |

|  | JUNE 30, 2000     |                           |                                   |              |                           |
|--|-------------------|---------------------------|-----------------------------------|--------------|---------------------------|
|  | PARENT<br>COMPANY | GUARANTOR<br>SUBSIDIARIES | NON-<br>GUARANTOR<br>SUBSIDIARIES | ELIMINATIONS | CONDENSED<br>CONSOLIDATED |
|  | -----             | -----                     | -----                             | -----        | -----                     |
|  | (IN THOUSANDS)    |                           |                                   |              |                           |

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|                                                          |             |           |          |       |
|----------------------------------------------------------|-------------|-----------|----------|-------|
| Revenues.....                                            | \$ 790      | \$599,225 | \$37,717 | \$ -- |
| Costs and expenses:                                      |             |           |          |       |
| Direct expenses.....                                     | --          | 431,997   | 30,389   | --    |
| Depreciation, depletion and<br>amortization expense..... | 1,162       | 66,453    | 3,357    | --    |
| General and administrative<br>expense.....               | 11,101      | 44,473    | 3,198    | --    |
| Interest.....                                            | 69,802      | 1,527     | 601      | --    |
| Other.....                                               | --          | 1,648     | --       | --    |
|                                                          | -----       | -----     | -----    | ----- |
| Total costs and expenses.....                            | 82,065      | 546,098   | 37,545   | --    |
|                                                          | -----       | -----     | -----    | ----- |
| Income (loss) before income taxes.....                   | (81,275)    | 53,127    | 172      | --    |
| Income tax (expense) benefit.....                        | 21,516      | (14,064)  | (46)     | --    |
|                                                          | -----       | -----     | -----    | ----- |
| Net income (loss) before extraordinary<br>items.....     | (59,759)    | 39,063    | 126      | --    |
| Extraordinary items, net of tax.....                     | 1,611       | --        | --       | --    |
|                                                          | -----       | -----     | -----    | ----- |
| Net income (loss).....                                   | \$ (58,148) | \$ 39,063 | \$ 126   | \$ -- |
|                                                          | =====       | =====     | =====    | ===== |

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KEY ENERGY SERVICES INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

JUNE 30, 2001, 2000 AND 1999

## 19. CONDENSED CONSOLIDATING FINANCIAL INFORMATION (CONTINUED)

|                                                          | JUNE 30, 1999     |                           |                                   |              |     |
|----------------------------------------------------------|-------------------|---------------------------|-----------------------------------|--------------|-----|
|                                                          | PARENT<br>COMPANY | GUARANTOR<br>SUBSIDIARIES | NON-<br>GUARANTOR<br>SUBSIDIARIES | ELIMINATIONS | CO  |
|                                                          | -----             | -----                     | -----                             | -----        | --- |
|                                                          | (IN THOUSANDS)    |                           |                                   |              |     |
| Revenues.....                                            | \$ 1,086          | \$463,813                 | \$26,918                          | \$ --        |     |
| Costs and expenses:                                      |                   |                           |                                   |              |     |
| Direct expenses.....                                     | --                | 349,936                   | 21,492                            | --           |     |
| Depreciation, depletion and<br>amortization expense..... | 428               | 58,403                    | 3,243                             | --           |     |
| General and administrative<br>expense.....               | 14,962            | 34,490                    | 3,656                             | --           |     |
| Interest.....                                            | 65,724            | 1,559                     | 118                               | --           |     |
| Other.....                                               | 10,811            | 5,928                     | --                                | --           |     |
|                                                          | -----             | -----                     | -----                             | -----        |     |
| Total costs and expenses.....                            | 91,925            | 450,316                   | 28,509                            | --           |     |
|                                                          | -----             | -----                     | -----                             | -----        |     |
| Income (loss) before income taxes.....                   | (90,839)          | 13,497                    | (1,591)                           | --           |     |
| Income tax (expense) benefit.....                        | 29,547            | (4,390)                   | 518                               | --           |     |
|                                                          | -----             | -----                     | -----                             | -----        |     |
| Net income (loss) before extraordinary<br>items.....     | (61,292)          | 9,107                     | (1,073)                           | --           |     |
| Extraordinary items, net of tax.....                     | --                | --                        | --                                | --           |     |

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|                        |             |          |            |       |
|------------------------|-------------|----------|------------|-------|
| Net income (loss)..... | \$ (61,292) | \$ 9,107 | \$ (1,073) | \$ -- |
|                        | =====       | =====    | =====      | ===== |

FISCAL YEAR ENDED JUNE 30, 2001

|                                      | PARENT<br>COMPANY | GUARANTOR<br>SUBSIDIARIES | NON-<br>GUARANTOR<br>SUBSIDIARIES | ELIMINATIONS | CO  |
|--------------------------------------|-------------------|---------------------------|-----------------------------------|--------------|-----|
|                                      | -----             | -----                     | -----                             | -----        | --- |
|                                      |                   |                           | (IN THOUSANDS)                    |              |     |
| Net cash provided by (used in)       |                   |                           |                                   |              |     |
| operating activities.....            | \$ 68,567         | \$ 64,408                 | \$ 9,742                          | \$ --        |     |
| Net cash provided by (used in)       |                   |                           |                                   |              |     |
| investing activities.....            | (19,459)          | (56,711)                  | (7,180)                           | --           |     |
| Net cash provided by (used in)       |                   |                           |                                   |              |     |
| financing activities.....            | (158,627)         | (8,456)                   | (59)                              | --           |     |
|                                      | -----             | -----                     | -----                             | -----        |     |
| Net increase (decrease) in cash..... | (109,519)         | (759)                     | 2,503                             | --           |     |
| Cash and cash equivalents at         |                   |                           |                                   |              |     |
| beginning of period.....             | 111,166           | (1,246)                   | (47)                              | --           |     |
|                                      | -----             | -----                     | -----                             | -----        |     |
| Cash and cash equivalents at end of  |                   |                           |                                   |              |     |
| period.....                          | \$ 1,647          | \$ (2,005)                | \$ 2,456                          | \$ --        |     |
|                                      | =====             | =====                     | =====                             | =====        |     |

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KEY ENERGY SERVICES INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

JUNE 30, 2001, 2000 AND 1999

19. CONDENSED CONSOLIDATING FINANCIAL INFORMATION (CONTINUED)

FISCAL YEAR ENDED JUNE 30, 2000

|                                      | PARENT<br>COMPANY | GUARANTOR<br>SUBSIDIARIES | NON-<br>GUARANTOR<br>SUBSIDIARIES | ELIMINATIONS | CON |
|--------------------------------------|-------------------|---------------------------|-----------------------------------|--------------|-----|
|                                      | -----             | -----                     | -----                             | -----        | --- |
|                                      |                   |                           | (IN THOUSANDS)                    |              |     |
| Net cash provided by (used in)       |                   |                           |                                   |              |     |
| operating activities.....            | \$ 18,962         | \$ 10,434                 | \$ 5,464                          | \$ --        | \$  |
| Net cash provided by (used in)       |                   |                           |                                   |              |     |
| investing activities.....            | (4,468)           | (26,671)                  | (6,627)                           | --           |     |
| Net cash provided by (used in)       |                   |                           |                                   |              |     |
| financing activities.....            | 80,070            | 9,287                     | (56)                              | --           |     |
|                                      | -----             | -----                     | -----                             | -----        |     |
| Net increase (decrease) in cash..... | 94,564            | (6,950)                   | (1,219)                           | --           |     |
| Cash and cash equivalents at         |                   |                           |                                   |              |     |
| beginning of period.....             | 16,602            | 5,704                     | 1,172                             | --           |     |
|                                      | -----             | -----                     | -----                             | -----        |     |

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|                                                 |                    |                     |                  |                |                |
|-------------------------------------------------|--------------------|---------------------|------------------|----------------|----------------|
| Cash and cash equivalents at end of period..... | \$111,166<br>===== | \$ (1,246)<br>===== | \$ (47)<br>===== | \$ --<br>===== | \$ --<br>===== |
|-------------------------------------------------|--------------------|---------------------|------------------|----------------|----------------|

## FISCAL YEAR ENDED JUNE 30, 1999

|                                                          | PARENT<br>COMPANY  | GUARANTOR<br>SUBSIDIARIES | NON-<br>GUARANTOR<br>SUBSIDIARIES | ELIMINATIONS   | CO    |
|----------------------------------------------------------|--------------------|---------------------------|-----------------------------------|----------------|-------|
|                                                          | -----              | -----                     | -----                             | -----          | ----- |
|                                                          |                    |                           | (IN THOUSANDS)                    |                |       |
| Net cash provided by (used in) operating activities..... | \$ (49,167)        | \$ 26,508                 | \$ 9,232                          | \$ --          |       |
| Net cash provided by (used in) investing activities..... | (272,620)          | (13,986)                  | (8,048)                           | --             |       |
| Net cash provided by (used in) financing activities..... | 313,526            | (7,196)                   | (36)                              | --             |       |
|                                                          | -----              | -----                     | -----                             | -----          |       |
| Net increase (decrease) in cash.....                     | (8,261)            | 5,326                     | 1,148                             | --             |       |
| Cash and cash equivalents at beginning of period.....    | 24,863             | 378                       | 24                                | --             |       |
|                                                          | -----              | -----                     | -----                             | -----          |       |
| Cash and cash equivalents at end of period.....          | \$ 16,602<br>===== | \$ 5,704<br>=====         | \$ 1,172<br>=====                 | \$ --<br>===== |       |

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## INDEPENDENT AUDITORS' REPORT

To The Board of Directors and Stockholders  
Key Energy Services, Inc.:

We have audited the accompanying consolidated balance sheets of Key Energy Services, Inc., and subsidiaries as of June 30, 2001 and 2000, and the related consolidated statements of operations, comprehensive income, cash flows and stockholders' equity for each of the years in the three-year period ended June 30, 2001. In connection with our audits of the consolidated financial statements, we also have audited the financial statement schedule listed in the Index at Item 14. These consolidated financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements and financial statement schedule based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Key Energy Services, Inc. and subsidiaries as of June 30, 2001 and 2000, and the

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results of their operations and their cash flows for each of the years in the three-year period ended June 30, 2001, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

As discussed in Note 8 to the consolidated financial statements, the Company changed its method of accounting for derivative instruments and hedging activities in 2001.

KPMG LLP

Midland, Texas  
August 16, 2001

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

None.

### PART III

### ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS.

The following table sets forth the names and ages, as of October 25, 2001, of each of the Company's executive officers and directors and includes their current positions.

| NAME<br>----             | AGE<br>----- | POSITION<br>-----                                                                                          |
|--------------------------|--------------|------------------------------------------------------------------------------------------------------------|
| Francis D. John.....     | 47           | Chairman of the Board, President, Chief Executive Officer and Chief Operating Officer                      |
| David J. Breazzano.....  | 45           | Director                                                                                                   |
| Kevin P. Collins.....    | 51           | Director                                                                                                   |
| William D. Fertig.....   | 45           | Director                                                                                                   |
| William D. Manly.....    | 78           | Director                                                                                                   |
| W. Phillip Marcum.....   | 57           | Director                                                                                                   |
| Morton Wolkowitz.....    | 73           | Director                                                                                                   |
| Thomas K. Grundman.....  | 41           | Executive Vice President of International Operations, Chief Financial Officer and Chief Accounting Officer |
| James J. Byerlotzer..... | 55           | Executive Vice President of Domestic Operations                                                            |

Francis D. John has been the President and Chief Executive Officer since October 1989. In addition, Mr. John has been Chairman of the Board since August 1996. Mr. John re-assumed the duties of Chief Operating Officer in April 1999. He has been a Director and President since June 1988 and served as the Chief Financial Officer from October 1989 through July 1997. Before joining the Company, he was Executive Vice President of Finance and Manufacturing of Fresenius U.S.A., Inc. Mr. John previously held operational and financial positions with Unisys, Mack Trucks and Arthur Andersen. He received a BS from Seton Hall University and an MBA from Fairleigh Dickinson University.

David J. Breazzano has been a Director since October 1997. Mr. Breazzano is



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one of the founding principals at DDJ Capital Management, LLC, an investment management firm established in 1996. Mr. Breazzano previously served as a Vice President and Portfolio Manager at Fidelity Investments ("Fidelity") from 1990 to 1996. Prior to joining Fidelity, Mr. Breazzano was President and Chief Investment Officer of the T. Rowe Price Recovery Fund. He is also a director of Waste Systems International, Inc. and Samuels Jewelers, Inc. He holds a BA from Union College and an MBA from Cornell University.

Kevin P. Collins has been a Director since March 1996. Mr. Collins has been a managing member of the Old Hill Company LLC since 1997. From 1992 to 1997, he served as a principal of JHP Enterprises, Ltd., and from 1985 to 1992, as Senior Vice President of DG Investment Bank, Ltd., both of which were engaged in providing corporate finance and advisory services. Mr. Collins was a director of WellTech, Inc. ("WellTech") from January 1994 until March 1996 when WellTech was merged into the Company. Mr. Collins is also a director of The Penn Traffic Company, Metrotek Technologies, Inc. and London Fog Industries, Inc. He holds a BS and an MBA from the University of Minnesota.

William D. Fertig has been a Director since April 2000. Mr. Fertig has been a Principal, Manager of Sales and Training at McMahan Securities Co. L.P. since 1990. Mr. Fertig previously served as a Senior Vice President and Manager of Convertible Sales at Drexel Burnham Lambert prior to joining McMahan

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Securities in 1990, and from 1979 to 1989, served as Vice President and Convertible Securities Sales Manager at Credit Suisse First Boston. He holds a BS from Allegheny College and an MBA from NYU Graduate Business School.

William D. Manly has been a Director since December 1989. He retired from his position as an Executive Vice President of Cabot Corporation in 1986, a position he had held since 1978. Mr. Manly is a director of Metallamics, Inc. and CitiSteel, Inc. He holds a BS and an MS from the University of Notre Dame.

W. Phillip Marcum has been a Director since March 1996. Mr. Marcum was a director of WellTech from January 1994 until March 1996 when WellTech was merged into the Company. From October 1995 until March 1996, Mr. Marcum was the acting Chairman of the Board of Directors of WellTech. He has been Chairman of the Board, President and Chief Executive Officer of Metrotek Technologies, Inc., formerly known as Marcum Natural Gas Services, Inc. ("Metrotek Technologies"), since January 1991 and is a director of TestAmerica, Inc. He holds a BBA from Texas Tech University.

Morton Wolkowitz has been a Director since December 1989. Mr. Wolkowitz served as President and Chief Executive Officer of Wolkow Braker Roofing Corporation, a company that provided a variety of roofing services, from 1958 through 1989. Mr. Wolkowitz has been a private investor since 1989. He holds a BS from Syracuse University.

Thomas K. Grundman has been an Executive Vice President and the Chief Financial Officer since July 1999 and the Chief Accounting Officer since November 1999. Effective December 1999, Mr. Grundman became Executive Vice President of International Operations. Mr. Grundman also served as Treasurer from July 1999 through August 2000. He joined the Company in April 1999 as Sr. Vice President of Strategic and Business Development. From late 1996 through April 1999, Mr. Grundman was Senior Vice President at PNC Bank, N.A. where he ran the Oil and Gas Corporate Finance Group and was responsible for providing financing and advisory services in all sectors of the energy industry. From 1984 through 1996, Mr. Grundman held several positions at Chase Manhattan Bank and its predecessor institutions, most recently as a Managing Director in the oil and gas group. Mr. Grundman holds a BS in Finance from Syracuse University.

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James J. Byerlotzter has been Executive Vice President of Domestic Well Service and Drilling Operations since July 1999. Effective December 1999, Mr. Byerlotzter's title was changed to Executive Vice President of Domestic Operations. He joined the Company in September 1998 as Vice President--Permian Basin Operations after the Company's acquisition of Dawson Production Services, Inc. ("Dawson"). From February 1997 to September 1998, he served as the Senior Vice President and Chief Operating Officer of Dawson. From 1981 to 1997, Mr. Byerlotzter was employed by Pride Petroleum Services, Inc. ("Pride"). Beginning in February 1996, Mr. Byerlotzter served as the Vice President--Domestic Operations of Pride. Prior to that time, he served as Vice President--Permian Basin of Pride and in various other operating positions in Pride's Gulf Coast and California operations. Mr. Byerlotzter holds a BA from the University of Missouri in St. Louis.

Directors are elected at the Company's annual meeting of stockholders and serve until the next annual meeting of stockholders and until their successors are elected and qualified. Each executive officer holds office until the first meeting of the Board of Directors following the annual meeting of stockholders and until his successor has been duly elected and qualified.

### COMPLIANCE WITH SECTION 16(A) OF THE EXCHANGE ACT

Section 16(a) of the Securities Exchange Act of 1934, as amended, requires the Company's directors, executive officers and persons who beneficially own more than 10% of a registered class of the Company's equity securities, to file initial reports of ownership on Form 3 and changes in ownership on Forms 4 or 5 with the Securities and Exchange Commission (the "Commission"). Such officers, directors and 10%

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stockholders also are required by Commission rules to furnish the Company with copies of all Section 16(a) reports they file. Based solely on its review of the copies of such forms furnished to the Company, the Company believes that its directors, executive officers and 10% stockholders complied with all Section 16(a) filing requirements during the fiscal year ended June 30, 2001.

### ITEM 11. EXECUTIVE COMPENSATION.

SUMMARY COMPENSATION TABLE. The following table reflects the compensation for services to the Company for the years ended June 30, 2001, 2000 and 1999 for (i) the Chief Executive Officer of the Company and (ii) the other two executive officers of the Company other than the Chief Executive Officer who were serving as executive officers at June 30, 2001 (the "Named Executive Officers").

| NAME AND PRINCIPAL POSITION | FISCAL YEAR | ANNUAL COMPENSATION |            | OTHER ANNUAL COMPENSATION (\$) | LONG TERM COMPENSATION AWARDS |
|-----------------------------|-------------|---------------------|------------|--------------------------------|-------------------------------|
|                             |             | SALARY (\$)         | BONUS (\$) |                                | SHARES UNDERLYING OPTIONS (1) |
| Francis D. John .....       | 2001        | 594,885             | 835,000    | 67,211 (2)                     | 1,460,000                     |
| President, Chief Executive  | 2000        | 589,519             | 307,776    | --                             | 2,000,000                     |
| Officer and Chief Operating | 1999        | 429,000             | --         | --                             | 1,200,000                     |
| Officer                     |             |                     |            |                                |                               |
| Thomas K. Grundman .....    | 2001        | 274,966             | 315,000    | --                             | 135,000                       |

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|                              |      |             |         |    |         |
|------------------------------|------|-------------|---------|----|---------|
| Executive Vice President of  | 2000 | 203,845     | 100,000 | -- | 500,000 |
| International Operations,    | 1999 | 35,259 (6)  | --      | -- | 300,000 |
| Chief Financial Officer, and |      |             |         |    |         |
| Chief Accounting Officer     |      |             |         |    |         |
| James J. Byerlotzer .....    | 2001 | 249,324     | 275,000 | -- | 115,000 |
| Executive Vice President of  | 2000 | 185,000     | 89,000  | -- | 300,000 |
| Domestic Operations          | 1999 | 121,153 (9) | --      | -- | 260,000 |

-----

- (1) Represents the number of shares issuable pursuant to vested and non-vested stock options granted during the applicable fiscal year.
- (2) Represents reimbursement of (i) medical expenses of \$12,186, (ii) professional fees of \$45,025, and (iii) other miscellaneous personal expenses of \$10,000.
- (3) Represents premium payments by the Company for life and health insurance.
- (4) Represents (i) forgiveness of relocation loan indebtedness and interest to Mr. Grundman of \$52,794, (ii) premium payments made by the Company for life insurance of \$24,725 and (iii) contributions by the Company on behalf of Mr. Grundman to the Key Energy Services, Inc. 401(k) Savings & Retirement Plan of \$1,000.
- (5) Represents (i) premium payments by the Company for life insurance of \$24,725 and (ii) contributions by the Company on behalf of Mr. Grundman to the Key Energy Services, Inc. 401(k) Savings & Retirement Plan of \$250.
- (6) Mr. Grundman joined the Company as an executive officer in April 1999.
- (7) Represents (i) payments to Mr. Byerlotzer pursuant to a non-competition agreement entered into in connection with the Company's acquisition of Dawson Production Services, Inc. of \$100,000, and (ii) contributions by the Company on behalf of Mr. Byerlotzer to the Key Energy Services, Inc. 401(k) Savings & Retirement Plan of \$1,000.

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- (8) Represents (i) payments to Mr. Byerlotzer pursuant to a non-competition agreement entered into in connection with the Company's acquisition of Dawson Production Services, Inc. of \$100,000, and (ii) contributions by the Company on behalf of Mr. Byerlotzer to the Key Energy Services, Inc. 401(k) Savings & Retirement Plan of \$250.
- (9) Mr. Byerlotzer joined the Company as an executive officer in September 1998.
- (10) Represents payments to Mr. Byerlotzer pursuant to a non-competition agreement entered into in connection with the Company's acquisition of Dawson Production Services, Inc.

### OPTION GRANTS IN LAST FISCAL YEAR

The following table sets forth certain information relating to options granted under the Key Energy Group, Inc. 1997 Incentive Plan (the "Plan") and outside the Plan to the Named Executive Officers during fiscal 2001. The Company did not grant any stock appreciation rights during fiscal 2001.

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| NAME                     | NUMBER OF<br>SECURITIES OF<br>UNDERLYING<br>OPTIONS<br>GRANTED | INDIVIDUAL GRANTS<br>% OF TOTAL<br>OPTIONS GRANTED<br>TO EMPLOYEES IN<br>FISCAL YEAR(1) | EXERCISE<br>PRICE PER<br>SHARE | EXPIRA<br>DATE |
|--------------------------|----------------------------------------------------------------|-----------------------------------------------------------------------------------------|--------------------------------|----------------|
| Francis D. John.....     | 960,000 (3)                                                    | 37.9%                                                                                   | \$8.25                         | 08/07          |
|                          | 500,000 (4)                                                    | 19.7%                                                                                   | \$8.25                         | 12/11          |
| Thomas K. Grundman.....  | 135,000 (5)                                                    | 5.3%                                                                                    | \$8.25                         | 12/11          |
| James J. Byerlotzer..... | 115,000 (6)                                                    | 4.5%                                                                                    | \$8.25                         | 12/11          |

-----

- (1) Based on options to purchase a total of 2,533,000 of Common Stock granted during fiscal 2001.
- (2) The grant date value of stock options was estimated using the Black-Scholes option pricing model with the following assumptions: expected volatility--59%; risk-free interest rate--4.3%; time of exercise--5 years; and no dividend yield.
- (3) These options were granted on August 7, 2000, and vested immediately on the date of grant.
- (4) These options were granted on December 11, 2000 and vested immediately on the date of grant.
- (5) These options were granted on December 11, 2000 and vest in three equal annual installments commencing on July 1, 2001 as follows: 45,000 on July 1, 2001; 45,000 on July 1, 2002; and 45,000 on July 1, 2003.
- (6) These options were granted on December 11, 2000 and vest in three equal annual installments commencing on July 1, 2001 as follows: 38,333 on July 1, 2001; 38,333 on July 1, 2002; and 38,334 on July 1, 2003.

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## AGGREGATED OPTION EXERCISES AND VALUES AS OF FISCAL YEAR END

The following table sets forth certain information as of June 30, 2001 relating to the number and value of (i) options exercised by the Named Executive Officers and (ii) unexercised options held by the Named Executive Officers.

| NAME                     | SHARES<br>ACQUIRED<br>ON<br>EXERCISE (#) | VALUE<br>REALIZED (\$) (1) | NUMBER OF UNEXERCISED<br>OPTIONS AT JUNE 30, 2001 |               |      |
|--------------------------|------------------------------------------|----------------------------|---------------------------------------------------|---------------|------|
|                          |                                          |                            | EXERCISABLE                                       | UNEXERCISABLE | EXE  |
| Francis D. John.....     | 1,825,000                                | 12,850,875                 | 2,418,333                                         | 791,667       | \$5, |
| Thomas K. Grundman.....  | 200,000                                  | 1,934,000                  | 250,000                                           | 485,000       | \$   |
| James J. Byerlotzer..... | 165,000                                  | 1,595,550                  | 159,167                                           | 350,833       | \$   |

- 
- (1) The dollar values in this column are calculated by determining the difference between the fair market value of the Company's common stock on the date of exercise of the relevant options and the exercise price of such options. The fair market value on the date of exercise is based on the last sale price of the Company's common stock on the NYSE on such date.
  - (2) The dollar values in this column are calculated by determining the difference between the fair market value of the Common Stock for which the relevant options are exercisable as of the end of the fiscal year and the exercise price of the options. The fair market value is based on the last sale price of the Common Stock on the NYSE on June 29, 2001 which was \$10.84.

#### EMPLOYMENT AGREEMENTS WITH EXECUTIVE OFFICERS

Effective as of July 1, 2001, the Company entered into an amended and restated employment agreement with Mr. John, which provides that Mr. John will serve as Chairman of the Board, President and Chief Executive Officer of the Company for a five-year term commencing July 1, 2001 and continuing until June 30, 2006, with an automatic one-year renewal on each June 30, commencing on June 30, 2006, unless terminated by the Company or by Mr. John with proper notice. Under this employment agreement, Mr. John's annual base salary is \$595,000 per year until December 31, 2002 and \$695,000 per year thereafter, in each case subject to increase after annual reviews by the Board of Directors. This employment agreement also provides that Mr. John will be entitled to (i) participate in the Company's Performance Compensation Plan, with performance criteria to be approved by the Compensation Committee, (ii) receive additional bonuses at the discretion of the Compensation Committee, and (iii) participate in stock option grants made to the Company's executives. In addition to salary and bonus, Mr. John is entitled to medical, dental, accident and life insurance, reimbursement of expenses and various other benefits. To the extent Mr. John is taxed on any such reimbursement or benefit, the Company will pay Mr. John an amount which, on an after-tax basis, equals the amount of these taxes.

In the event that Mr. John's employment is terminated by the Company voluntarily or by nonrenewal, or by Mr. John for "Good Reason," or by either the Company or Mr. John following a "Change in Control" (in each case as defined in the employment agreement), Mr. John will be entitled to receive: (i) his accrued but unpaid salary and bonuses to the date of termination, and a PRO RATA bonus for the year in which termination occurs; (ii) a severance payment in an amount equal to five times his average total annual compensation (I.E., salary plus bonus) for the preceding three years; (iii) immediate vesting and exercisability of all stock options held by him (to the extent not already vested and exercisable) for the remainder of the original terms of the options; (iv) any other amounts or benefits earned, accruing or owing to him, but not yet paid; and (v) continued participation in medical, dental and life insurance coverage, as well as the receipt of other benefits to which he was entitled, until the first to occur of the third year anniversary of the date his employment was terminated or the date on which he receives

equivalent coverage and benefits under the plans and programs of a subsequent employer (or, in the event of a "Change in Control," an amount in cash equal to the reasonable expenses that the Company would incur if it were to provide these benefits for three years). In the event that Mr. John's employment is terminated as a result of Mr. John's disability, Mr. John will be entitled to receive (i) through (v) above, except that his severance compensation will be an amount equal to three times his average total annual compensation for the preceding three years, reduced by the amount of any Company-paid disability insurance

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proceeds paid to Mr. John. In the event that Mr. John's employment is terminated by the Company for "Cause," as defined in the employment agreement, or by Mr. John voluntarily or by nonrenewal, he will be entitled to receive only (i) and (v) above and will forfeit any restricted stock or options not previously vested. In the event Mr. John's employment is terminated by reason of his death, he will be entitled to receive (i), (iii), (iv) and (v) above, except that his family will be entitled to receive the medical and dental insurance coverage provided in (v) above until the death of Mr. John's spouse. In addition, if any of the above benefits are subject to the tax imposed by Section 4999 of the Internal Revenue Code, the Company will reimburse Mr. John for such tax on an after-tax basis.

The employment agreement specifies that Mr. John may not engage in any activities that are competitive with the Company for a period of three years after the termination of his employment.

Pursuant to the employment agreement, the Company will pay to Mr. John, on or prior to December 31, 2001, a one-time retention incentive bonus equal to the aggregate amount of all principal and interest on loans previously made by the Company to Mr. John that were to be forgiven over a ten year period beginning July 1, 2001, as well as the amount, on an after-tax basis, required to pay the taxes incurred Mr. John in connection with such payment. The after-tax proceeds of the bonus will be used to repay such loans. The employment agreement goes on to provide that if, prior to June 30, 2011, Mr. John is terminated by the Company for Cause, or by Mr. John voluntarily or by nonrenewal, Mr. John will repay to the Company a percentage of the retention incentive bonus beginning at 100% during the first year and declining at the rate of 10% each year to 0% on and after June 30, 2011.

Mr. Grundman entered into an employment agreement with the Company effective as of July 1, 1999, which was amended effective July 1, 2000. This agreement is for a three-year term and thereafter for successive one-year terms unless terminated 60 days prior to the commencement of an extension term. Under this agreement, Mr. Grundman initially receives an annual base compensation of \$200,000, which can be increased but not decreased, and is eligible for additional annual incentive bonuses. If, during the term of his employment agreement, Mr. Grundman is terminated by the Company for any reason other than for cause, or if he terminates his employment because of a material breach by the Company or following a change of control of the Company, he will be entitled to severance compensation equal to his base compensation in effect at the time of termination payable in equal installments over a 36-month period following termination; PROVIDED, HOWEVER, that if termination results from a change of control of the Company, severance compensation will be payable in a lump sum on the date of termination. Also, if Mr. Grundman is subject to the tax imposed by Section 4999 of the Internal Revenue code, the Company has agreed to reimburse him for such tax on an after-tax basis.

Mr. Byerlotzer entered into an employment agreement with the Company effective as of July 1, 1999 for a three-year term and thereafter for successive one-year terms unless terminated 30 days prior to the commencement of an extension term. Under the agreement, Mr. Byerlotzer receives an annual base compensation of \$185,000 and is eligible for additional annual incentive bonuses. If during the term of his employment agreement Mr. Byerlotzer is terminated by the Company for any reason other than for "Cause", or if he terminates his employment because of a material breach by the Company or following a change of control of the Company, he will be entitled to severance compensation equal to his base compensation in effect at the time of termination payable in equal installments over a 24-month period following termination; PROVIDED, HOWEVER, that if termination results from a change of control of the Company, severance compensation will be payable in a lump sum on the date of termination.

## DIRECTOR COMPENSATION

No director who is also an employee of the Company or any of its subsidiaries received any fees from the Company for his services as a Director or as a member of any committee of the Board. During the fiscal year ended June 30, 2001 all other Directors ("Non-employee Directors") received a fee equal to \$3,000 per month for each month of service and are reimbursed for travel and other expenses directly associated with Company business. Additionally, during fiscal 2001 the Company paid the premiums with respect to life insurance for the benefit of Messrs. Collins and Marcum in the amount of \$2,906 and \$5,389, respectively.

## ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

## MANAGEMENT

The following table sets forth as of October 25, 2001, the number of shares of Common Stock beneficially owned by each (i) each Director, (ii) each Named Executive Officer, and (iii) all Directors and executive officers of the Company as a group. Except as noted below, each holder has sole voting and investment power with respect to all shares of Common Stock listed as owned by such person.

| NAME OF BENEFICIAL OWNER<br>-----                               | NUMBER OF<br>SHARES (1)<br>----- | PERCENTAGE OF<br>OUTSTANDING<br>SHARES (2)<br>----- |
|-----------------------------------------------------------------|----------------------------------|-----------------------------------------------------|
| Francis D. John (3).....                                        | 2,613,833                        | 2.5%                                                |
| Kevin P. Collins (4).....                                       | 223,405                          | *                                                   |
| William D. Fertig (5).....                                      | 30,000                           | *                                                   |
| William D. Manly (6).....                                       | 221,042                          | *                                                   |
| W. Phillip Marcum (7).....                                      | 223,405                          | *                                                   |
| David J. Breazzano (8).....                                     | 208,333                          | *                                                   |
| Morton Wolkowitz (9).....                                       | 608,302                          | *                                                   |
| Thomas K. Grundman (10).....                                    | 355,000                          | *                                                   |
| James J. Byerlotzer (11).....                                   | 263,667                          | *                                                   |
| Directors and Executive Officers as a group (9<br>persons)..... | 4,716,987                        | 4.4%                                                |

\* Less than 1%

- (1) Includes all shares with respect to which each Director or executive officer directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, has or shares the power to vote or to direct voting of such shares and/or to dispose or to direct the disposition of such shares. Includes shares that may be purchased under currently exercisable stock options and warrants.
- (2) Based on 102,357,547 shares of Common stock outstanding at October 25, 2001, plus, for each beneficial owner, those number of shares underlying currently exercisable options held by each executive officer or Director.
- (3) Includes 2,543,333 shares issuable upon exercise of vested options. Does not include 666,667 shares issuable pursuant to options that have not vested.

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- (4) Includes 218,333 shares issuable upon the exercise of vested options. Does not include 51,667 shares issuable pursuant to options that have not vested.
- (5) Includes 25,000 shares issuable upon the exercise of vested options. Does not include 25,000 shares issuable pursuant to options that have not vested.
- (6) Includes 218,333 shares issuable upon the exercise of vested options. Does not include 51,667 shares issuable pursuant to options that have not vested.

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- (7) Includes 218,333 shares issuable upon the exercise of vested options. Does not include 51,667 shares issuable pursuant to options that have not vested.
- (8) Includes 148,333 shares issuable upon the exercise of vested options. Does not include 51,667 shares issuable pursuant to options that have not vested.
- (9) Includes 118,000 shares issuable upon the exercise of vested options. Does not include 57,000 shares issuable pursuant to options that have not vested.
- (10) Includes 345,000 shares issuable upon the exercise of vested options. Does not include 390,000 shares issuable pursuant to options that have not vested.
- (11) Includes 241,667 shares issuable upon the exercise of vested options. Does not include 268,333 shares issuable pursuant to options that have not vested.

### CERTAIN BENEFICIAL OWNERS

The following table sets forth, as of October 25, 2001, certain information regarding the beneficial ownership of Common Stock by each person, other than the Company's directors or executive officers, who is known by the Company to own beneficially more than 5% of the outstanding shares of Common Stock.

| NAME AND ADDRESS OF BENEFICIAL<br>OWNER, IDENTITY OF GROUP<br>-----                            | SHARES BENEFICIALLY OWNED<br>AT OCTOBER 19, 2001 |                  |
|------------------------------------------------------------------------------------------------|--------------------------------------------------|------------------|
|                                                                                                | NUMBER<br>-----                                  | PERCENT<br>----- |
| Perkins, Wolf, McDonnell & Co. (1).....<br>53 W. Jackson Blvd., Suite 722<br>Chicago, IL 60604 | 11,036,014 (2)                                   | 10.8%            |
| Berger, L.L.C. (3).....<br>210 University Boulevard<br>Suite 900<br>Denver, CO 80206           | 9,810,240 (2)                                    | 9.6%             |
| Mellon Financial Corporation (4).....<br>One Mellon Center<br>Pittsburgh, PA 15258             | 6,183,414                                        | 6.0%             |
| T. Rowe Price Associates, Inc. (5).....<br>100 E. Pratt Street<br>Baltimore, MD 21202          | 6,735,600                                        | 6.6%             |



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- (1) As reported on Schedule 13G filed with the Commission on October 11, 2001.
  - (2) The Company believes that Perkins, Wolf, McDonnell & Co. shares voting power with respect to 9,810,240 of its shares with Berger, LLC and that, therefore, the 9,810,240 shares shown as being beneficially owned by Berger, LLC are the same securities shown as being beneficially owned by Perkins, Wolf, McDonnell & Co.
  - (3) As reported on Schedule 13F filed with the Commission on August 14, 2001.
  - (4) As reported on Schedule 13G filed with the Commission on January 26, 2001.
  - (5) As reported on Schedule 13G (Amendment No. 1) filed with the Commission on February 8, 2001.

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#### ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

In connection with the negotiation of the terms of a five-year employment agreement with Mr. Francis D. John, Chairman of the Board, President and Chief Executive Officer of the Company, and as an inducement to Mr. John to enter into such employment agreement, the Company entered into a separate agreement with Mr. John dated as of August 2, 1999, which as amended through June 30, 2001, provides that \$6.5 million in loans previously made by the Company to Mr. John, together with the accrued interest payable thereon (accruing at a rate equal to 125 basis points above LIBOR, adjusted monthly) will be forgiven ratably during the ten year period commencing on July 1, 2001 and ending on June 30, 2011. The agreement provides that the foregoing forgiveness of indebtedness is predicated and conditioned upon Mr. John remaining employed by the Company during such period. In addition, in the event that Mr. John is terminated by the Company for "Cause" (as defined in the agreement), or in the event that Mr. John voluntarily terminates his employment with the Company, the agreement further provides that the entire remaining principal balance of these loans, together with accrued interest payable thereon, will become immediately due and payable by Mr. John. However, in the event that Mr. John's employment is terminated for "Good Reason", or as a result of Mr. John's death or "Disability", or as a result of a "Change in Control" (all as defined in that agreement), the agreement stipulates that the remaining principal balance outstanding on the loans, together with accrued interest thereon will be forgiven. This agreement further provides that with respect to any forgiveness of the payment of principal and interest on the loans, Mr. John will be entitled to receive a "gross-up" payment in an amount sufficient for him to pay any federal, state, or local income taxes that may be due and payable by him with respect to the forgiveness of such indebtedness (principal and interest). The agreement has been effectively superseded by Mr. John's new employment agreement that provides for a one-time retention incentive bonus used to repay all amounts owed under the agreement (See Item 11--Executive Compensation--Employment Agreements with Executive Officers).

In connection with the negotiation of an employment agreement with Thomas K. Grundman, the Company's Executive Vice President of International Operations, Chief Financial Officer and Chief Accounting Officer, the Company made a \$240,000 short-term loan and a \$150,000 relocation loan to assist Mr. Grundman's relocation to the Company's executive offices. Interest on these loans accrues at a rate of 6.125% per annum. The short-term loan has been repaid. The relocation loan together with accrued interest will be forgiven in three installments of \$50,000 each on July 1, 2000, 2001 and 2002; PROVIDED, HOWEVER, that if Mr. Grundman's employment is terminated during such period in a way that (i) triggers severance obligations, all amounts owed shall be

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immediately forgiven or (ii) does not trigger severance obligations, all amounts owed shall be immediately due and payable. This agreement further provides that with respect to any forgiveness of the payment of principal and interest on the loans, Mr. Grundman will be entitled to receive a "gross-up" payment in an amount sufficient for him to pay any federal, state, or local income taxes that may be due and payable by him with respect to the forgiveness of such indebtedness (principal and interest).

### PART IV

#### ITEM 14. EXHIBITS, FINANCIAL STATEMENTS AND REPORTS ON FORM 8-K.

##### (a) Index to Exhibits

The following documents are filed as part of this report:

(1) See Index to Financial Statements set forth in Item 8.

(2) Financial Statements Schedules:

Key Energy Services, Inc.:  
Consolidated Supplementary Financial Statement Schedule As of and for  
Each of the

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Three Years Ended June 30, 2001:  
Schedule II-Consolidated Valuation and Qualifying  
Accounts.....S-1

The supplemental schedules other than the one listed above are omitted because of the absence of the conditions under which they are required or because the required information is included in the Consolidated Financial Statements or Notes thereto.

##### (3) Exhibits:

- 3.1 Amended and Restated Articles of Incorporation of the Company. (Incorporated by reference to the Company's Registration Statement on Form S-4, Registration No. 333-369).
- 3.2 Amended and Restated By-Laws of the Company. (Incorporated by reference to the Company's Registration Statement on Form S-4 dated March 8, 1996, Registration No. 333-369).
- 3.3 Amendment to the Amended and Restated Articles of Incorporation of the Company. (Incorporated by reference to Exhibit 3.1 of the Company's Current Report on Form 8-K dated February 2, 1998, File No. 1-8038).
- 3.4 Amendment to the Amended and Restated Articles of Incorporation of the Company. (Incorporated by reference to Exhibit A of the definitive proxy statement on Schedule 14A filed by the Company on November 17, 1998, File No. 1-8038).
- 3.5 Articles of Amendment to Amended and Restated Articles of Incorporation of the Company (Incorporated by reference to Exhibit 3.1 of the Company's Quarterly Report on Form 10-Q

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for the quarter ended March 31, 2000, File No. 1-8038).

- 3.6 Unanimous Consent of the Board of Directors of the Company dated January 11, 2000, limiting the designation of the additional authorized shares to common stock (Incorporated by reference to Exhibit 3.2 of the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2000, File No. 1-8038).
  - 4.1 7% Convertible Subordinated Debenture of the Company due July 1, 2003. (Incorporated by reference to Exhibit 4.1 of the Company's Annual Report on Form 10-K dated June 30, 1996, File No. 1-8038).
  - 4.2 Indenture for the 7% Convertible Subordinated Debentures of the Company due July 1, 2003. (Incorporated by reference to Exhibit 4.2 of the Company's Annual Report on Form 10-K dated June 30, 1996, File No. 1-8038).
  - 4.3 First Supplemental Indenture dated as of November 20, 1996 by and between Key Energy Group, Inc. and American Stock Transfer & Trust Company, as Trustee. (Incorporated by reference to Exhibit 10(i) to the Company's Quarterly Report on Form 10-Q dated December 31, 1996, File No. 1-8038).
  - 4.4 Registration Rights Agreement among the Company, McMahan Securities Co., L.P. and Rausher Pierce Refsnes, Inc., dated as of July 3, 1996. (Incorporated by reference to Exhibit 4.3 of the Company's Annual Report on Form 10-K dated June 30, 1996, File No. 1-8038).
  - 4.5 Registration Rights Agreement dated as of March 2, 1996 among the Company and certain of its stockholders. (Incorporated by reference to Exhibit 4.3 of the Company's Registration Statement on Form S-4, Registration No. 333-369).
  - 4.6 Form of Common Stock Purchase Warrant to Purchase Key Common Stock issued in connection with the WellTech Merger. (Incorporated by reference to Exhibit 4.1 of the Company's Registration Statement on Form S-4, Registration No. 333-369).
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- 4.7 Indenture dated as of September 25, 1997, among Key Energy Group, Inc. and American Stock Transfer and Trust Company. (Incorporated by reference to Exhibit 10(a) of the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 1997, File No. 1-8038).
  - 4.8 Registration Rights Agreement among Key Energy Group, Inc., Lehman Brothers Inc., and McMahan Securities Co. L.P. dated as of September 25, 1997. (Incorporated by reference to Exhibit 10(a) of the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 1997, File No. 1-8038).
  - 4.9 Indenture dated February 20, 1997 between Dawson Production

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Services, Inc. and U.S. Trust Company of Texas, N.A.  
(Incorporated by reference to Exhibit 99.10 of the Company's Current Report on Form 8-K dated September 28, 1998, File No. 1-8038).

- 4.10 Supplemental Indenture dated September 21, 1998, among Key Energy Group, Inc., its Subsidiaries and U.S. Trust Company of Texas, N.A. (Incorporated by reference to Exhibit 99.11 of the Company's Current Report on Form 8-K dated September 28, 1998, File No. 1-8038).
- 4.11 Warrant Agreement dated as of January 22, 1999 between the Company and The Bank of New York, a New York banking corporation as warrant agent. (Incorporated by reference to Exhibit 99(b) of the Company's Form 8-K filed on February 3, 1999, File No. 1-8038).
- 4.12 Indenture dated as of January 22, 1999 between the Company and The Bank of New York as trustee. (Incorporated by reference to Exhibit 99(c) of the Company's Form 8-K filed on February 3, 1999, File No. 1-8038).
- 4.13 Registration Rights Agreement dated January 22, 1999 by and among the Registrant, certain of its subsidiaries, and Lehman Brothers, Inc., Bear, Stearns & Co. Inc., F.A.C./Equities, a division of First Albany Corporation, and Dain Rauscher Wessels, a division of Dain Rauscher Incorporated. (Incorporated by reference to Exhibit 99(d) of the Company's Form 8-K filed on February 3, 1999, File No. 1-8038).
- 4.14 Warrant Registration Rights Agreement dated January 22, 1999, by and among the Company and Lehman Brothers Inc., Bear, Stearns & Co. Inc., F.A.C./Equities, a division of First Albany Corporation, and Dain Rauscher Wessels, a division of Dain Rauscher Incorporated. (Incorporated by reference to Exhibit 99(e) of the Company's Form 8-K filed on February 3, 1999, File No. 1-8038).
- 4.15 Indenture dated March 6, 2001 between the Company and The Chase Manhattan Bank, a New York banking corporation, as Trustee (Incorporated by reference to Exhibit 4.1 of the Company's Form 8-K filed on March 20, 2001, File No. 1-8038)
- 4.16 Registration Rights Agreement dated March 6, 2001 among the Company, certain of its subsidiaries, Lehman Brothers, Inc., and Bear Stearns & Co., Inc. (Incorporated by reference to Exhibit 99.2 of the Company's Current Report of Form 8-K dated March 20, 2001 File No. 1-8038)
- 10.1 Employment Agreement between the Company and D. Kirk Edwards, dated as of July 1, 1996. (Incorporated by reference to Exhibit 10.1 of the Company's Annual Report on Form 10-K for the year ended June 30, 1997, File No. 1-8038).

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- 10.2 Amended and Restated Senior Credit Facility among Key Energy Group, Inc. and several other financial institutions dated as of June 6, 1997 as amended and restated through November 6, 1997. (Incorporated by reference to Exhibit 10(s) of the Company's Quarterly Report on Form 10-Q for the quarter ended December 31, 1997, File No. 1-8038).
- 10.3 First Amendment to the Amended and Restated Credit Agreement dated as of June 6, 1997, as amended and restated through November 6, 1997 dated December 3, 1997. (Incorporated by reference to Exhibit 10(t) of the Company's Quarterly Report on Form 10-Q for the quarter ended December 31, 1997, File No. 1-8038).
- 10.4 Escrow Agreement among Key Energy Group, Inc., Lehman Brothers Inc., Lehman Commercial Paper Inc. and The Bank of New York, dated as of September 14, 1998 (Incorporated by reference to Exhibit 99.6 of the Company's Current Report on Form 8-K dated September 28, 1998, File No. 1-8038).
- 10.5 \$550,000,000 Second Amended and Restated Senior Credit Facility, among Key Energy Group, Inc., PNC Bank, National Association, Norwest Bank Texas, N.A., PNC Capital Markets, Inc. and the several lenders from time to time parties thereto, dated as of June 6, 1997, as amended and restated through September 14, 1998 (Incorporated by reference to Exhibit 99.7 of the Company's Current Report on Form 8-K dated September 28, 1998, File No. 1-8038).
- 10.6 Amended and Restated Master Guarantee and Collateral Agreement made by Key Energy Group, Inc. and certain of its subsidiaries in favor of Norwest Bank Texas, N.A., dated as of June 6, 1998, as amended and restated through September 14, 1998 (Incorporated by reference to Exhibit 99.8 of the Company's Current Report on Form 8-K dated September 28, 1998, File No. 1-8038).
- 10.7 Intercreditor and Collateral Agency Agreement, dated as of September 14, 1998. (Incorporated by reference to Exhibit 99.9 of the Company's Current Report on Form 8-K dated September 28, 1998, File No. 1-8038).
- 10.8 Consulting Agreement, dated as of October 7, 1998, by and among Key Energy Group, Inc. and Michael E. Little. (Incorporated by reference to Exhibit 10(a) of the Company's Quarterly Report on Form 10-Q for the quarter ended December 31, 1998, File No. 1-8038).
- 10.9 Employment Agreement, dated November 13, 1998, by and between Key Energy Group, Inc. and James J. Byerlotzer. (Incorporated by reference to Exhibit 10(b) the Company's Quarterly Report on Form 10-Q for the quarter ended December 31, 1998, File No. 1-8038).
- 10.10 Non-Compete Agreement, dated November 13, 1998, by and between Key Energy Group, Inc. and James J. Byerlotzer. (Incorporated by reference to Exhibit 10(c) of the Company's Quarterly Report on Form 10-Q for the quarter ended December 31, 1998, File No. 1-8038).
- 10.11 Non-Compete Agreement, dated October 20, 1998, by and between Key Energy Group, Inc. and Joseph B. Eustace.

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(Incorporated by reference to Exhibit 10(e) of the Company's Quarterly Report on Form 10-Q for the quarter ended December 31, 1998, File No. 1-8038).

- 10.12 Consulting Agreement, dated as of November 12, 1998, by and among Key Energy Group, Inc. and C. Ron Laidley. (Incorporated by reference to Exhibit 10(f) of the Company's Quarterly Report on Form 10-Q for the quarter ended December 31, 1998, File No. 1-8038).

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- 10.13 Key Energy Group, Inc. Performance Compensation Plan. (Incorporated by reference to Exhibit 10(g) of the Company's Quarterly Report on Form 10-Q for the quarter ended December 31, 1998, File No. 1-8038).

- 10.14 First Amendment, dated as of December 3, 1997, to the Second Amended and Restated Senior Credit Facility, dated as of June 6, 1997, as amended and restated through November 6, 1997. (Incorporated by reference to Exhibit 10(h) of the Company's Quarterly Report on Form 10-Q for the quarter ended December 31, 1998, File No. 1-8038).

- 10.15 Second Amendment, dated as of December 29, 1998, to the Second Amended and Restated Senior Credit Facility, dated as of June 6, 1997, as amended and restated through September 14, 1998, and as amended by the First Amendment dated as of November 19, 1998. (Incorporated by reference to Exhibit 10(i) of the Company's Quarterly Report on Form 10-Q for the quarter ended December 31, 1998, File No. 1-8038).

- 10.16 Purchase Agreement dated January 19, 1999 by and among the Registrant, certain of its subsidiaries, Lehman Brothers, Inc., Bear, Stearns & Co. Inc., First Albany Corporation, Dain Rauscher Wessels, a division of Dain Rauscher Incorporated. (Incorporated by reference to Exhibit 99(a) of the Company's Form 8-K filed on February 3, 1999, File No. 1-8038).

- 10.17 Employment Agreement between the Company and William C. McCurdy dated as of January 4, 1999. (Incorporated by reference to Exhibit 10(f) of the Company's Quarterly Report on Form 10-Q for the quarter ended December 31, 1998, File No. 1-8038).

- 10.18 Employment Agreement between the Company and Michael R. Furrow dated as of January 4, 1999. (Incorporated by reference to Exhibit 10(g) of the Company's Quarterly Report on Form 10-Q for the quarter ended December 31, 1998, File No. 1-8038).

- 10.19 Purchase Agreement, among the Company, Green-Cohn Group, LLC, ZPG Securities L.L.C. and DFG Corporation, dated as of April 15, 1999. (Incorporated by reference to Exhibit 99.2 of the Company's Current Report on Form 8-K dated April 8, 1999, File No. 1-8038).

- 10.20 Commitment Letter, between the Company and PNC Investment

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Corp., dated April 15, 1999. (Incorporated by reference to Exhibit 99.3 of the Company's Current Report on Form 8-K dated April 8, 1999, File No. 1-8038).

- 10.21 Fee letter, between the Company and PNC Capital Markets, Inc., dated April 15, 1999. (Incorporated by reference to Exhibit 99.4 of the Company's Current Report on Form 8-K dated April 8, 1999, File No. 1-8038).
- 10.22 Third Amendment, dated as of April 8, 1999, to the Second Amended and Restated Senior Credit Facility, among the Company, the several lenders from time to time parties thereto, PNC Bank, National Association, as Administrative Agent, Norwest Bank Texas, N.A., as Collateral Agent and PNC Capital Markets, Inc., as Arranger. (Incorporated by reference to Exhibit 99.5 of the Company's Current Report on Form 10-K dated April 8, 1999, File No. 1-8038).

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- 10.23 Fourth Amendment, dated as of April 15, 1999, to the Second Amended and Restated Senior Credit Facility, among the Company, the several lenders from time to time parties thereto, PNC Bank, National Association, as Administrative Agent, Norwest Bank Texas, N.A., as Collateral Agent and PNC Capital Markets, Inc., as Arranger. (Incorporated by reference to Exhibit 99.6 of the Company's Current Report on Form 10-K dated April 8, 1999, File No. 1-8038).
- 10.24 Underwriting Agreement, dated May 4, 1999, among the Company, and Friedman, Billings, Ramsey & Co., Inc., for itself and as representative for the other underwriter named in Schedule I thereto. (Incorporated by reference to Exhibit 1.1 of the Company's Current Report on Form 8-K dated May 4, 1999, File No. 1-8038).
- 10.25 Letter Agreement, dated May 4, 1999, among the Company, PNC Capital Markets, Inc. and PNC Investment Corp. (Incorporated by reference to Exhibit 99.1 of the Company's Current Report on Form 8-K dated May 4, 1999, File No 1-8038).
- 10.26 Fifth Amendment, dated as of May 10, 1999, to the Second Amended and Restated Senior Credit Facility, among the Company, the several lenders from time to time parties thereto, PNC Bank, National Association, as Administrative Agent, Norwest Bank Texas, N.A., as Collateral Agent, and PNC Capital Markets, Inc., as Arranger. (Incorporated by reference to Exhibit 10.91 of the Company's Annual Report on Form 10-K dated June 30, 1999, File No. 1-8038).
- 10.27 Consulting Agreement between Key Energy Group, Inc. and The Old Hill Company LLC dated as of December 2, 1998. (Incorporated by reference to Exhibit 10.92 of the Company's Annual Report on Form 10-K dated June 30, 1999, File No. 1-8038).
- 10.28 Amended and Restated Employment Agreement dated July 1, 1999, between Francis D. John and Key Energy Services, Inc. (Incorporated by reference to Exhibit 10.1 of the Company's

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Quarterly Report on Form 10-Q for the quarter ended September 30, 1999, File No. 1-8038).

- 10.29 Employment Agreement dated August 5, 1999, between Thomas K. Grundman and Key Energy Services, Inc. (Incorporated by reference to Exhibit 10.2 of the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 1999, File No. 1-8038).
- 10.30 Employment Agreement dated July 1, 1999, between Danny R. Evatt and Key Energy Services, Inc. (Incorporated by reference to Exhibit 10.3 of the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 1999, File No. 1-8038).
- 10.31 Employment Agreement dated July 1, 1999, between James J. Byerlotzer and Key Energy Services, Inc. (Incorporated by reference to Exhibit 10.4 of the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 1999, File No. 1-8038).
- 10.32 Agreement dated as of August 2, 1999, between Francis D. John and Key Energy Services, Inc. (Incorporated by reference to Exhibit 10.5 of the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 1999, File No. 1-8038).

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- 10.33 Promissory Note dated August 3, 1999, made by Thomas K. Grundman in favor of Key Energy Services, Inc. (Incorporated by reference to Exhibit 10.6 of the Quarterly Report on Form 10-Q for the quarter ended September 30, 1999, File No. 1-8038).
- 10.34 Demand Note dated August 3, 1999, made by Thomas K. Grundman in favor of Key Energy Services, Inc. (Incorporated by reference to Exhibit 10.7 of the Quarterly Report on Form 10-Q for the quarter ended September 30, 1999, File No. 1-8038).
- 10.35 Confidential Separation and Release Agreement dated as of July 1, 1999, between Key Energy Services, Inc. and Stephen E. McGregor (Incorporated by reference to Exhibit 10.8 of the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 1999, File No. 1-8038).
- 10.36 Amendment No. 1 dated as of December 1, 1999, to Agreement dated as of August 2, 1999, between Francis D. John and Key Energy Services, Inc. (Incorporated by reference to Exhibit 10.1 of the Company's Quarterly Report on Form 10-Q for the quarter ended December 31, 1999, File No. 1-8038).
- 10.37 Amendment No. 1 dated as of November 24, 1999, to the Confidential Separation and Release Agreement dated as of July 1, 1999, between Key Energy Services, Inc. and Stephen E. McGregor (Incorporated by reference to Exhibit 10.2 of the Company's Quarterly Report on Form 10-Q for the quarter ended December 31, 1999, File No. 1-8038).



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- 10.38 Sixth Amendment, dated as of July 14, 1999, to the Second Amended and Restated Senior Credit Facility, among the Company, the several lenders from time to time parties thereto, PNC Bank, National Association, as Administrative Agent, Norwest Bank Texas, N.A., as Collateral Agent, and PNC Capital Markets, Inc., as Arranger (Incorporated by reference to Exhibit 10.1 of the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2000, File No. 1-8038).
- 10.39 Seventh Amendment, dated as of March 1, 2000, to the Second Amended and Restated Senior Credit Facility, among the Company, the several lenders from time to time parties thereto, PNC Bank, National Association, as Administrative Agent, Norwest Bank Texas, N.A., as Collateral Agent, and PNC Capital Markets, Inc., as Arranger (Incorporated by reference to Exhibit 10.2 of the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2000, File No. 1-8038).
- 10.40 Production and Delivery Agreement dated March 31, 2000, among Odessa Exploration Incorporated and Norwest Energy Capital, Inc., (Incorporated by reference to Exhibit 10.3 of the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2000, File No. 1-8038).
- 10.41 Agreement dated March 31, 2000, among Odessa Exploration Incorporated, Norwest Energy Capital, Inc. and the Company (Incorporated by reference to Exhibit 10.4 of the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2000, File No. 1-8038).
- 10.42 Underwriting Agreement dated June 27, 2000, among the Company and Lehman Brothers Inc. for itself and as Representative of the several underwriters named in Schedule I thereto (Incorporated by reference to Exhibit 1.1 of the Company's Current Report on Form 8-K dated June 29, 2000, File No. 1-8038).

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- 10.43 Membership Interest Exchange Agreement dated April 5, 2000 by and between Tetra Services, Inc. and Brooks Well Servicing, Inc. (Incorporated by reference to Exhibit 10.82 of the Company's Annual Report on Form 10-K dated June 30, 2000, File No. 1-8038).
- 10.44 Amendment No. 2 dated as of June 16, 2000 to Agreement dated as of August 2, 1999, as amended between Francis D. John and Key Energy Services, Inc. (Incorporated by reference to Exhibit 10.83 of the Company's Annual Report on Form 10-K dated June 20, 2000, File No. 1-8038).
- 10.45 Amendment dated July 1, 2000 to Employment Agreement dated August 5, 1999 between Thomas K. Grundman and Key Energy Services, Inc. (Incorporated by reference to Exhibit 10.1 of the Company's Quarterly report on Form 10-Q for the quarter ended September 30, 2000, File No. 1-8038).

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- 10.46 Letter Agreement Amendment dated July 1, 2000 to the Demand Note dated August 3, 1999 made by Thomas K. Grundman in favor of Key Energy Services, Inc. (Incorporated by reference to Exhibit 10.2 of the Company's Quarterly Report of Form 10-Q for the quarter ended September 30, 2000, File No. 1-8038).
- 10.47 Purchase Agreement dated March 1, 2001 among the Company, certain of its subsidiaries, Lehman Brothers, Inc., and Bear Stearns & Co., Inc. (Incorporated by reference to Exhibit 1.1 of the Company's Form 8-K filed on March 20, 2001, File No. 1-8038)
- 10.48 Eighth Amendment to the Second Amended and Restated Senior Credit Facility, dated as of June 6, 1997, as amended and restated through September 14, 1998 and as further amended, among Key Energy Group, Inc. (now known as Key Energy Services, Inc.), the several Lenders from time to time parties thereto, PNC Bank, National association, as Administrative Agent, Norwest Bank Texas, N.A., as Collateral Agent and PNC Capital markets, Inc., as Arranger. (Incorporated by reference to Exhibit 99.3 of the Company's Form 8-K filed on March 20, 2001, File No. 1-8038)
- 10.49 Amendment No. 3 dated as of May 14, 2001 to Agreement dated as of August 2, 1999, as amended, between Francis D. John and Key Energy Services, Inc.
- \*10.50 Second Amended and Restated Employment Agreement dated October 16, 2001 between Francis D. John and Key Energy Services, Inc.
- 21 Significant Subsidiaries of the Company.
- 23 Consent of KPMG LLP.

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\* Filed herewith.

(b) Reports on Form 8-K

The Company did not file any reports on Form 8-K during the quarter ended June 30, 2001.

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SIGNATURES

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

KEY ENERGY SERVICES, INC.  
(Registrant)

Dated: October 26, 2001

By: \_\_\_\_\_ /s/ FRANCIS D. JOHN

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Francis D. John  
CHAIRMAN OF THE BOARD, PRESIDENT,  
AND CHIEF EXECUTIVE OFFICER

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

Dated: October 26, 2001

By: /s/ FRANCIS D. JOHN

Francis D. John  
CHAIRMAN OF THE BOARD, PRESIDENT,  
AND CHIEF EXECUTIVE OFFICER

Dated: October 26, 2001

By: /s/ THOMAS K. GRUNDMAN

Thomas K. Grundman  
CHIEF FINANCIAL OFFICER  
AND CHIEF ACCOUNTING OFFICER

Dated: October 26, 2001

By: /s/ MORTON WOLKOWITZ

Morton Wolkowitz  
DIRECTOR

Dated: October 26, 2001

By: /s/ DAVID J. BREAZZANO

David J. Breazzano  
DIRECTOR

Dated: October 26, 2001

By: /s/ WILLIAM MANLY

William Manly  
DIRECTOR

Dated: October 26, 2001

By: /s/ KEVIN P. COLLINS

Kevin P. Collins  
DIRECTOR

Dated: October 26, 2001

By: /s/ W. PHILLIP MARCUM

W. Phillip Marcum  
DIRECTOR

Dated: October 26, 2001

By: /s/ WILLIAM D. FERTIG

William D. Fertig  
DIRECTOR

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|                                  |                                 | ADDITIONS              |                                  |        |
|----------------------------------|---------------------------------|------------------------|----------------------------------|--------|
|                                  | BALANCE AT<br>BEGINNING OF YEAR | CHARGED TO<br>EXPENSES | CHARGED TO<br>OTHER ACCOUNTS (A) | DEDUCT |
|                                  |                                 |                        |                                  |        |
|                                  |                                 |                        | (IN THOUSANDS)                   |        |
| Allowance for doubtful accounts: |                                 |                        |                                  |        |
| 2001.....                        | \$3,189                         | \$1,263                | \$ --                            | \$ 3   |
| 2000.....                        | 6,790                           | 1,648                  | --                               | 5,2    |
| 1999.....                        | 2,843                           | 5,928                  | 3,112                            | 5,0    |

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(a) Additions to allowance for doubtful accounts established through purchase accounting.

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