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TIDELANDS OIL & GAS CORP/WA  
Form 10-Q  
August 21, 2006

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 20549

Form 10-Q

(Mark one)

Quarterly Report Under Section 13 or 15(d) of The Securities Exchange Act of 1934

For the quarterly period ending June 30, 2006

Transition Report Under Section 13 or 15(d) of The Securities Exchange Act of 1934

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

Commission File Number: 0-29613

TIDELANDS OIL & GAS CORPORATION  
(Exact name of small business issuer as specified in its charter)

Nevada

66-0549380

-----  
(State of incorporation)

-----  
(IRS Employer ID Number)

1862 West Bitters Rd., San Antonio, TX 78248

-----  
(Address of principal executive offices)

(210) 764-8642  
(Issuer's telephone number)

Securities registered under Section 12 (b) of the Exchange Act: None

Securities registered under Section 12(g) of the Exchange Act:  
Common Stock - \$0.001 par value

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definitions of "accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer , Accelerated filer , Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined by Rule 12b-2 of the Exchange Act. Yes  No

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APPLICABLE ONLY TO CORPORATE ISSUERS

As of June 30, 2006, there were 80,565,815 shares of Common Stock issued and outstanding.

Transitional Small Business Disclosure Format : Yes [ ] No [X]

## TIDELANDS OIL & GAS CORPORATION FORM 10-Q

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PART I - Financial Information

Item 1. Financial Statements

TIDELANDS OIL & GAS CORPORATION  
CONDENSED CONSOLIDATED BALANCE SHEETS

ASSETS

|                                   | June 30,<br>2006     | December 31,<br>2005 |
|-----------------------------------|----------------------|----------------------|
|                                   | -----<br>(Unaudited) | -----                |
| Current Assets:                   |                      |                      |
| Cash and Cash Equivalents         | \$ 3,312,026         | \$ 1,113,911         |
| Accounts and Loans Receivable     | 306,744              | 468,458              |
| Inventory                         | 84,346               | 142,204              |
| Prepaid Expenses                  | 299,811              | 183,938              |
|                                   | -----                | -----                |
| Total Current Assets              | 4,002,927            | 2,197,017            |
|                                   | -----                | -----                |
| Property Plant and Equipment, Net | 11,193,722           | 10,042,088           |
|                                   | -----                | -----                |
| Other Assets:                     |                      |                      |
| Deposits                          | 74,004               | 14,004               |
| Restricted Cash                   | 51,707               | 76,803               |
| Note Receivable                   | 285,287              | 288,506              |
| Deferred Charges                  | 1,264,245            | 0                    |
| Goodwill                          | 1,158,937            | 1,158,937            |
|                                   | -----                | -----                |
| Total Other Assets                | 2,834,180            | 1,249,744            |
|                                   | -----                | -----                |
| Total Assets                      | \$ 18,030,829        | \$ 13,488,849        |
|                                   | =====                | =====                |

LIABILITIES AND STOCKHOLDERS' EQUITY

|  |            |            |
|--|------------|------------|
| Current Liabilities:   |            |            |
| Current Maturities - Notes Payable   | \$ 225,000 | \$ 225,000 |
| Accounts Payable and Accrued Expenses  | 691,015    | 1,225,554  |
|  | -----      | -----      |
| Total Current Liabilities  | 916,015    | 1,450,554  |
|  | -----      | -----      |
| Long-Term Debt   | 10,950,183 | 4,271,768  |
|  | -----      | -----      |
| Total Liabilities  | 11,866,198 | 5,722,322  |
|  | -----      | -----      |
| Commitments and Contingencies  | --         | --         |
| Stockholders' Equity:  |            |            |
| Common Stock, \$.001 Par Value per Share,<br>250,000,000 Shares Authorized, 80,565,815<br>and 78,495,815 Shares Issued and |            |            |

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|  |               |               |
|--|---------------|---------------|
| Outstanding at June 30, 2006<br>and December 31, 2005 Respectively | 80,567        | 78,497        |
| Paid-in Capital in Excess of Par Value                             | 42,760,404    | 40,818,174    |
| Subscriptions Receivable   | (440,000)     | (550,000)     |
| Minority Interest  | --            | --            |
| Accumulated (Deficit)  | (36,236,340)  | (32,580,144)  |
|  | -----         | -----         |
| Total Stockholders' Equity   | 6,164,631     | 7,766,527     |
|  | -----         | -----         |
| Total Liabilities and Stockholders' Equity                         | \$ 18,030,829 | \$ 13,488,849 |
|  | =====         | =====         |

See Accompanying Notes to Condensed Consolidated Financial Statements

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TIDELANDS OIL & GAS CORPORATION  
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS  
(UNAUDITED)

|  | Three Months Ended<br>June 30, 2006 | Three Months Ended<br>June 30, 2005 |
|--|-------------------------------------|-------------------------------------|
|  | -----                               | -----                               |
|  |                                     | (Restated)                          |
| Revenues:                              |                                     |                                     |
| Gas Sales and Pipeline Fees            | \$ 392,108                          | \$ 262,541                          |
| Construction Services                  | 15,016                              | 77,995                              |
|  | -----                               | -----                               |
| Total Revenues                         | 407,124                             | 340,536                             |
|  | -----                               | -----                               |
| Expenses:                              |                                     |                                     |
| Cost of Sales                          | 206,413                             | 130,569                             |
| Operating Expenses                     | 99,587                              | 62,363                              |
| Depreciation                           | 116,038                             | 120,954                             |
| Interest                               | 373,950                             | 184,073                             |
| Beneficial Conversion Feature Interest | 0                                   | (4,601,054)                         |
| Sales, General and Administrative      | 1,599,803                           | 2,858,659                           |
| Impairment Losses                      | 0                                   | 5,200,000                           |
|  | -----                               | -----                               |
| Total Expenses                         | 2,395,791                           | 3,955,564                           |
|  | -----                               | -----                               |
| (Loss) From Operations                 | (1,988,667)                         | (3,615,028)                         |
| Derivative Gain (Loss)                 | 0                                   | 8,062,500                           |
| (Loss) on Sale of Asset                | 0                                   | 0                                   |
| Interest and Dividend Income           | 28,118                              | 33,659                              |
|  | -----                               | -----                               |
| Net Income (Loss)                      | \$ (1,960,549)                      | \$ 4,481,131                        |
|  | =====                               | =====                               |

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|  |            |            |
|--|------------|------------|
| Net Income (Loss) Per Common Share:                  |            |            |
| Basic and Diluted                                    | \$ (0.03)  | \$ 0.07    |
|  | =====      | =====      |
| Weighted Average Number of Common Shares Outstanding | 80,080,815 | 68,321,251 |
|  | =====      | =====      |

See Accompanying Notes to Condensed Consolidated Financial Statements

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TIDELANDS OIL & GAS CORPORATION  
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS  
(UNAUDITED)

|  | Six Months Ended<br>June 30, 2006 | Six Months Ended<br>June 30, 2005 |
|--|-----------------------------------|-----------------------------------|
|  | -----                             | -----                             |
|  |                                   | (Restated)                        |
| Revenues:                              |                                   |                                   |
| Gas Sales and Pipeline Fees            | \$ 1,064,614                      | \$ 849,490                        |
| Construction Services                  | 144,404                           | 119,121                           |
|  | -----                             | -----                             |
| Total Revenues                         | 1,209,018                         | 968,611                           |
|  | -----                             | -----                             |
| Expenses:                              |                                   |                                   |
| Cost of Sales                          | 583,279                           | 415,248                           |
| Operating Expenses                     | 184,118                           | 129,137                           |
| Depreciation                           | 231,802                           | 236,395                           |
| Interest                               | 485,009                           | 393,860                           |
| Beneficial Conversion Feature Interest | 0                                 | 135,789                           |
| Sales, General and Administrative      | 3,442,745                         | 4,677,070                         |
| Impairment Losses                      | 0                                 | 5,200,000                         |
|  | -----                             | -----                             |
| Total Expenses                         | 4,926,953                         | 11,187,499                        |
|  | -----                             | -----                             |
| (Loss) From Operations                 | (3,717,935)                       | (10,218,888)                      |
| Derivative Gain (Loss)                 | 0                                 | 5,168,000                         |
| (Loss) on Sale of Equipment            | 0                                 | (3,167)                           |
| Interest and Dividend Income           | 61,739                            | 69,651                            |
|  | -----                             | -----                             |
| Net (Loss)                             | \$ (3,656,196)                    | \$ (4,984,404)                    |

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|   |            |            |
|---|------------|------------|
|   | =====      | =====      |
| Net (Loss) Per Common Share:                            |            |            |
| Basic and Diluted                                       | \$ (0.05)  | \$ (0.07)  |
|   | =====      | =====      |
| Weighted Average Number of Common<br>Shares Outstanding | 79,896,700 | 67,941,251 |
|   | =====      | =====      |

See Accompanying Notes to Condensed Consolidated Financial Statements

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TIDELANDS OIL & GAS CORPORATION  
STATEMENTS OF CONDENSED CONSOLIDATED CASH FLOWS  
(UNAUDITED)

|  | Six Months Ended<br>June 30, 2006<br>----- | Six Months Ended<br>June 30, 2005<br>-----<br>(Restated) |
|--|--|--|
| Cash Flows Provided (Required) By  |  |  |
| Operating Activities:  |  |  |
| Net (Loss)   | \$ (3,656,196)                             | \$ (4,984,404)   |
| Adjustments to Reconcile Net (Loss)<br>to Net Cash Provided (Required) By<br>Operating Activities: |  |  |
| Depreciation   | 231,802                                    | 236,395  |
| Loss on Disposal of Equipment  | 0  | 3,167  |
| Change in Derivative Liability   | 0  | (5,168,000)  |
| Issuance of Common Stock:  |  |  |
| For Services Provided  | 1,499,300                                  | 2,677,125  |
| Beneficial Conversion Feature Interest   | 0  | 135,789  |
| Changes in:  |  |  |
| Accounts Receivable  | 161,714                                    | 207,064  |
| Inventory  | 57,858                                     | 6,950  |
| Prepaid Expenses   | (115,873)                                  | 184,957  |
| Deferred Charges   | (1,264,245)                                | 116,250  |
| Deposits   | (60,000)                                   | (2,500)  |
| Restricted Cash  | 25,096                                     | 0  |
| Accounts Payable and<br>Accrued Expenses   | (89,539)                                   | 82,078   |

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|  |             |             |
|--|-------------|-------------|
| Impairment Losses                                | 0           | 5,200,000   |
|  | -----       | -----       |
| Net Cash (Required) By Operating Activities      | (3,210,083) | (1,305,129) |
|  | -----       | -----       |
| Cash Flows Provided (Required)                   |             |             |
| By Investing Activities:                         |             |             |
| Acquisitions of Property, Plant<br>and Equipment | (1,383,436) | (784,640)   |
| Disposals of Equipment                           | 0           | 800         |
|  | -----       | -----       |
| Net Cash (Required) By Investing Activities      | (1,383,436) | (783,840)   |
|  | -----       | -----       |

See Accompanying Notes to Condensed Consolidated Financial Statements

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TIDELANDS OIL & GAS CORPORATION  
STATEMENTS OF CONDENSED CONSOLIDATED CASH FLOWS  
(CONTINUED)

(UNAUDITED)

|   | Six Months Ended<br>June 30, 2006 | Six Months Ended<br>June 30, 2005 |
|---|-----------------------------------|-----------------------------------|
|   | -----                             | -----                             |
| Cash Flows Provided (Required)                  |                                   | (Restated)                        |
| by Financing Activities:                        |                                   |                                   |
| Proceeds from Stock Subscriptions<br>Receivable | 110,000                           | 0                                 |
| Proceeds from Long-Term Loans                   | 6,678,415                         | 149,108                           |
| Repayment of Loan to Related Party              | 3,219                             | 492                               |
|   | -----                             | -----                             |
| Net Cash Provided by Financing Activities       | 6,791,634                         | 149,600                           |
|   | -----                             | -----                             |
| Net Increase (Decrease) in Cash                 | 2,198,115                         | (1,939,369)                       |
| Cash at Beginning of Period                     | 1,113,911                         | 5,484,054                         |
|   | -----                             | -----                             |
| Cash at End of Period                           | \$ 3,312,026                      | \$ 3,544,685                      |
|   | =====                             | =====                             |

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### Supplemental Disclosures of

#### Cash Flow Information:

|                                    |            |            |
|------------------------------------|------------|------------|
| Cash Payments for Interest         | \$ 408,657 | \$ 266,938 |
|                                    | =====      | =====      |
| <br>Cash Payments for Income Taxes | <br>\$ 0   | <br>\$ 0   |
|                                    | =====      | =====      |

### Non-Cash Investing and Financing Activities:

#### Issuance of Common Stock:

|                                     |         |              |
|-------------------------------------|---------|--------------|
| Repayment of Note                   | \$ 0    | \$ 2,512,500 |
| Repayment of Convertible Debentures | 0       | 2,520,000    |
| Payment of Accrued Expense          | 445,000 | 0            |
|                                     | -----   | -----        |

|   |            |              |
|---|------------|--------------|
| Total Non-Cash Investing and Financing Activities | \$ 445,000 | \$ 5,032,500 |
|   | =====      | =====        |

See Accompanying Notes to Condensed Consolidated Financial Statements

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TIDELANDS OIL & GAS CORPORATION  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2006

#### NOTE 1 - BASIS OF PRESENTATION

-----

The accompanying unaudited condensed consolidated financial statements for the six month periods ended June 30, 2006, and 2005, have been prepared in conformity with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Regulation S-X. The financial information as of December 31, 2005, is derived from the registrant's Form 10-K for the year ended December 31, 2005. Certain information or footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission.

The preparation of condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. In the opinion of management, the accompanying financial statements include all adjustments necessary (which are of a normal and recurring nature) for the fair presentation of the results of the interim periods presented. While the registrant believes that the disclosures presented are adequate to keep the information from being misleading, it is suggested that these accompanying financial statements be read in conjunction with the registrant's audited consolidated financial statements and notes for the year ended December



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31, 2005, included in the registrant's Form 10-K for the year ended December 31, 2005.

Operating results for the six-month period ended June 30, 2006, are not necessarily indicative of the results that may be expected for the remainder of the fiscal year ending December 31, 2006. The accompanying unaudited condensed consolidated financial statements include the accounts of the registrant, its wholly-owned subsidiaries, Rio Bravo Energy, LLC, Sonora Pipeline, LLC, Arrecefe Management, LLC, Marea Associates, LP, Reef Ventures, LP, Reef International, LLC, Reef Marketing, LLC, Terranova Energia S. de R. L. de C. V., and Esperanza Energy, LLC. All significant inter-company accounts and transactions have been eliminated in consolidation.

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### TIDELANDS OIL & GAS CORPORATION NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS JUNE 30, 2006

#### NOTE 2 - LITIGATION

-----

On January 6, 2003, we were served as a third party defendant in a lawsuit titled Northern Natural Gas Company vs. Betty Lou Sheerin vs. Tidelands Oil & Gas Corporation, ZG Gathering, Ltd. and Ken Lay, in the 150th Judicial District Court, Bexar County, Texas, Cause Number 2002-C1-16421. The lawsuit was initiated by Northern Natural Gas (Northern) when it sued Betty Lou Sheerin (Sheerin) for her failure to make payments on a note she executed payable to Northern in the original principal amount of \$1,950,000. Northern's suit was filed on November 13, 2002. Sheerin answered Northern's lawsuit on January 6, 2003. Sheerin's answer generally denied Northern's claims and raised the affirmative defenses of fraudulent inducement by Northern, estoppel, waiver and the further claim that the note does not comport with the legal requirements of a negotiable instrument. Sheerin seeks a judicial ruling that Northern be denied any recovery on the note. Sheerin's answer included a counterclaim against Northern, ZG Gathering, Ltd., and Ken Lay generally alleging, among other things, that Northern, ZG Gathering, Ltd., and Ken Lay, fraudulently induced her execution of the note. Northern has filed a general denial of Sheerin's counterclaims. Sheerin's answer included a third party cross claim against Tidelands Oil and Gas Corporation (Tidelands). She alleges that Tidelands entered into an agreement to purchase the Zavala Gathering System from ZG Gathering, Ltd., and that, as a part of the agreement, Tidelands agreed to satisfy all of the obligations due and owing to Northern, thereby relieving Sheerin of all obligations she had to Northern on the \$1,950,000 promissory note in question. Tidelands and Sheerin agreed to delay the Tidelands' answer date in order to allow time for mediation of the case. Tidelands participated in

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mediation on March 11, 2003. The case was not settled at that time. Tidelands answered the Sheerin suit on March 26, 2003. Tidelands' answer denies all of Sheerin's allegations.

On May 24 and June 16, 2004, respectively, Betty Lou Sheerin filed her first and second amended original answer, affirmative defenses, special exceptions and second amended original counterclaim, second amended original third party cross-actions and requests for disclosure. In these amended pleadings, she sued Michael Ward, Royis Ward, James B. Smith, Carl Hessel and Ahmed Karim in their individual capacities. Her claims against these individuals are for fraud, breach of contract, breach of the Uniform Commercial Code, breach of duty of good faith and fair dealing and conversion. Sheerin has now non-suited her claims against Michael Ward, Royis Ward, and James B. Smith.

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### TIDELANDS OIL & GAS CORPORATION NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS JUNE 30, 2006

#### NOTE 2 - LITIGATION (CONTINUED)

-----  
-----  
In September 2002, as a pre-closing deposit to the purchase of the Zavala Gathering System, the Company executed a \$300,000 promissory note to Betty L. Sheerin, a partner of ZG Gathering, Ltd. In addition, the Company issued 1,000,000 shares of its common stock to various partners of ZG Gathering, Ltd. On December 3, 2003, Sheerin filed a separate lawsuit against Tidelands in the 150th District Court of Bexar County, Texas on this promissory note seeking a judgment against Tidelands for the principle amount of the note, plus interest. On December 29, 2003, Tidelands answered this lawsuit denying liability on the note. On April 1, 2004, Tidelands filed a plea in abatement asking the court to dismiss or abate Sheerin's lawsuit on the \$300,000 promissory note as it was related to and its outcome was dependent on the outcome of the Sheerin third party cross action against Tidelands in Cause Number 2002-C1-16421. The Company believes that the promissory note and shares of common stock should be cancelled based upon the outcome of the litigation described above. Accordingly, our financial statements reflect this belief.

On September 15, 2004, and again on October 15, 2004, respectively, Sheerin amended her pleadings to include a third and fourth amended third party cross action against Tidelands adding a claim for the \$300,000 promissory note. In these amended pleadings, Sheerin also deleted her claims against Carl Hessel and Ahmed Karim. After adding the claim on the \$300,000 promissory note to the third party claims of Sheerin against Tidelands in Cause No. 2002-C1-16421, Sheerin dismissed Cause Number 2002-C1-16421.

Tidelands won a partial summary judgment against Sheerin as to all of

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her tort claims pled against Tidelands, save and except only her claim for conversion of 500,000 shares of Tidelands' stock.

Sheerin seeks damages against Tidelands for indemnity for any sums found to be due from her to Northern Natural Gas Company, unspecified amounts of actual damages, statutory damages, unspecified amounts of exemplary damages, attorneys fees, costs of suit, and prejudgment and post judgment interest.

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TIDELANDS OIL & GAS CORPORATION  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2006

NOTE 2 - LITIGATION (CONTINUED)

-----

On August 5, 2005, Northern Natural Gas Company filed its Fourth Amended Original Petition which, for the first time, named Tidelands as a defendant to Northern. Northern seeks to impose liability on Tidelands for \$1,950,000 promissory note signed by McDay Energy Partners, Ltd. (the predecessor to ZG Gathering, Ltd.) and Sheerin and the \$1,700,000 promissory note signed by McDay only. Northern contends that Tidelands is alternatively liable to Northern for payment of both such promissory notes totaling \$3,709,914 plus interest because Northern is a third-party beneficiary under a December 3, 2001 purchase and sale agreement between ZG Gathering, Ltd., and Tidelands claiming that in such agreement Tidelands agreed to assume and satisfy all indebtedness due and owing Northern by Sheerin and ZG Gathering, Ltd. Northern also claims that it is entitled to foreclosure of a lien on the gas gathering system and pipeline that was the subject of the promissory notes in question.

On March 6, 2006, Tidelands won a summary judgment motion it filed against Northern and the court has now dismissed Northern's claims against Tidelands.

On November 28, 2005, ZG Gathering, Ltd. and ZG Pipeline Management ("ZG") filed its answer to Northern's Fifth Amended Petition, its counter-claim against Northern, and its answer and cross claim against Tidelands. ZG contends that the promissory notes given by ZG and Sheerin to Northern were procured by Northern's fraudulent misrepresentations and it claims unspecified amounts of damages against Northern. ZG's cross action against Tidelands claims that Tidelands entered into an agreement to purchase the Zavala Gathering System from ZG and that, as part of that agreement, Tidelands agreed to satisfy the \$3,700,914 Northern indebtedness of ZG, and to defend, indemnify, and

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hold ZG and Sheerin harmless from such indebtedness to pay off a Sheerin loan of \$300,000, and to issue 1 million shares of Tidelands' stock, of which 500,000 was to be free-trading shares. ZG claims that Tidelands breached this agreement by failing to satisfy the Northern indebtedness, failing to defend and indemnify it from such debt, failing to pay off the \$300,000 note, failing to issue the free-trading shares in Tidelands, and by placing a stop transfer order on the restricted stock that was issued by Tidelands. ZG seeks specific performance of the agreement, recovery of an unspecified amount of damages, and its attorney's fees.

Much of the discovery has been completed at this time. Based on investigation, and discovery to date, Tidelands appears to have a number of potential defenses to the claims of Sheerin and Northern. Tidelands intends to aggressively defend these lawsuits. The complexity of the issues in this case and the inherent uncertainties in litigation of this kind prevent a more definitive evaluation of the extent of Tidelands' liability exposure.

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TIDELANDS OIL & GAS CORPORATION  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2006

NOTE 2 - LITIGATION (CONTINUED)

-----

During April and May, 2005, three separate legal actions were initiated against Sonterra Energy Corporation (Sonterra), a wholly-owned subsidiary of the Company. Two of the actions concern claims made by developers against Sonterra for their failure to pay rent and easement use fees as a result of their asset purchase from Oneok Propane Distribution Company on November 1, 2004. The third action involves a claim made by a builder that Sonterra does not have a proper easement for the current use of certain property. The Company believes that the three actions filed are without merit and intend to vigorously defend itself. Litigation regarding these three actions are still in their early stages, therefore, potential financial impacts, if any, cannot be determined at this time.

In accordance with Statement of Financial Accounting Standards No. 5, "Accounting for Contingencies," management has reached the conclusion that there is a remote possibility that any or all of the aforementioned claims would be upheld at trial and has also determined that the amount of the claims cannot be reasonably estimated. Accordingly, the Company's financial statements reflect no accrual of a loss contingency with response to the above legal matters.

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TIDELANDS OIL & GAS CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2006

NOTE 3 - COMMON STOCK TRANSACTIONS  
-----

On May 10, 2006, the Company issued 10,000 shares of its restricted common stock valued at \$7,900 to an employee/officer of a subsidiary of the Company.

On May 10, 2006, the Company issued 60,000 shares of its restricted common stock valued at \$47,400 pursuant to an employment contract with an officer of the Company.

On June 7, 2006, the Company issued 500,000 shares of its restricted common stock valued at \$542,500 pursuant to an employment contract with an officer of the Company.

On June 27, 2006, the Company issued 20,000 shares of its restricted common stock valued at \$16,000 to an employee of the Company.

On June 27, 2006, the Company issued 20,000 shares of its restricted common stock valued at \$16,000 to an employee of the Company.

NOTE 4 - RELATED PARTY TRANSACTION  
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The Company executed an agreement in January 2004 with a related party to provide charter air transportation for its employees, customers and contractors to job sites and other business related destinations. A \$300,000 5% interest bearing loan due in January 2007 was made by the Company regarding the transaction. The loan balance is credited by airtime charges at standard industry rates offset by interest charges computed on the average monthly balance. At June 30, 2006, the loan balance was \$285,287.

During 2006, the President acquired the airplane being utilized to provide charter air transportation for the Company. The transaction includes assumption of the \$300,000 5% interest bearing loan due in January 2007 to the Company.

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TIDELANDS OIL & GAS CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2006

NOTE 5 - DEBT FINANCING  
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On January 20, 2006, the Company completed a private placement of \$6,569,750 of convertible debt with seven institutional investors. The net proceeds realized by the Company were \$4,964,410. The Company issued original issue discount debentures with a maturity date of January 20, 2008, and a conversion feature which permitted the holders to convert into common stock of the Company at a price of \$0.87 per share. The investors also received three year "Series A Common Stock Warrants" to purchase, in the aggregate, 2,491,975 shares of common stock of the Company at a conversion price of \$0.935 per share. Additionally, the Company issued to the investors "Series B Common Stock Warrants" which provided for a thirteen month exercise period, at a conversion price of \$1.275 per share, and an aggregate purchase total of 7,551,432 shares of common stock of the Company.

In accordance with this private placement, the Company entered into a "Registration Rights Agreement" with the investors, whereby, among other terms and conditions, the Company must comply with various effective dates and periods or, if in default of said dates and/or periods, be subject to liquidated damages as outlined in the master agreement. During June 2006, the investors billed and were paid \$64,566 liquidated damages for not meeting the required effective date.

NOTE 6 - SUBSEQUENT EVENTS  
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On July 9, 2006, the Company acquired a 50% interest in a 24-mile natural gas pipeline located in Medina, Atascosa and Bexar Counties in the state of Texas. In addition, the Company also acquired an undivided 50% working interest in two leases with 5 recompleted natural gas wells on approximately 1,000 acres with at least 10 additional natural gas wells for re-entry. These leases are located in Atascosa and Medina counties. The Company expects to participate in acquiring additional leases which could be developed around the area serviced by the pipelines. Total consideration for these transactions is \$500,000 which is being paid to a related party.

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operation

Business Overview

Our products and services are primarily focused on development and operation of transportation, processing, distribution and storage projects for natural gas and natural gas liquids in the northeastern states of Mexico (Chihuahua, Coahuila, Nuevo Leon and Tamaulipas) and the state of Texas in the United States of America. The Company has also begun a feasibility study for the potential development of an offshore LNG regasification terminal and connecting natural gas pipeline in the vicinity of Long Beach, California.

We derive our revenue from transportation fees from delivery of natural gas to Conagas, the local distribution company in Piedras Negras, Coahuila, through the pipeline owned by Reef Ventures, L.P. Additionally, revenues are derived from the provision of construction services for yard lines and meter sets installed to a homeowner's lot, and the sale of propane gas to residential customers in Central Texas through the assets owned by Sonterra Energy Corporation.

Recent Developments

In the six months ended June 30, 2006, several significant developments occurred with respect to the businesses operated by the Company.

Financing Transaction

On January 20, 2006, the Company entered into Securities Purchase Agreements with seven accredited investors (collectively, "Purchasers or Holders"). We sold \$6,569,750 Dollars, in the aggregate principal amount, of discounted convertible debentures ("Debentures") and Series A and Series B Warrants to purchase common stock ("Warrants") for an aggregate payment of \$5,396,098 after deduction for the interest discount. The Company paid an 8% commission to the placement agent, HPC Capital Management, LLC, a registered broker-dealer. The Company granted HPC Capital Management Series A Common Stock Purchase Warrants as additional transaction compensation. The Company received net proceeds of \$4,949,291.88 after deduction of legal costs, commissions and interest discount. We intend to use the proceeds for working capital.

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The sale of these securities required the Company to increase its authorized common stock capital because it had insufficient authorized capital to comply with all of the Debenture conversion and Warrant exercise provisions contained in the Transaction Documents. We have reserved 9,000,000 common shares of our

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unissued authorized common stock capital for the transaction. On April 17, 2006, an amendment to the articles of incorporation of the Company was approved via written consent in lieu of a special meeting of the shareholders of the Company and on April 19, 2006, the Company amended its articles of incorporation by increasing its authorized common stock capital from One Hundred Million (100,000,000) shares, par value \$0.001 per share to Two Hundred Fifty Million (250,000,000) shares, par value \$0.001 per share, thus satisfying the requirements of the financing documents.

We have also agreed to file a registration statement on Form S-1 with the U.S. Securities and Exchange Commission ("SEC") to register the common stock underlying the Debentures and Warrants.

We sold these securities in an exempt transaction under the Securities Act of 1933, (the "Act") as amended, pursuant to Section 4(2) and Regulation D Rule 506. These are restricted securities and may not be resold without registration under the Act or an exemption from the registration requirements of the Act.

The Debentures are Original Issue Discount Convertible Debentures with an aggregate face amount of \$6,569,750. The purchasers paid an aggregate principal sum of \$5,396,098. The face amount of the Debentures is due January 20, 2008. The difference between the face amount and the aggregate principal paid represents the interest expense. The Debenture Holder may convert all or part of the Debenture face amount into shares of Tidelands common stock at any time at an initial conversion rate of \$0.87 per share.

The Purchasers have agreed to restrict their ability to convert their Debentures or Exercise their Warrants and receive our shares such that the number of shares of common stock held by each of them individually in the aggregate after such conversion or exercise does not exceed 4.99% of the then issued and outstanding Company common shares. This beneficial ownership limitation may be waived by the Holder.

Subject to specific terms and conditions in the Debenture, the Company has the option to force conversion of the Debentures into common shares if the Company's share price as quoted on the Over-the-Counter Electronic Bulletin Board exceeds 250% of the then Conversion Price for a period of time based on a Volume Weighted Average Price (VWAP) formula. The VWAP share price must exceed this 250% price for at least 20 consecutive Trading Days.

The conversion price will be subject to adjustment for corporate events, such as stock splits, stock dividends, and stock combinations, as more specifically outlined in the transaction documents.

We granted the Purchasers Series A Common Stock Purchase Warrants (Series A Warrants) to purchase 2,491,974 shares of our common stock at \$0.935 per share.

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We also granted HPC Capital Management 65,697 Series A Common Warrants to purchase our common stock at \$0.935 per share.

The Series A Warrants may be exercised immediately by the Purchasers and will terminate on January 20, 2009. Subject to specific terms and conditions in the Series A Warrant including an effective registration statement registering underlying shares, the Company has the call option to force conversion of this Warrant into common shares if the Company's share price as quoted on the Over-the-Counter Electronic Bulletin Board exceeds 250% of the then effective Exercise Price for a period of time based on a Volume Weighted Average Price (VWAP) formula. The VWAP share price must exceed this 250% threshold price for



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at least 20 consecutive Trading Days.

If at any time after one year from the date of issuance there is no effective registration statement registering, or no current prospectus available for the resale of the underlying shares, then this Warrant may also be exercised by means of "cashless exercise" as determined by a formula described in the Warrant. The exercise price will be subject to adjustment for corporate events, such as stock splits, stock dividends, and stock combinations, as more specifically outlined in the transaction documents.

We granted the Purchasers Series B Common Stock Purchase Warrants ("Series B Warrants") to purchase 7,551,432 shares of our common stock at \$1.275 per share. The Purchasers have the right to exercise the Series B Warrants commencing at any time on, or after January 20, 2007 and on, or before February 19, 2007. Subject to specific terms and conditions in the Series B Warrant, including an effective registration statement registering underlying shares, the Company has the option to force the exercise of this Warrant into common shares if the Company's share price as quoted on the Over-the-Counter Electronic Bulletin Board exceeds 150% of the then effective Exercise Price for a period of time based on a Volume Weighted Average Price (VWAP) formula. The VWAP share price must exceed this 150% threshold price for at least 20 consecutive Trading Days.

If at any time after one year from the date of issuance there is no effective registration statement registering, or no current prospectus available for the resale of the underlying shares, then this Warrant may also be exercised by means of "cashless exercise" as determined by a formula described in the Warrant. The exercise price will be subject to adjustment for corporate events, such as stock splits, stock dividends, and stock combinations, as more specifically outlined in the transaction documents.

We have granted the Purchasers and HPC Capital Management registration rights on the shares underlying the Debentures and the Warrants. The Common Stock underlying the Debentures and Warrants will be registered under the Securities Act of 1933, as amended, for re-offer and re-sale by the Purchasers and HPC Capital Management. If the Company fails to timely file a registration statement or is unable to have the registration statement declared effective by the SEC within the stated periods of time, we will trigger a default and be subject to among other things, acceleration of the Debentures, at the Purchasers' options, additional default interest payment and monetary liquidated damages. The liquidated damages will be capped at 20% of the Debentures face amounts.

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### Esperanza Energy LLC

Esperanza Energy LLC ("Esperanza") was formed as a wholly owned subsidiary of the Company in March 2006 to evaluate the feasibility of developing an offshore, deep-water liquefied natural gas (LNG) regas terminal in the offshore waters near Long Beach, California. Esperanza would utilize TORP Technology's HiLoad LNG Regas unit which attaches to an LNG tanker, directly vaporizes the LNG as it is offloaded and injects the regasified natural gas into an undersea pipeline for transportation of the natural gas to onshore metering stations and transmission pipelines to supply nearby gas markets. The TORP HiLoad LNG Regas unit eliminates the need for extensive above-ground storage tanks or large marine structures required for berthing and processing of the LNG.

Esperanza is conducting the feasibility study for this project with the assistance of best-in-class LNG, environmental, pipeline and legal experts that include:

- o David Maul, former Manager of the California Energy Commission Natural Gas

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- Office,
- o ENTRIX, Inc., a professional environmental consulting company specializing in environmental permitting and compliance for major offshore oil and gas projects in California and the United States,
  - o Project Consulting Services, Inc., a leader in engineering, construction, management, and inspection of onshore and offshore pipelines, and
  - o Pillsbury Winthrop Shaw Pittman, LLP, an interdisciplinary law firm with leading practices in environmental, land use and energy legal advice and in project development and finance.

Active consultations continue with California stakeholders, commercial counterparties, financial investors, and the above mentioned team regarding the optimal design and operational configuration of the project. A primary objective of the project feasibility study is to design the project to exceed California environmental, public health and safety requirements.

Sonora Pipeline, LLC and Terranova Energia, S. de R.L. de C.V.

The cross-border gas pipeline and storage development activities of the above entities to establish the Burgos Hub Export/Import project progressed forward in two principal areas:

### Permitting Activities -

Sonora Pipeline, LLC continued its efforts to finish all activities necessary to move from NEPA pre-filing status to a submission for Certification for its two International Pipeline U.S. segments, the Progreso International Pipeline and the Mission International Pipeline. Sonora believes it has filed all needed revisions to the Draft Environmental Report for both pipeline segments with FERC for purposes of the NEPA Environmental Assessment requirements. The Progreso International Pipeline is the eastern leg of the U.S. pipelines which will interconnect with the Tennessee Gas Pipeline transmission lines at the Alamo Station and deliver natural gas to the Brasil Storage facility approximately 17 miles south of the U.S./Mexico border at Progreso, Texas. The Mission International Pipeline segment was re-designed in the first quarter of 2006 due to a routing conflict with a fiber optic line. It will be approximately 24 miles long and will commence at the existing HPL Valero-Gilmore gas plant in Hidalgo

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County, Texas and extend southward to the Arguelles crossing of the Rio Grande River into Mexico near the city of Mission, Texas. We anticipate the issuance of an Environmental Assessment by the staff of FERC in the third quarter of 2006 to be followed by a complete application for a Certificate of Public Convenience and Necessity to construct, own, operate and maintain the proposed pipelines. The current catalog of FERC correspondence for Sonora's activities is located at [www.ferc.gov](http://www.ferc.gov) under Docket No. PF05-15.

On May 23, 2006, Terranova Energia, S. de R.L. de C.V. ("Terranova"), a wholly owned subsidiary of the Company, was awarded a permit by the Comision Reguladora de Energia de Mexico ("CRE") to construct its 30 inch diameter natural gas pipeline segment in Mexico to link to the Sonora Pipeline LLC United States pipelines and Terranova's proposed underground natural gas storage facility in the Brasil field (located approximately 17 miles south of Nuevo Progreso on the U.S./Mexico border in Texas). Terranova submitted the application for the storage facility permit to the CRE on August 5, 2005 and it was accepted for full review on October 14, 2005. Several unique questions are presented by the filing of this permit due to the proposed location and the lack of previous storage permit applications having been considered by the CRE. The CRE has recently selected GEOSTOCK (an entity owned 50% by Total, 25% by BP, and 25% by Entrepouse Contracting) as its technical consultant to review the storage

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facility permit application. GEOSTOCK is an international engineering group with over 40 years experience in the design, construction and operation of all types of underground storage facilities for liquid, liquefied or gaseous hydrocarbons. The technical review of the permit application is expected to be completed by the end of 2006. Management expects the storage permit application will be presented for decision by staff to the CRE Commissioners in the first quarter of 2007.

### Commercial Activities -

The Company continues to present the pipeline and storage segments of the Burgos Hub Export/Import project to commercial audiences in efforts to solicit their interest and participation in the project at various levels. There have been numerous introductory meetings with staff of the CFE and the Monterrey industrial consumers of natural gas with a view toward clarifying their need and usage of the proposed project facilities. Future efforts will concentrate on the development and negotiation of precedent agreements for capacity reservation of the project facilities. Preliminary evaluation of demand for storage capacity reservation based upon direct discussion with the various customers is conservatively estimated at 40 Bcf for the market area influenced by the project. Similarly, several discussions continue with interested parties in the U.S. and Mexico regarding the execution of a joint development agreement between Terranova and their firms for the funding, development and ownership of the project.

### FORWARD-LOOKING STATEMENTS:

We have included forward-looking statements in this report. For this purpose, any statements contained in this report that are not statements of historical fact may be deemed to be forward looking statements. Without limiting the foregoing, words such as "may", "will", "expect", "believe", "anticipate",

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"estimate", "plan" or "continue" or the negative or other variations thereof or comparable terminology are intended to identify forward-looking statements. These statements by their nature involve substantial risks and uncertainties, and actual results may differ materially depending on a variety of factors. Factors that might cause forward-looking statements to differ materially from actual results include, among other things, overall economic and business conditions, demand for the Company's products, competitive factors in the industries in which we compete or intend to compete, natural gas availability and cost and timing, impact and other uncertainties of our future acquisition plans.

### Results of Operations

Three Months Ended June 30, 2006, Compared with Three Months Ended June 30, 2005

**REVENUES:** The Company reported revenues of \$ 407,124 for the three months ended June 30, 2006 versus revenues of \$340,536 for the three months ended June 30, 2005 which is an improvement of 19.5% for the quarter ended June 30, 2006 versus the quarter ended June 30, 2005. The revenue increase resulted from increasing volumes and product prices of propane sold by our Sonterra Energy Corporation subsidiary to residential consumers.

**TOTAL COSTS AND EXPENSES:** Total Costs and Expenses for the three months ended June 30, 2006 were \$2,395,791 versus \$3,955,564 for the three months ended June 30, 2005 which is a decrease of 39% for the quarter ended June 30, 2006 versus the quarter ended June 30, 2005. The primary reason for this decrease was the \$1,258,856 decrease in Sales, General and Administrative expenses for the

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quarter ended June 30, 2006 versus the quarter ended June 30, 2005. A secondary reason for the decrease was the absence of Beneficial Conversion Interest Income and Impairment Losses in the quarter ended June 30, 2006 versus the quarter ended June 30, 2005.

NET INCOME (LOSS): Net Loss for the three months ended June 30, 2006 was (\$1,960,549) versus a Net Income for the three months ended June 30, 2005 of \$4,481,131. The primary reason for this difference was the absence of Derivative Gain in the quarter ended June 30, 2006 versus a Derivative Gain of \$8,062,500 for the quarter ended June 30, 2005.

Six Months Ended June 30, 2006, Compared with Six Months Ended June 30, 2005

REVENUES: The Company reported revenues of \$1,209,018 for the six months ended June 30, 2006 as compared with revenues from continuing operations of \$968,611 for the six months ended June 30, 2005. The revenue increase resulted primarily from increasing revenues of Sonterra Energy Corporation due to an increase in total customers served and product prices in the first six months of 2006 versus the first six months of 2005.

TOTAL COSTS AND EXPENSES: Total costs and expenses from continuing operations decreased from \$11,187,489 for the six months ended June 30, 2005 to \$4,926,953 for the six months ended June 30, 2006. The principal reason for this amount of decrease was the lack of expense for Beneficial Conversion Feature Interest and Impairment Loss in the six months ended June 30, 2006 versus the six months ended June 30, 2005.

COST OF SALES: Total Cost of Sales increased from \$415,248 for the six months ended June 30, 2005 to \$583,279 for the six months ended June 30, 2006. This increase resulted from the increased cost and volume of propane sold by Sonterra Energy Corporation in the six months ended June 30, 2006 versus June 30, 2005.

OPERATING EXPENSES: Operating expenses from continuing operations increased from \$129,137 for the six months ended June 30, 2005 to \$184,118 for the six months ended June 30, 2006. This increase was primarily due to additional operating expenses incurred by Sonterra Energy Corporation in its operations for the period which were not present in the comparative six months for 2005. Depreciation expense declined in the first six months of 2006 versus the first six months of 2005, decreasing from \$236,395 for the six months ended June 30, 2005 to \$231,802 for the six months ended June 30, 2006 reflecting a minor decrease in depreciable assets for the respective periods due to impairment charges.

INTEREST EXPENSE: Interest expense increased from \$393,860 for the six months ended June 30, 2005 to \$485,009 for the six months ended June 30, 2006 as a result of interest rate increases related to the note owed to Impact International LLC. No expense for Beneficial Conversion Feature Interest was recorded for the six months ended June 30, 2006 as compared to \$135,789 for the six months ended June 30, 2005 (as restated). The market price for the Company's common stock at the relevant measurement dates during the six months ended June 30, 2006 was less than the conversion price for the debentures issued on January

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20, 2006. Accordingly, there was no benefit to the holders of the debentures in the event of conversion during those periods and no beneficial conversion interest charge was recorded.

SALES, GENERAL AND ADMINISTRATIVE: Sales, General & Administrative Expenses decreased by \$1,234,325 during the six months ended June, 2006 to a total amount

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of \$3,442,745 as compared \$4,677,070 for the six months ended June 30, 2005. This decrease was due primarily to the absence of financing costs paid to Impact International LLC during the period ended June 30, 2006 as compared to financing costs of \$1,272,500 paid to Impact International LLC during the period ended June 30, 2005.

**IMPAIRMENT LOSS:** No expense for impairment loss was recorded for the six months ended June 30, 2006 compared to \$5,200,000 of impairment of goodwill recorded as a loss for the period ended June 30, 2005.

**DERIVATIVE GAIN:** Gain from embedded derivative instrument liabilities decreased from (\$5,168,000) for the six months ended June 30, 2005 (as restated) to zero for the six months ended June 30, 2006. The warrants issued in connection with the January 20, 2006 financing had an exercise price that was greater than the fair market value of the Company's common stock at the relevant measurement dates. Accordingly, no derivative gain or reduction in liability for the issuance of the warrants in this financing transaction was recorded for the six months ended June 30, 2006.

**NET LOSS:** Net loss of (\$4,984,404) for the six months ended June 30, 2005 (as restated) decreased to (\$3,656,196) for the six months ended June 30, 2006, a decrease in the amount of loss of \$1,328,208. The principal reason for this amount of decline in net loss was the reduction in Sales, General and Administrative Expenses achieved in the six months ended June 30, 2006 versus the six months ended June 30, 2005. Included in the net loss of (\$3,656,196) for the six months ended June 30, 2006 is \$1,499,300 of expenses for employment contract costs and legal fees paid by issuance of common stock.

**LIQUIDITY AND CAPITAL RESOURCES:** With regard to liquidity and adequacy of capital resources, management believes that adequate liquidity and cash resources exist to sustain current corporate activities for the remainder of the fiscal year. However, in the event that a decision to proceed with the offshore LNG regas terminal project in Southern California is made during the upcoming months, additional funding for the permit process will be needed. Management will evaluate the required budget and funding alternatives for such an effort as an integral part of the project feasibility study underway. Direct capital expenditures during the six months ended June 30, 2006 totaled \$1,383,436. The capital expenditures were composed of increased pre-construction costs regarding potential international pipeline crossings and storage facilities in Mexico, pre-construction costs regarding an offshore LNG terminal in Southern California, and additional machinery, equipment, trucks, autos and trailers for the operation of the Sonterra Energy Corporation propane systems. Total debt increased from \$5,722,322 at December 31, 2005 to \$ 11,866,198 at June 30, 2006. The increase in total debt is due primarily to the issuance of \$6,569,750 of convertible debentures in the financing transaction of January 20, 2006. Net

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loss for the six months ended June 30, 2006 was (\$3,656,196) a decrease in net loss of 27% from the net loss of (\$4,984,404) for the six months ended June 30, 2005. Basic and diluted net loss per common share decreased 28.6% to (\$0.05). The net loss per share calculation for the six months ended June 30, 2006 included an increase in actual and equivalent shares outstanding.

### Item 3. Quantitative and Qualitative Disclosures About Market Risk

#### Cash and Cash Equivalents

We have historically invested our cash and cash equivalents in short-term, fixed rate, highly rated and highly liquid instruments which are reinvested when they

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mature throughout the year. Although our existing investments are not considered at risk with respect to changes in interest rates or markets for these instruments, our rate of return on short-term investments could be affected at the time of reinvestment as a result of intervening events. As of June 30, 2006, we had cash and cash equivalents in the aggregate \$3,312,026.

The Company does not issue or invest in financial instruments or their derivatives for trading or speculative purposes. The operations of the Company are conducted primarily in the United States, and, are not subject to material foreign currency exchange risk. Although the Company has outstanding debt and related interest expense, market risk of interest rate exposure in the United States is currently not material.

### Debt

The interest rate on our Impact International debt obligation is generally determined based on the prime interest rate plus two percent and may be subject to market fluctuation as the prime rate changes.

### Item 4. Controls and Procedures

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

As of the end of the reporting period, June 30, 2006, we carried out an evaluation, under the supervision and with the participation of our management, including the Company's Chairman and Chief Executive Officer/Principal Accounting Officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Rule 13a-15(e) of the Securities Exchange Act of 1934 (the "Exchange Act"), which disclosure controls and procedures are designed to insure that information required to be disclosed by a company in the reports that it files under the Exchange Act is recorded, processed, summarized and reported within required time periods specified by the SEC's rules and forms. Based upon that evaluation, the Chairman and the Chief Financial Officer concluded that our disclosure controls and procedures are effective in timely alerting them to material information relating to the Company required to be included in the Company's period SEC filings.

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#### (b) Changes in Internal Control.

Subsequent to the date of such evaluation as described in subparagraph(a)above, there were no changes in our internal controls or other factors that could significantly affect these controls, including any corrective action with regard to significant deficiencies and material weaknesses.

#### (c) Limitations.

Our management, including our Principal Executive Officer and Principal Financial Officer, does not expect that our disclosure controls or internal controls over financial reporting will prevent all errors or all instances of fraud. However, we believe that our disclosure controls and procedures are designed to provide reasonable assurance of achieving this objective. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system's objectives will be met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within our Company have been detected. These

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inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Controls can also be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is based in part upon certain assumptions about the likelihood of future events, and any design may not succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with policies or procedures. Because of the inherent limitation of a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

### PART II - OTHER INFORMATION

#### Item 1. Legal Proceedings

##### Matter No. 1:

On January 6, 2003, we were served as a third party defendant in a lawsuit titled Northern Natural Gas Company vs. Betty Lou Sheerin vs. Tidelands Oil & Gas Corporation, ZG Gathering, Ltd. and Ken Lay, in the 150th Judicial District Court, Bexar County, Texas, Cause Number 2002-C1-16421. The lawsuit was initiated by Northern Natural Gas when it sued Betty Lou Sheerin for her failure to make payments on a note she executed payable to Northern in the original principal amount of \$1,950,000. Northern's suit was filed on November 13, 2002. Sheerin answered Northern's lawsuit on January 6, 2003. Sheerin's answer generally denied Northern's claims and raised the affirmative defenses of fraudulent inducement by Northern, estoppel, waiver and the further claim that

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the note does not comport with the legal requirements of a negotiable instrument. Sheerin seeks a judicial ruling that Northern be denied any recovery on the note. Sheerin's answer included a counterclaim against Northern, ZG Gathering, and Ken Lay generally alleging, among other things, that Northern, ZG Gathering, Ltd. and Ken Lay, fraudulently induced her execution of the note. Northern has filed a general denial of Sheerin's counterclaims. Sheerin's answer included a third party cross claim against Tidelands. She alleges that Tidelands entered into an agreement to purchase the Zavala Gathering System from ZG Gathering Ltd. and that, as a part of the agreement, Tidelands agreed to satisfy all of the obligations due and owing to Northern, thereby relieving Sheerin of all obligations she had to Northern on the \$1,950,000 promissory note in question. Tidelands and Sheerin agreed to delay the Tidelands' answer date in order to allow time for mediation of the case. Tidelands participated in mediation on March 11, 2003. The case was not settled at that time. Tidelands answered the Sheerin suit on March 26, 2003. Tidelands' answer denies all of Sheerin's allegations.

On May 24 and June 16, 2004 respectively, Betty Lou Sheerin filed her first and second amended original answer, affirmative defenses, special exceptions and second amended original counterclaim, second amended original third party cross-actions and requests for disclosure. In these amended pleadings, she sued Michael Ward, Royis Ward, James B. Smith, Carl Hessell and Ahmed Karim in their individual capacities. Her claims against these individuals are for fraud, breach of contract, breach of the Uniform Commercial Code, breach of duty of good faith and fair dealing and conversion. Sheerin has now non-suited her claims against Michael Ward, Royis Ward, and James B. Smith.

In September 2002, as a pre-closing deposit to the purchase of the Zavala Gathering System, the Company executed a \$300,000 promissory note to Betty L.

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Sheerin, a partner of ZG Gathering, Ltd. In addition, the Company issued 1,000,000 shares of its common stock to various partners of ZG Gathering, Ltd. On December 3, 2003, Sheerin filed a separate lawsuit against Tidelands in the 150th District Court of Bexar County, Texas on this promissory note seeking a judgment against Tidelands for the principle amount of the note, plus interest. On December 29th, 2003, Tidelands answered this lawsuit denying liability on the note. On April 1, 2004, Tidelands filed a plea in abatement asking the court to dismiss or abate Sheerin's lawsuit on the \$300,000 promissory note as it was related to and its outcome was dependent on the outcome of the Sheerin third party cross action against Tidelands in Cause Number 2002-C1-16421. The company believes that the promissory note and shares of common stock should be cancelled based upon the outcome of the litigation described above. Accordingly, our financial statements reflect this belief.

On September 15, 2004 and again on October 15, 2004 respectively, Sheerin amended her pleadings to include a third and fourth amended third party cross action against Tidelands adding a claim for the \$300,000 promissory note. In these amended pleadings, Sheerin also deleted her claims against Carl Hessel and Ahmed Karim. After adding the claim on the \$300,000 promissory note to the

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third party claims of Sheerin against Tidelands in Cause No. 2002-C1-16421, Sheerin dismissed Cause Number 2002-C1-16421.

Tidelands won a partial summary judgment against Sheerin as to all of her tort claims pled against Tidelands, save and except only her claim for conversion of 500,000 shares of Tidelands stock.

Sheerin seeks damages against Tidelands for indemnity for any sums found to be due from her to Northern Natural Gas Company, unspecified amounts of actual damages, statutory damages, unspecified amounts of exemplary damages, attorneys fees, costs of suit, and prejudgment and post judgment interest.

On August 5, 2005, Northern Natural Gas Company filed its Fourth Amended Original Petition which, for the first time, named Tidelands as a defendant to Northern. Northern seeks to impose liability on Tidelands for \$1,950,000 promissory note signed by McDay Energy Partners, Ltd. (the predecessor to ZG Gathering, Ltd.) and Sheerin and the \$1,700,000 promissory note signed by McDay only. Northern contends that Tidelands is alternatively liable to Northern for payment of both such promissory notes totaling \$3,709,914 plus interest because Northern is a third party beneficiary under a December 3, 2001 purchase and sale agreement between ZG and Tidelands claiming that in such agreement Tidelands agreed to assume and satisfy all indebtedness due and owing Northern by Sheerin and ZG. Northern also claims that it is entitled to foreclosure of a lien on the gas gathering system and pipeline that was the subject of the promissory notes in question.

Tidelands has won a summary judgment motion it filed against Northern and the court has now dismissed Northern's claims against Tidelands.

On November 28, 2005, ZG Gathering, Ltd. and ZG Pipeline Management ("ZG") filed its answer to Northern's Fifth Amended Petition, its counter-claim against Northern, and its answer and cross claim against Tidelands. ZG contends that the promissory notes given by ZG and Sheerin to Northern were procured by Northern's fraudulent misrepresentations and it claims unspecified amounts of damages against Northern. ZG's cross action against Tidelands claims Tidelands entered into an agreement to purchase the Zavala Gathering System from ZG and that, as part of that agreement, Tidelands agreed to satisfy the \$3,700,914 Northern indebtedness of ZG, and to defend, indemnify, and hold ZG and Sheerin harmless



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from such indebtedness, to pay off a Sheerin loan of \$300,000, and to issue 1 million shares of Tidelands stock, of which 500,000 was to be free trading shares. ZG claims that Tidelands breached this agreement by failing to satisfy the Northern indebtedness, failing to defend and indemnify it from such debt, failing to pay off the \$300,000 note, failing to issue the free trading shares in Tidelands, and by placing a stop transfer order on the restricted stock that was issued by Tidelands. ZG seeks specific performance of the agreement, recovery of an unspecified amount of damages, and its attorney's fees.

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Much of the discovery has been completed at this time. Based on investigation, and discovery to date, Tidelands appears to have a number of potential defenses to the claims of Sheerin and Northern. Tidelands intends to aggressively defend these lawsuits. The complexity of the issues in this case and the inherent uncertainties in litigation of this kind prevent a more definitive evaluation of the extent of Tidelands' liability exposure.

### Matter No. 2:

On May 4, 2005, HBH Development Company, LLC, ("HBH") initiated legal action against Sonterra Energy Corporation in the District Court of Travis County, Texas, 98th Judicial District, Cause No. GN 501626 HBH Development Co., LLC vs. Sonterra Energy Corp. This action involves the developer of the Austin's Colony Subdivision in Travis County, Texas and the propane distribution system originally constructed by Southern Union Company. Southern Union entered into a letter agreement with HBH concerning the construction and operation of a propane distribution system in the subdivision to be owned and operated by Southern Union. Southern Union assigned the letter agreement and its interests in the propane system to Oneok, Inc., the parent company of Oneok Propane Company. Sonterra acquired its interest in the propane system from Oneok Propane Distribution Company. HBH is claiming that Sonterra has failed or refused to pay HBH rent and easement use fees under the terms of the letter agreement. HBH alleges that Sonterra's actions cause a failure of the assignment whereby it acquired rights in the propane system or alternatively, if the assignment is effective, for breach of contract. HBH seeks to have the court terminate Sonterra's rights in the propane distribution system, award unspecified monetary damages, cancellation of the contract and rights associated with the propane distribution system, issue to HBH a writ of possession for the property, and for attorneys fees. HBH has amended its complaint adding claims for mutual mistake and reformation as to the letter agreement and a developer's bonus under terms of the letter agreement.

Sonterra is defending the legal action. It believes that under the terms of the letter agreement between HBH Development Company and Southern Union Company, that the easement use fees terminated when Southern Union conveyed its interest in the propane distribution system to Oneok Propane Company.

### Matter No. 3:

On May 4, 2005, Senna Hills, Ltd. initiated legal action against Sonterra Energy Corporation in the District Court of Travis County, Texas, 53rd Judicial District Cause No. GN 501625 Senna Hills, Ltd. vs Sonterra Energy Corp. This action involves the developer of the Senna Hills Subdivision in Travis County, Texas and the propane distribution system originally constructed by Southern Union Company. Southern Union entered into a letter agreement with Senna Hills concerning the construction and operation of a propane distribution system in the subdivision to be owned and operated by Southern Union. Southern Union assigned the letter agreement and its interests in the propane system to Oneok, Inc., the parent company of Oneok Propane Company. Sonterra acquired its

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interest in the propane system from Oneok Propane Distribution Company. Senna Hills is claiming that Sonterra has failed or refused to pay Senna Hills rent and easement use fees under the terms of the letter agreement. Senna Hills alleges that Sonterra's actions cause a failure of the assignment whereby it acquired rights in the propane system or alternatively, if the assignment is effective, for breach of contract. Senna Hills seeks to have the court terminate Sonterra's rights in the propane distribution system, award unspecified monetary damages, and cancellation of the contract and rights associated with the propane distribution system, issue to Senna Hills a writ of possession for the property, and attorneys fees.

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Senna Hills sold certain undeveloped sections of Senna Hills Subdivision to a new owner. Sonterra believes that it has the right to expand its distribution system into such undeveloped sections of the subdivision. Sonterra plans to expand the distribution system into these sections under an agreement with the new owner. Senna Hills has stated that although it is not presently objecting to Sonterra's expansion of the system at this time, it is reserving its claim that Sonterra does not have the right to do so and that it intends to ask the court to cancel Sonterra's right to use and possession of the propane distribution system, including the system in the new sections of the subdivision. Senna Hills has amended its complaint adding claims for mutual mistake and reformation as to the letter agreement and a developer's bonus under terms of the letter agreement.

Sonterra is defending the legal action. It believes that under the terms of the letter agreement between Senna Hills and Southern Union Company, that the easement use fees terminated when Southern Union conveyed its interest in the propane distribution system to Oneok Propane Company.

Matter No. 4:

On April 7, 2005, Goodson Builders, Ltd. named Sonterra Energy Corporation in a legal action titled, Goodson Builders, Ltd, Plaintiff vs. Jim Blackwell and BNC Engineering, LLC, Defendants. The legal action is in the District Court of Travis County, Texas 345th Judicial District. This legal action arises from a claim that an underground propane storage tank and underground distribution lines is situated on the Plaintiff's lot in the Hills of Lakeway subdivision, Travis County, Texas. Plaintiff alleges that there is no recorded easement setting forth the rights and obligations of the parties for use of the propane tank and lines. However, there is reference to a "suburban propane easement" on the plat document. Plaintiff alleges that the property is being used without permission and the use constitutes an on-going trespass. Plaintiff asks the court to determine that his lot is not subject to a "suburban propane easement", declare the propane equipment the property of plaintiff, enjoin Sonterra from use of Plaintiff's land, and award damages. The Plaintiff seeks damages of \$165,000 based on a market rental rate he claims to be \$5,000 per month, \$50,000 damages for depreciation of the value of the lot, an unspecified amount of exemplary damages, and attorneys' fees. Sonterra is defending the claims.

Item 1A. Risk Factors

n/a

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

During this fiscal quarter, we issued the following common stock:

On May 10, 2006, we issued Jason Jones, a Tideland's subsidiary employee, 10,000

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common shares valued at \$7,900 pursuant to his employment agreement.

On May 10, 2006, we issued Robert Dowies, a Tidelands' officer, 60,000 common shares valued at \$97,400 under the terms of his employment agreement.

On June 7, 2006, we issued Michael Ward, a Tidelands' officer, 500,000 common shares valued at \$542,500 under the terms of his employment agreement.

On June 27, 2006, we issued Fran Jenkins, a Tidelands' employee, 20,000 common shares valued at \$16,000 as employee compensation.

On June 27, 2006, the Company issued 20,000 common shares to Natasha Dempsey, a Tidelands' employee, as compensation.

These are restricted securities and may not be resold absent registration under the Securities Act of 1933, as amended (the "Securities Act") or an exemption from the registration provisions of the Securities Act. We relied on Section 4(2) of the Securities Act as securities transaction exemption.

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### Item 3. Defaults Upon Senior Securities

None.

### Item 4. Submission of Matters to a Vote of Security Holders

During the first and second quarters, the Company solicited shareholder written consents in lieu of a special meeting of the shareholders. The consents were counted and effective April 17, 2006. The Company obtained a 77.5% majority shareholder consent to amend our Company's Certificate of Incorporation increasing our authorized Capital Stock from 100,000,000 shares to 250,000,000 shares.

### Item 5. Other Information

#### Regency Energy Transaction

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On July 9, 2006, Tidelands Exploration and Production, Inc., ("TEPI") a corporation formed by Tidelands Oil & Gas Corporation ("TIDE"), entered into a Participation Agreement (Exhibit 10.1) and Joint Operating Agreement (Exhibit 10.2) with Regency Energy, Inc. ("Regency"), a Texas corporation. TEPI has agreed to participate and jointly operate natural gas wells and a pipeline located in Texas. When the agreements are performed, we will acquire a 50% interest in a 24-mile natural gas pipeline located in Medina, Atascosa and Bexar counties, Texas. Additionally, we will acquire a 50% working interest in two leases with five re-completed natural gas wells located in Medina and Atascosa counties, Texas. We have agreed to pay \$500,000 to Regency for these interests. TIDE deposited the sum of \$250,000 with Regency on behalf of TEPI. Regency is principally owned and controlled by Royis Ward, the father of Michael Ward, Tidelands Oil & Gas Corporation President and member of the board of directors.

TEPI was recently organized as a Texas corporation for this transaction with Regency. TEPI will be a wholly owned subsidiary of TIDE when it completes its organizational phase. No TEPI operations have commenced and these interests have not been formally transferred to TEPI as of the date of this report.

#### Scout Aviation, LLC Transaction

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Tidelands Oil & Gas Corporation executed an Aircraft Prepaid Lease/ Use Agreement (Exhibit 10.3) in January 2004 with Royis Ward, to provide charter air transportation in his Beechcraft King Air, for Tidelands' employees, customers and contractors to job sites and other business related destinations. A \$300,000 5% interest bearing loan (Exhibit 10.4) due in January 2007 was made by the Company to Royis Ward regarding the transaction. The loan balance was credited by airtime charges at standard industry rates offset by interest charges computed on the average monthly balance. At December 31, 2005, the loan balance was \$288,506. On April 14, 2006, Michael Ward, through Scoot Aviation, LLC, acquired the Royis Ward aircraft and the loan obligation. As of June 30, 2006, the outstanding loan balance was \$285,287.

### Small Business Issuer Ineligibility

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Tidelands will commence filing its periodic reports with the Securities and Exchange Commission under Regulation S-X instead of S-B due to the fact that the Company had exceeded the \$25,000,000 public float (the aggregate market value of its outstanding common equity held by non-affiliates) limitations of Regulation S-B. As a result of this limitation and at the request of the Securities and Exchange Commission, Tidelands will be re-filing its Annual Report on Form 10-K for the period ending December 31, 2005 and re-filing its Quarterly Report on Form 10-Q for the period ending March 31, 2006.

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### Item 6. Exhibits

#### a) Exhibits

| Exhibit No. | Exhibit Name  |
|-------------|---|
| 10.1        | Regency Energy Participation Agreement  |
| 10.2        | Regency Energy Joint Operating Agreement  |
| 10.3        | Aircraft Prepaid Lease/Use Agreement  |
| 10.4        | Promissory Note for Aircraft Prepaid Lease/Use Agreement  |
| 31.1        | Chief Executive Officer-Section 302 Certification pursuant to Sarbanes-Oxley Act.               |
| 31.2        | Chief Financial Officer- Section 302 Certification pursuant to Sarbanes-Oxley Act.              |
| 32.1        | Chief Executive and Financial Officer-Section 906 Certification pursuant to Sarbanes-Oxley Act. |

### SIGNATURES

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

TIDELANDS OIL & GAS CORP.

Dated: August 21, 2006

/s/ Michael Ward

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By: Michael Ward  
Title: President, CEO

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Dated: August 21, 2006

/s/ James B. Smith

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By: James B. Smith  
Title: CFO, Principal Accounting  
Officer