BLAST ENERGY SERVICES, INC.
Form 10KSB/A
June 05, 2006

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

**Form 10-KSB/A**

**x ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the fiscal year ended December 31, 2004**

**¨TRANSITIONAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the transition period from ______ to ______**

**Commission file number: 333-64122**

**VERDISYS, INC.**
**(Name of small business issuer in its charter)**

| | |
|---|---|
| **California** | **22-3755993** |
| **(State of incorporation)** | **(IRS Employer Identification Number)** |

**14550 Torrey Chase Blvd, Suite 330**
**Houston, Texas 77014**
**(Address of principal executive offices)**

**(281) 453-2888**
**(Telephone number)**

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

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

Check whether issuer (1) 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 ¨

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B contained in this form, and no disclosure will be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of the Form 10-KSB or any amendments to this Form 10-KSB. x

Issuer’s revenues for the most recent fiscal year: $1,453,344

The aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the average bid and asked price of such common equity, as of February 27, 2005 is $9,050,540.

The number of shares outstanding of each of the issuer’s classes of common equity, as of December 31, 2004:

Common Stock: 33,443,691 shares

No (1) annual report to security holders; (2) proxy or information statement; or (3) any prospectus filed pursuant to Rule 424(b) or (c) of the Securities Act of 1933; are incorporated by reference into any part of this Form 10-KSB.

Transitional Small Business Disclosure Format: ¨ Yes; x No

**Explanatory Note**

Verdisys, Inc. (now known as Blast Energy Services, Inc.) is filing this amended Annual Report on Form 10-KSB/A for the year ended December 31, 2004 (“Amended Annual Report”) to amend its Annual Report on Form 10-KSB for the year ended December 31, 2004 (the “Original Annual Report”), which was filed with the Securities and Exchange Commission on March 30, 2005.

The Amended Annual Report amends the Company’s financial statements to reflect a non-cash adjustment to impair the carrying value of the Company’s Intellectual Property as of December 31, 2004, including the associated footnotes to the financial statements and disclosures under Part I, Item 1 “Financial Statements,” Item 2 “Management’s Discussions and Analysis of Financial Condition and Plan of Operation - Forward Looking Statements and Part II, Item 8a “Controls and Procedures.” Except for these items no other information in the original Report is amended hereby.

**Table of Contents**

**PART I**

**Item 1. Description of Business**

**Forward-Looking Statements**

Certain statements concerning our plans and intentions included herein may constitute forward-looking statements, including, but not limited to, statements identified by the words "anticipate", "believe", "expect" and similar expressions and statements regarding our business strategy, plans, beliefs and objectives for future operations. Although management believes that the expectations reflected in these forward looking statements are reasonable, we can give no assurance that such expectations will prove to have been correct. There are a number of factors that may affect our future results, including, but not limited to, (a) our ability to obtain additional funding for development and operations, (b) the continued availability of management to execute the business plan, (c) successful deployment and market acceptance of our products and (d) the resolution of legal matters that may inhibit the execution of the business plan.

This annual report may contain both historical facts and forward-looking statements. Any forward-looking statements involve risks and uncertainties. Moreover, future revenue and margin trends cannot be reliably predicted.

**Business Development**

In September 2000, we were incorporated as Rocker & Spike Entertainment, Inc, a California corporation. Until December 31, 2000, operations consisted of organizational matters and the search for an operating company with which to perform a merger or acquisition. Effective January 1, 2001, we purchased the assets and web domain of Accident Reconstruction Communications Network from its sole proprietor. Following the acquisition, we changed our name from Rocker & Spike Entertainment, Inc. to Reconstruction Data Group, Inc. At that time, we provided research, communication and marketing exposure to the accident reconstruction industry through our website and seminars.

In April 2003, we entered into a merger agreement with Verdisys, Inc. ("Verdisys"). Verdisys was initially incorporated as TheAgZone Inc. in 1999 as a California corporation. Its purpose was to provide e-Commerce satellite services to agribusiness. They changed their name to Verdisys in 2001, and in 2003, with the acquisition of exclusive rights to a proprietary lateral drilling process throughout most of the U.S. and Canada, they changed their market focus to concentrate on services to the oil and natural gas ("oil and gas") industry.

The merger agreement with Verdisys called for us to be the surviving company. In connection with the merger, our name changed to Verdisys, our articles of incorporation and bylaws remained in effect, the officers and directors of Verdisys became our officers and directors, each share of Verdisys' common stock was converted into one share of our common stock, and our accident reconstruction assets were sold.

**Business of Issuer**

Our mission is to substantially improve the economics of existing oil and gas operations through the application of our licensed and proprietary technologies. We have been striving to develop a commercially viable lateral drilling technology with the potential to penetrate through well casing and into reservoir formations to stimulate oil and gas production. In 2003, with the acquisition of exclusive rights to a proprietary horizontal drilling process we began to deploy lateral drilling services in the field. In mid 2004, it became apparent that this process was limited in its application to various types of oil and gas formations. After redesigning and improving the existing process and designing and testing some newer technologies, we now believe that we can deliver a valuable and cost effective production enhancement service to onshore oil and gas producers, particularly operators of marginally producing fields. The goal is to make this new service reliably predictable and consistently dependable for our customers. Our next step is to build our first new generation lateral drilling rig with the capability of abrasive fluid jetting and generating much higher hydraulic horsepower. Following favorable results and customer acceptance of this initial rig's capabilities, we intend to order the construction of additional rigs and significantly grow the deployment of our abrasive jetting service. Funding for developing this abrasive cutting capability into a lateral drilling application is expected to come from current and future capital commitments as well as from the proceeds of the assignment of the exclusive rights acquired in 2003. No assurances can be given that the capital from these sources will be adequate. If this is the case, we will be required to obtain additional capital from equity markets. No assurances can be given that such capital will be available or that the terms will be acceptable.

Our primary segment will be our abrasive jetting lateral drilling business. We intend to deploy a commercially viable lateral drilling technology with the potential to penetrate though well casing and into reservoir formations to stimulate oil and gas production using specially fabricated mobile drilling rigs. This service should provide oil and gas producers with an attractive, lower cost alternative to existing well stimulation or horizontal drilling services.

Our secondary business segment is providing satellite services to oil and gas companies. This service allows them to remotely monitor and control well head, pipeline or drilling operations through low cost broadband data and voice services to remote operations where conventional land based communication networks do not exist or are too costly to install. Longer term, our vision is to introduce additional early stage technologies in the energy service sector, all of which would fit our mission of helping energy companies economically produce more oil and gas.

**Industry**

We operate in the oilfield service industry which services the broader energy industry, where companies explore, develop and produce oil and gas. This industry is comprised of a diversity of operators, ranging from the very small to the extremely large. While the major portion of oil and gas production is provided by very large international oil companies, there are also a large number of smaller independent companies, who own the vast majority of existing wells.

As a smaller firm with a specialized service, we intend to provide lateral drilling and satellite services to both small and large operators in the energy industry. Initially, the lateral drilling business will be focused toward North American onshore-based independent producers while the satellite business already has the large oil and gas operators as customers. As we grow, we intend to cater to all segments of the industry in situations where the application of our services can add value to our customers.

Demand for our services depends on our ability to demonstrate improved economics to the oil and gas production sector we serve. We believe that they will use our lateral drilling service where it costs less than alternative services and/or when they perceive it enhances production. It will also be driven by macro-economic factors driving oil and gas fundamentals. The report of the Energy Information Agency of the U.S. Department of Energy entitled “International Energy Outlook 2000” forecasts that world oil consumption will increase at an annual rate of approximately 2% through 2020 and that world gas consumption will increase at an annual rate of approximately 3% over the same period. The projected increase in demand for oil is based on worldwide economic and population growth, primarily in developing countries. The projected increase in gas consumption over this period is expected to result from higher demand across residential, industrial and commercial sectors, as well as from the increasing use of gas as a source of fuel for electric power generation, particularly in North and South America. We also believe that reliance on traditional sources of oil and gas will be limited due to the inadequate delivery infrastructure and political unrest in major supplying countries.

The U.S. Geological Survey estimates there are 1,400 trillion cubic feet (“Tcf”) of recoverable gas resources in the U.S.- enough to last decades - “But most of it is off-limits to recover because of restrictive environmental rules and lawsuits.” This is particularly the case with drilling moratoriums on the East and West Coasts of America, parts of the Rocky Mountain Area and Alaska. On its website, www.naturalgasfacts.org, the American Petroleum Institute advocates “A multi-pronged approach is essential for meeting future U.S. gas demand: (1) using energy wisely and conserving where possible; (2) developing more U.S. supplies; (3) diversifying supplies through pipelines to bring Arctic gas to consumers; (4) facilitating more liquefied gas (LNG) imports.” We believe a more immediate impact can be made by exploiting existing U.S. supplies. Developing such supplies is dependent on drilling new wells in existing fields, or new reserves in expensive less accessible fields. We believe our lateral drilling technology can access previously uneconomic reserves and bring them to market cost effectively thereby helping to resolve this supply/demand imbalance.

The Office of Fossil Energy, U.S. Department of Energy, estimates there are nearly 500,000 oil wells and 230,000 gas wells that are marginal or classified as “stripper” wells. These stripper wells produce either 15 barrels or less of oil a day or 60 thousand cubic feet of gas or less a day. Although low producing stripper wells account for the “same of the amount of oil that America imports from Saudi Arabia” according to the Office of Fossil Energy “together (stripper wells) account for 1.25 Tcf of gas, or about 8 percent of the gas produced.” Such wells are potentially considered uneconomic or marginal with the strong potential of being abandoned due to poor production economics. Indeed approximately 150,000 marginal wells were abandoned between 1993 and 2000 “costing the U.S. more than $3.5 billion in lost economic output” according to the Office of Fossil Energy. In seeking to revitalize marginal and stripper wells both the Department of Energy and American Petroleum Institute have emphasized the need for new technologies to access more of the reserves available. We believe we have the ability to generate new business by re-entering existing wells rather than being dependent on the production companies drilling new wells. With our unique abrasive jetting well stimulation and lateral drilling technology, we believe we can provide potentially improved recovery rates rather than abandoning a field because of the depletion of its oil or gas reserves.

We believe that producing companies will react to the combination of the increased demand and the decreased supply of oil and gas in a manner that requires them to utilize both segments of our business. We believe that oil and gas producers have great economic incentive to recover additional production and reserves from known reservoirs rather than pursuing a more risky exploration approach. Our extraction methods may permit producers to add value by potentially recovering a significant additional percentage of the oil and gas from a reservoir. We believe that there exists a large potential market in North America that comprises logical candidates to apply our abrasive jetting lateral drilling method.

Activity in the energy services industry tends to be cyclical with oil and gas prices. In addition to the currently positive industry fundamentals, we believe the following sector-specific trends enhance the growth potential of our business:

- While oil prices are unpredictable, they have remained and are projected to remain relatively high by historic terms for several years. Continuing high consumption, limitations in delivery infrastructures and political unrest in major supplying countries are expected to be contributing factors.

- Gas prices are projected to remain high for several years due to the combination of strong demand and major supply constraints. About one-half of U.S. reserves have been depleted with the remainder increasingly expensive and difficult to reach. Significant new supplies from Alaska and the Canadian north require the construction of new pipelines which are estimated to be several years away. The situation is serious enough that Federal Reserve Bank Chairman Greenspan has expressed concern as to its effect as a constraint to U.S. economic growth.

- There is no substitution threat to oil and gas in the foreseeable future. In particular, any significant substitution by hydrogen or any other potential source is believed by management to be some decades away.

**Abrasive Jetting Lateral Drilling Services**

Our abrasive jetting service intends to provide casing milling, well stimulation and lateral drilling services to oil and gas producers. We have signed an exclusive worldwide licensing agreement with Alberta Energy Holdings (“Alberta”) for the application of their patent pending Abrasive Fluid Jet (“AFJ”) cutting technique to cut through well casing and formation rock in oil and gas wells. AFJ is being added to, and will enhance the existing principles of lateral drilling and completion techniques utilized by us and the industry. Applications of such abrasive cutting techniques are a proven feature in industries as diverse as munitions disposal in the military, offshore platform dismantlement in the salvage industry and cutting specialty glass and steel in the machining business. We would be among the first to commercially apply the proven abrasive fluid techniques to the energy producing business.

We have commenced the construction of a new generation drilling rig based upon modifications using existing coiled tubing technology. The capabilities of our new rig will include: 1.0 - 1.5 inch coiled tubing with a depth capability of 8,500 feet, a fluid pressure pumping system generating up to 15,000 pounds per square inch and a flow rate in excess of twenty gallons per minute; an abrasive slurry system capable of delivering 150 pounds of abrasive material at thirty minute intervals; and a computer-controlled system to guide and control the down-hole formation access tool for precise casing milling and jetting services. Based upon our current schedule we expect this rig to be completed and commercially ready for service during the summer of 2005. After the initial rig establishes a reliable and commercial oilfield service, we intend to begin construction on additional rigs with similar capabilities as the market demands.

Abrasive cutting utilizes high-pressure fluid and up to 15% of abrasives, such as fine garnet sand, up to 15,000 pounds per square inch. It can cut through surfaces as tough as four inches of steel as well as granite rock. Abrasive cutting represents an off-the-shelf technology requiring application to drilling rather than developing a new invention. The successful application of abrasive cutting should allow us to provide a range of services to well operators such as conventional milling, specially designed completions and well stimulation.

We believe that our abrasive jetting lateral drilling will have the ability to access previously uneconomic reserves and bring them to market cost effectively, due to our unique and environmentally sound drilling process. These services have appeal for both small independent operators as well as large integrated companies. At our lower comparative costs, we can make it feasible to enhance production from a large potential market in North America and worldwide that would otherwise be cost prohibitive to recover. The existing oil and gas independent producers in North America are leading potential customers of these services.

Many of the nation’s mature oil and gas fields contain new infield reservoir compartments and bypassed pockets of productive zones that have not been economic to produce. By extending 2” or greater diameter channels extended distances in multiple directions from the casing of the well, our lateral drilling provides an economic way to enhance production levels of existing reservoirs. Our lateral drilling process uses high pressure abrasive fluid jetting process, capable of drilling lateral holes from existing wells extended distances beyond the near well bore damage in wells as deep as 8,500 feet.

With conventional horizontal drilling, the transition from drilling vertically to horizontal drilling may take 200 feet or more and take many days to accomplish. With our patented technology, we can make this transition in two feet in a rapid fashion. This enables us to be extremely precise in targeting and staying within specific pay zones for a potentially significant enhancement to the production of the well.

We are developing abrasive jetting lateral drilling technology using specially designed deflection shoes, nozzles and hoses to drill 2" and larger diameter well bores into the producing formation in multiple directions. By increasing the surface area opened to the producing reservoir, oil or gas production should be increased, potentially a large value-added application in conventional drilling and completion operations. The figure below more precisely illustrates the process.

Our abrasive jetting lateral drilling process is designed to work on both new and existing wells, but may have greater attraction to operators of marginal wells who may be otherwise ready to abandon these wells because they are no longer economically viable. The strong market potential is that this negates the continual need for more exploration, new drilling and denser infield drilling. Such fields that may be ready to be abandoned and have remaining resource potential, can have their production re-established and their economic lives significantly extended.

The figure below demonstrates how drilling multiple lateral wells from existing vertical well bores can drastically expand the production area within a given field. An average vertical well will recover petroleum from an area of up to 120 feet from the well bore. However, each lateral can extend in multiple directions from the well bore, thus potentially increasing the area of productive capacity several fold. With our lateral drilling process we have the ability to drill multiple laterals in different directions and at multiple depths within the same producing intervals in a matter of days. The average price for our service will range from $25,000 to $40,000 per well depending upon the size of the project. Specialized directional drilling companies typically charge $250,000 or more to drill horizontally in one direction and in only one horizon and may require weeks to drill each well.

Potential Benefits of our lateral drilling service:

· Increase production rate and recoverable reserves from marginal wells.

· Allows stimulation of wells with acid, steam, $CO_2$, etc.

· Allows multi-layer application in thicker reservoir zones.

· Provides an economic alternative to conventional infield drilling programs.

· Provides a time efficient and cost effective casing milling process.

· Offers an alternative to high cost well stimulation services such as hydraulic fracturing.

· Limits the time the well is out of production due to rapid jetting times.

*Major Customers*

We currently have no active customers as we are in the construction mode. However, we have strong indications of interest in using the new AFJ drill rig once it is placed into service.

*Customer Acceptance*

We are encouraged by the level of interest from several existing and prospective customers in the lateral drilling technology as it relates to conventional oil and gas production as well as coal bed methane opportunities.

Our abrasive jetting lateral drilling service directly competes with the need for new wells by laterally drilling from existing wells to extend the pay zone resulting in increased production through existing well bores. Our ability to target new or previously untapped deposits makes our technology potentially very compelling. By cost effectively extending the accessibility of reserves through the existing well bore, our technology can provide an economic alternative for a customer to add value to an existing field. The field operator's next best economic alternatives are all more expensive than our service. This has the potential to be not only compelling economically but also very environmentally friendly because it uses previously established well bores rather than building new surface locations to drill new wells.

According to the Department of Energy Report - Natural Gas Fundamentals, June, 2003, there are "Over 7,000 small independent businesses (that) drill 85% of wells and produce 65% of gas in the U.S. from over 350,000 U.S. wells." These independent producers are potential customers for our lateral drilling service. In the same report it estimates 10,000 to 15,000 new gas wells are drilled and completed each year costing anywhere from less than $100,000 to several million. These new wells are necessary just to replace depleted supplies from existing wells in an effort to maintain current U.S. production levels.

Recent changes in U.S. tax laws provide for incentives to keep smaller oil and gas wells pumping even at lower energy prices. Operators of the nation's 650,000 marginally producing wells, representing approximately 25% of total U.S. production, receive tax credits of up to $9 per well per day. We believe such credits will be reinvested by the operators toward services such as lateral drilling in an effort to increase production and the value of their oil and gas fields

*Market*

It has become clear in recent years that while the demand of oil and gas in the U.S. is growing, its ability to meet this demand from existing and new sources is declining. This accelerated decline will require producers to seek new extraction methods or technologies to exploit oil and gas production from existing fields and our abrasive jetting lateral drilling process is expected to help supply the need for these new technologies. According to the Department of Energy, there have been 2.25 million wells drilled in the U.S. since 1949. Many oil reservoirs have only had 35% of their reserves produced, leaving huge potential upsides.

*Emphasis on Gas*

The United States consumed 22.78 Tcf of gas in 2002 - heating over 60 million households and meeting 25% of the country's energy requirements, according to the U.S. Energy Information Administration (EIA). In that same year, U.S. production of gas totaled 19.13 Tcf, 84% of the amount consumed. According to the EIA, this gap between demand and supply is estimated to grow over the next decade. Demand will grow because gas is a versatile, clean burning and, historically, an economic fuel. At the same time, the new domestic fields being found are smaller and have shorter productive lives. So, with legal and political barriers to drilling on new lands, producers will seek alternative to extend the lives from existing fields, such as new energy service technologies.

*Competition*

Source: Department of Energy - Natural Gas Fundamentals, June, 2003

Our lateral drilling business should operate in a niche that lies below the more expensive and higher impact conventional horizontal drilling business and the much cheaper and lower impact perforation business. Our lateral drilling service can provide significant reservoir exposure, and therefore greater production potential, like horizontal drilling at closer to the cost of the perforation service.

Conventional horizontal or directional drilling is slow and significantly more expensive to the extent that it is only being used if its much longer drilling radius was required as is necessary in offshore or environmentally sensitive areas. Companies offering this service include Halliburton, Baker Hughes, Schlumberger and other independent service companies. They traditionally drill one lateral through the existing well bore. That lateral can take over 200 feet to achieve the turn to the horizontal and be limited to only one “pay” zone. It usually costs over $250,000 and positive financial returns require very high producing rates.
However, many of our competitors are better financed, equipped and resourced than us.

**Satellite Services**

Our second business segment provides satellite services to oil and gas producers. It has been common practice to gather much of the data involved in energy management manually. This is not only expensive but also causes a significant time lag in the availability of critical management information. The Verdisys Satellite Private Network (VSPN’s) services utilize two-way satellite broadband to provide oil and gas companies with a wide variety of remote energy management applications. Our satellite services can be optimized to provide cost effective applications such as Voice over Internet “VoIP”, Virtual Private Networking “VPN” and Real-time Supervisory Control and Data Acquisition Systems, commonly referred to as SCADA. SCADA permits oil and gas companies to dispense with a manual structure and move to a real-time, automated, energy management program. Utilizing SCADA, a service we currently offer, production levels can be optimized to meet current market conditions and commitments.

At present, we are shipping modem hardware from ViaSat, Isotropic Networks and Spacenet, space segment services from SES and Loral and hub services from Constellation, Spacenet and Immeon.

VSPN uses satellite communications that are low cost and that ensure worldwide availability, even in geographic areas with a poor communications infrastructure. VSPN is based on industry standards to lower implementation costs and to simplify the integration into existing systems. Reliability and availability are critical considerations for SCADA. VSPN is provided twenty four hours a day, seven days a week with 98.2% availability virtually anywhere in the world and there are fewer points of failure than comparable terrestrial services. It provides uniform service levels, and is faster and more cost effective to deploy. VSPN is also very flexible and easily accommodates site additions, relocations, bandwidth expansion, and network reconfiguration.

Additionally, security, integrity, and reliability have been designed into VSPN to ensure that information is neither corrupted nor compromised. VSPN communications are more secure than many normal telephone lines.

*Major Customers*

Our current satellite services customers include Apache Corporation with 40 remote sites, BP America Production Company with 20 remote sites, Noble Energy with 22 remote sites and Dynegy Inc. with 11 remote sites. We are also breaking into new markets in West Africa with ExxonMobil, Kellogg Brown & Root Inc. and General Electric Power Company. Contracts are usually for hardware, backhaul, and bandwidth. We are dependent upon a small number of customers which tend to be large companies with extensive remote operations. However, virtually any oil and gas producer, of which there are thousands, is a potential customer for our satellite services.

*Market*

There are more than two million oil and gas wells in existence in the United States alone, many of which could benefit from the economics of Verdisys' high speed connectivity services. Our focus is serving the needs of oil and gas producers worldwide to control their production effectively and to enhance customer satisfaction by providing worldwide real-time access to information. This market for satellite services is very competitive with increasing pressure on margins as our larger competitors offer services at substantially discounted prices. We attempt to compete against such competitors by addressing niche market needs and offering alternative solutions that solve customers' more difficult communication problems at more cost effective rates. We utilize satellite, Wi-Fi and other wireless technology for the last mile of wellhead connectivity for these customers and focus almost exclusively on the oil and gas market. The common denominator throughout is Multiple Protocol Label Switching "MPLS/ATM" network transport services.

*Competition*

The satellite communication industry is intensely competitive due to overcapacity, but the competition is less severe in the oil and gas producing sector. Other satellite services providers in the oil and gas industry include Petrocom, Stratus Global, Tachyon, Schlumberger and Caprock. Caprock, Schlumberger and Stratus are focused on the top 5% of the market, particularly offshore platforms, and Petrocom and Stratus Global are focused on the offshore market using a traditional wireless network. Our satellite services offer advantages over those services by:

- Customizing the provided service to better meet the customer's needs;
- Offering superior speed;
- Providing single vendor convenience; and
- Offering lower up-front infrastructure and operating costs.

**Insurance**

Our operations are subject to hazards inherent in the oil and gas industry, such as accidents, blowouts, explosions, craterings, fires and oil spills. These conditions can cause:

- personal injury or loss of life,
- damage to or destruction of property, equipment and the environment; and
- suspension of operations

In addition, claims for loss of oil and gas production and damage to formations can occur in the well service industry. Litigation arising from a catastrophic occurrence at a location where our equipment and services are being used may result in us being named as a defendant in lawsuits asserting large claims.

We maintain insurance coverage that we believe to be customary in the industry against these hazards. However, we may not be able to maintain adequate insurance in the future at rates we consider reasonable. In addition, our insurance is subject to coverage limits and some policies exclude coverage for damages resulting from environmental contamination. The occurrence of a significant event or adverse claim in excess of the insurance coverage that we maintain or that is not covered by insurance could have a materially adverse effect on our financial condition and results of operations.

**Patents and Licenses**

In November 2004, we signed an exclusive worldwide licensing agreement with Alberta for the application of their patent pending AFJ cutting technique to cut through well casing in oil and gas wells. The agreement is for a term of ten years and automatically extends for additional two-year terms unless we give notice at least thirty days prior to the expiration of any term. The license is automatically renewable provided we pay a minimum royalty payment of $50,000 per year beginning with the 12 month period immediately following commercial deployment of the first mobile drilling unit.

Under the terms of the licensing agreement, as specific phases of the AFJ process are successfully applied, Alberta is entitled to receive four tranches of warrants for our common stock. Each tranche will entitle Alberta the right to purchase 250,000 shares of our common stock and each tranche is contingent upon the attainment of certain specific milestones as fully described in the agreement. The warrants will have a three-year term, with an exercise price of $0.50 per share for the first tranche and $0.62 per share for the remaining tranches. The initial tranche will be fully vested as of the date of the agreement and the remaining warrants will vest at 31,250 shares per quarter from the date of issuance.

Under the terms of the agreement, we have agreed to pay Alberta a $10,000 per month consulting fee for six months beginning on November 30, 2004. In addition, royalties are payable by us at the rate of $1,000 per well for services billed at $40,000 or less and for services above $40,000, a royalty of 2% per well is payable quarterly. The agreement also provides for the mutual sharing of the proceeds from the sale of the technology by us, subject to a maximum of $10 million.

On April 24, 2003 we entered into an agreement to license the Landers Horizontal Drilling Process, based on U.S. Patent Nos. 5,413,184, 5,853,056, and 6,125,949 relating to certain oil and gas well production enhancement techniques and devices and related trade secrets with the inventor and holder of the patents and trade secrets, Carl Landers. The license gives us exclusive rights to apply the technology and the related trade secrets in all of the U.S. (except for part of Colorado West of the Rockies, and Utah) and Canada. Mr. Landers also reserves the rights to certain applications in which he has a direct interest but may not compete with us. Any improvements to the technology remain the sole property of the licensor but are provided to us without additional licensing fees. The license terminates upon the expiration of the underlying patents, the earliest date being October 1, 2013. We amended the license on September 4, 2003, to provide for consideration to Mr. Landers of a fixed amount of $500 for every well drilled in which the Landers Horizontal Drill method is utilized, instead of the original 10% royalty payment, and 500,000 shares of our restricted common stock. In addition, in exchange for a reduction of the note payable associated with the license from $2,750,000 to $2,500,000, we issued an additional 125,000 shares of our restricted common stock. We amended the license again in February 2004 when $1,695,000 of outstanding payment obligations to Mr. Landers for technology fees were waived in exchange for the issuance of 300,000 shares of our common stock and the payment of $500,000 in cash.

On March 8, 2005, we entered into an Assignment of License Agreement with Maxim TEP, Inc. ("Maxim"). The President and Chief Executive Officer of Maxim is Dan Williams, our former President and CEO. Under the assignment, we assigned to Maxim our rights in the license of the Landers Horizontal Drilling Process; all current and future negotiations for assignments, sublicenses or territorial royalty pertaining to the license and two lateral drilling rigs. As consideration, Maxim agreed to pay us a total sum of $1.3 million payable in four installments (two of which were received by March 22, 2005) and release a $270,000 credit obligation we owe to Maxim. In connection with the sale, we fully impaired the asset while creating an account receivable for the sales value. We will retain a non-exclusive sublicense interest in the Landers license, as long as we pay all required royalties on which the Landers Horizontal Technology is utilized.

The lateral drilling technology and related trade secrets are instrumental to our competitive edge in the oil and gas service industry. We are committed to protecting the technology. We cannot assure our investors that the scope of any protection we are able to secure for our license will be adequate to protect it, or that we will have the financial resources to engage in litigation against parties who may infringe on our exclusive license. We also can not provide our investors with any degree of assurance regarding the possible independent development by others of technology similar to that which we have licensed, thereby possibly diminishing our competitive edge.

**Governmental Regulation**

Our operations are subject to various local, state and federal laws and regulations intended to protect the environment. Our operations routinely involve the handling of waste materials, some of which are classified as hazardous substances. Consequently, the regulations applicable to our operations include those with respect to containment, disposal and controlling the discharge of any hazardous oilfield waste and other non-hazardous waste material into the environment, requiring removal and cleanup under certain circumstances, or otherwise relating to the protection of the environment. Laws 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 may expose us to liability for the conduct of, or conditions caused by, others, or for our 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 could be substantial and could have a material adverse effect on our financial condition. Management believes that it conducts our operations in substantial compliance with all material federal, state and local laws as they relate to the environment. Although we have incurred certain costs in complying with environmental laws, such amounts have not been material to our financial results.

We depend on the demand for our products and services from oil and gas companies. This demand is affected by changing taxes, price controls and other laws relating to the oil and gas industry generally, including those specifically directed to oilfield operations. The adoption of laws curtailing exploration and development drilling for oil and gas in our areas of operation could also adversely affect our operations by limiting demand for our products and services. We cannot determine the extent to which our future operations and earnings may be affected by new legislation, new regulations or changes in existing legislation regulations or enforcement.

Our satellite services utilize products that are incorporated into wireless communications systems that must comply with various government regulations, including those of the Federal Communications Commission (FCC). In addition, we provide services to customers through the use of several satellite earth hub stations, which are licensed by the FCC. Regulatory changes, including changes in the allocation of available frequency spectrum and in the military standards and specifications that define the current satellite networking environment, could materially harm our business by (1) restricting development efforts by us and our customers, (2) making our current products less attractive or obsolete, or (3) increasing the opportunity for additional competition. Changes in, or our failure to comply with, applicable regulations could materially harm our business and impair the value of our common stock. In addition, the increasing demand for wireless communications has exerted pressure on regulatory bodies worldwide to adopt new standards for these products and services, generally following extensive investigation of and deliberation over competing technologies. The delays inherent in this government approval process have caused and may continue to cause our customers to cancel, postpone or reschedule their installation of communications systems. This, in turn, may have a material adverse effect on our sales of products to our customers.

**Research and Development Activities**

During 2004 and 2003, we incurred an insignificant amount of research and development costs as it relates to our lateral drilling process. We incurred no research and development costs in our satellite business.

**Employees**

As of December 31, 2004, we had a total of seven employees, all of which were full-time employees. A new president and chief financial officer were brought into the company in January 2004. We also utilize a number of independent contractors and consultants to assist us conducting the drilling operations, installing the telecommunications equipment, maintaining and supervising such services, and the like, in order to complement our existing work force, as needed from time to time. Our agreements with these independent contractors and consultants are usually short-term. We are not a party to any collective bargaining agreement with any employees, and believe relations with our employees, independent contractors and consultants are good.

**Item 2. Description of Property**

*Office Facilities*

We lease approximately 2,000 square feet of office space in Houston, Texas for our principal executive office at a cost of $2,800 per month. Our lease has been extended through August of 2006.

*Equipment*

As of December 31, 2004, our primary equipment consisted of three mobile lateral drilling rigs, which can be driven to oil and gas fields throughout North America. Lateral drilling equipment consists of heavy trucks mounted with high powered water compressors, flexible hose and other assorted downhole equipment which is used to conduct the lateral drilling process with high pressure jetting technology. We also maintained certain satellite communication and computer equipment at our principal executive office.

We believe that our facilities and equipment are in good operating condition and that they are adequate for their present use. However, the new generation drilling rig planned for 2005, will replace our plans to use the existing rigs designed under the Landers technology. In fact, under an Assignment of License Agreement, dated March 8, 2005, two of the existing lateral drilling rigs were sold.

**Item 3. Legal Proceedings**

*Lawsuits Involving Edge Capital Group, Inc. (Settled)*

Effective January 19, 2005, Edge Capital Group, Inc. ("Edge"), certain entities affiliated with Edge, Eric McAfee (our former Vice Chairman) and us, entered into a Settlement Agreement and Mutual Release to fully settle and resolve the disputes between Edge and its affiliated entities, Mr. McAfee, our directors and us. As part of the settlement, we issued an aggregate of 750,000 shares of our common stock along with warrants to purchase 750,000 shares of our common stock to Edge. In addition, we agreed to provide Edge a drilling rig to provide certain lateral drilling services. As part of the drilling services, Edge has agreed to provide a fee per well, along with a share of the revenues generated from each well drilled. Also, as part of the settlement, at closing, we have agreed to sublicense our Landers horizontal drilling technology to Edge for certain limited purposes. As part of the settlement, the parties to the agreement have agreed to a mutual release and have agreed to dismiss all pending claims and litigation between them upon performance of the obligations in the settlement agreement. If we do not perform our remaining obligations under the settlement agreement, this would cause the release to not be effective and could lead to the underlying lawsuit being reinstituted. An adverse finding in such lawsuit against us would have a material adverse effect on our financial condition.

We had initiated a lawsuit against Edge that requested a declaratory judgment that a purported agreement between us and Edge was not enforceable. It was filed in Montgomery County, Texas in February 2004. The lawsuit arose from Edge's contention that one of our ex-officers committed us to purchase certain alleged oil and gas properties from Edge. Edge had filed a counterclaim against us and asserted claims against Dan Williams (our former President and CEO), Eric McAfee, Ron Robinson (our former CEO and current Board member), Andrew Wilson (our former CFO) and our current Board members Joseph Penbera, Frederick Ruiz, James Woodward and John Block. Edge has also made claims against Solarcom, L.L.C., DeLage Landen Financial Services, Inc., Andrew Wilson and Allen Voight. Edge had sought to enforce the agreement we challenged and alleged several causes of action including claims for fraud, breach of contract, negligence and conspiracy. Edge had asserted actual damages in excess of $85 million and has claimed punitive damages as well.

Edge and one of its apparent owners, Frazier Ltd., had initiated a lawsuit in Summin County, Ohio against us, Solarcom, L.L.C., DeLage Landen Financial Services, Inc. and Firstmerit Bank, N.A. that sought an injunction against the draw against a letter of credit pledged as collateral for a credit advanced to Edge. Edge asserted that its transaction with us was the product of fraud and that its creditor, DeLage Landen as assignee from Solarcom, should not be allowed to draw against Edge's letter of credit from Firstmerit. The Ohio state court denied Edge's request for a temporary injunction. The pleadings in the Ohio action did not include any claim for damages from us.

*Class Action Lawsuits (Settled)*

In March 2005, we entered into an agreement, subject to court approval, to settle the class action lawsuit brought by former shareholders in March 2004 in the U.S. District Court for the Southern District. Under terms of the agreement, we will issue to the class 1,150,000 shares of common stock and pay up to $55,000 in legal and administrative fees for the plaintiffs. The lawsuit alleged that we and our former CEO, Dan Williams, and our former CFO, Andrew Wilson, violated Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, and Rule 10b-5 promulgated thereunder. The lawsuits alleged that the defendants had made material misstatements about our financial results. More specifically, the Complaints alleged that the defendants had failed to disclose and indicate: (1) that we had materially overstated our net income and earnings per share; (2) that we prematurely recognized revenue from contracts between us, Edge and Energy 2000 NGC, Inc. ("Energy 2000") in violation of GAAP and our own revenue recognition policy; (3) that we lacked adequate internal controls and was therefore unable to ascertain the true financial condition of the company; and (4) that as a result of recognizing revenue prematurely, our financial results were inflated at all relevant times. We had filed a motion to dismiss all actions in the litigation against us.

*Securities and Exchange Commission Investigation Inquiries*

We received notice, in January 2004, that the Securities and Exchange Commission ("SEC") has initiated a formal investigation into our reporting practices and our public statements in 2003.

The SEC has requested substantiation and documentary evidence from us concerning the performance of certain lateral drilling services by subcontractors in the period from May 2003 to September 2003, supervision of such services by our executive management at the time, revenue recognition related to the performance of such services, the third quarter 2003 earnings restatement, public statements concerning the services performed, and related matters. The SEC has also requested information and documentary evidence related to our acquisition of certain assets of QuikView, Inc., a related party company, in June 2003. In its letters to us requesting documents, the SEC stated that the staff's inquiry should not be construed as an indication that any violations of securities laws have occurred or as an adverse reflection on any persons, company or security.

Since December 2003, we have taken several steps to address issues related to the SEC's inquiries, including the termination and replacement of the previous Chief Executive Officer and Chief Operating Officer and the reassignment of its Chief Financial Officer. Two directors have resigned from our board and we have appointed a new CFO. Internal controls have been strengthened overall, particularly with respect to the public release of information and the recognition of revenue. We had also initiated an internal investigation of the matters of concern to the SEC. Consequently, we restated our second and third quarter financial statements for fiscal year 2003 and deferred all revenue related to the aforementioned period until such time that we can substantiate whether or not the services were performed.

We are cooperating fully with the SEC, including the provision of numerous documents and voluntary testimony by our current executives. In December 2004, the staff of the SEC notified us that it was considering recommending that the SEC bring a civil injunction (including a possible permanent injunction and a civil penalty) against us alleging violations of provisions of the Sections 10(b), 13(b)(2)(A), 13(b)(2)(B) and 15(d) of the Securities Exchange Act of 1934 and rules promulgated thereunder in connection with the purchase and sale of our securities, recordkeeping, internal controls, certification and disclosure obligations. We were notified of our right to make a Wells submission. We have provided information to the SEC setting forth the specific steps we have taken to upgrade the quality and effectiveness of our board of directors, replace the previous management team with industry experts, improve our recordkeeping, internal and disclosure controls, and revenue recognition procedures. Although we are working to bring the matter to a prompt conclusion, we cannot make any assurance that the investigation will be resolved positively or that it will not have negative effects on our limited resources or our ability to raise capital and use our stock as acquisition currency during the period of the investigation.

*Claims by Investor (Partially Settled)*

In February 2005, we entered into an Agreed Judgment and Order of Severance with Gryphon Master Fund, L.P. ("Gryphon") as to all breach of contract claims related to our delay in registering common stock acquired by Gryphon in October 2003. Under the terms of the Agreed Judgment, we are obligated to pay liquidated damages of $0.5 million to Gryphon on or before September 30, 2005. Additionally, Gryphon has agreed to abate their remaining claims and related discovery in the lawsuit against us until after September 30, 2005. We agreed to register the shares issued to Gryphon on or before March 2004 or be subject to certain liquidated damages. Gryphon had made a claim against us for the maximum liquidated damages in an amount of $400,000. Gryphon has also claimed that it has sustained actual damages in excess of $6.2 million. In July 2004, Gryphon filed a lawsuit in the state district court in Dallas County, Texas against us, alleging, among other things, breach of contract and securities fraud by us. In connection with the lawsuit, Gryphon requested liquidated damages, actual damages, punitive damages, interest, costs and attorneys' fees among other claims. We intend to vigorously defend ourselves in this matter with respect to the remaining claims of Gryphon. If Gryphon prevails, it may obtain significant damages that may have a material adverse effect on our financial condition.

*Claim by Former CEO*

In July 2004, we were informed that one of our former Chief Executive Officers filed a lawsuit against us for breach of contract and wrongful discharge. The lawsuit seeks relief in excess of $0.5 million related to an alleged employment agreement and damages related to an excess of 4 million stock options claimed due pursuant to the alleged employment agreement. The lawsuit was filed in state court in San Diego, California. We intend to vigorously defend ourselves in this matter. If the plaintiff prevails, they may obtain significant damages that may have a material adverse effect on our financial condition.

*Energy 2000 (Settled)*

In October 2004, we entered into an agreement with Berg McAfee Companies, Energy 2000 and Eric McAfee (collectively, "McAfee Group") to settle several outstanding legal issues. Energy 2000 has agreed to settle a finders fee and lateral drilling services dispute by delivering 300,000 shares of Natural Gas Systems, Inc. ("NGS") stock into escrow for us. We have plans to monetize those shares as soon as practical. Furthermore, to settle the "Lawsuits Involving Edge Capital Group, Inc.", the McAfee Group exchanged 500,000 shares of NGS for 500,000 shares of our common stock. In January of 2005, the McAfee Group replaced the 500,000 shares of NGS stock with $625,000 in cash. We submitted that cash and an additional 250,000 shares of our common stock to Edge as part of that settlement. We have also agreed to dismiss the QuikView, Inc. lawsuit, which we had filed against certain individuals.

*Concluding Statement*

We have never been in bankruptcy, receivership or any similar legal proceeding. Other than the aforementioned legal matters, we are not aware of any other threatened legal proceedings. The foregoing is also true with respect to each officer, director and control shareholder as well as any entity owned by any officer, director and control shareholder, over the last five years.

As part of our regular operations, we may become party to various pending or threatened claims, lawsuits and administrative proceedings seeking damages or other remedies concerning its' commercial operations, products, employees and other matters. Although we can give no assurance about the outcome of these or any other pending legal and administrative proceedings and the effect such outcomes may have on the company, except as described above, we believe that any ultimate liability resulting from the outcome of such proceedings, to the extent not otherwise provided for or covered by insurance, will not have a material adverse effect on our financial condition or results of operations.

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

No matter was submitted during the fourth quarter of the fiscal year covered by this report to a vote of security holders, through the solicitation of proxies or otherwise.

## Part II

**Item 5. Market for Common Equity and Related Stockholder Matters**

After the consummation of the merger between Reconstruction Data Group, Inc. and Verdisys, our common stock commenced trading on the OTC Bulletin Board on July 18, 2003 under the symbol "VDYS." Prior to the merger, our common stock had been listed for trading on the OTC Bulletin Board under the symbol "RDGI". The RDGI stock was listed on January 13, 2003, but active trading did not begin until May 2, 2003. The following table sets forth, for the periods indicated, the high and low bid prices of a share of our common stock as reported on the OTC Bulletin Board since active trading began on May 2, 2003. The quotations provided are for the over the counter market which reflect interdealer prices without retail mark-up, mark-down or commissions, and may not represent actual transactions.

| | HIGH | LOW |
|---|---|---|
| 2003 | | |
| Second Quarter (from May 2, 2003) | $ 1.72 | $ 1.53 |
| Third Quarter | $ 6.32 | $ 5.65 |
| Fourth Quarter | $ 11.03 | $ 10.14 |
| 2004 | | |
| First Quarter | $ 9.54 | $ 3.35 |
| Second Quarter | $ 4.75 | $ 1.50 |
| Third Quarter | $ 1.95 | $ 0.25 |
| Fourth Quarter | $ 1.00 | $ 0.40 |

**Holders**

As of February 28, 2005, we had 34,973,673 shares of common stock issued and outstanding and held by approximately 500 shareholders.

**Dividends**

We have never paid cash dividends. At present, we do not anticipate paying any dividends on our common stock in the foreseeable future and intend to devote any earnings to the development of the company's business.

**EQUITY COMPENSATION PLAN INFORMATION**

The following table provides information as of December 31, 2004 regarding compensation plans (including individual compensation arrangements) under which equity securities are authorized for issuance:

| Plan Category | Number of securities to be issued upon exercise of outstanding options, warrants and rights | Weighted-average exercise price of outstanding options, warrants and rights | Number of securities available for future issuance under equity compensation plans (excluding securities shown in first column) |
|---|---|---|---|
| Equity compensation plans approved by shareholders | | | |
| Equity compensation plans not approved by shareholders | 2,413,680 | $ 1.67 | 5,586,320 |
| Total | 2,413,680 | $ 1.67 | 5,586,320 |

**Recent Sales of Unregistered Securities**

The following table details shares issued under transactions that were a private offering we believe to be exempt from registration under Regulation D promulgated under Section 4(2) of the Securities Act. The sales of stock were to individuals or entities, each of whom was an accredited investor, as that term is defined in Rule 501 of Regulation D promulgated under Section 4(2) of the Securities Act and had adequate access to information pertaining to us. Furthermore, no advertisements were made and the securities are restricted pursuant to Rule 144.

| Date | Number of Shares of Common Stock | Value | Offering Costs | Other Terms |
|---|---|---|---|---|
| January and February 2005 | 433,000 | $ 216,500 | 15,800 shares of common stock and warrants to purchase 15,800 shares of our common stock at $1.00 per share | Two year warrants to purchase 433,000 shares of our common stock at a price of $1.00 per share were issued in connection with the private placement. The proceeds will be allocated between the common stock and the warrants based on their respective relative fair values. |
| May through June 2004 | 179,500 | $ 359,000 | 17,950 shares of common stock and warrants to purchase 7,180 shares of our common stock at $2.00 per share | Two year warrants to purchase 71,800 shares of our common stock at a price of $2.00 per share were issued in connection with the |

| | | | | | |
|---|---|---|---|---|---|
| | | | | | private placement. The proceeds were allocated between the common stock and the warrants based on their respective relative fair values. |
| July through August 2003 | 609,000 | $ | 1,218,000 | 59,400 shares of common stock and warrants to purchase 9,501 shares of our common stock at $2.00 per share | |

The following table details sales of stock we believe to be exempt from registration under Section 4(2) of the Securities Act. Each of the recipients of our stock was an accredited investor, as that term is defined in Rule 501 of Regulation D promulgated under Section 4(2) of the Securities Act and had access to information concerning us and our business prospects. Furthermore, no advertisements were made and the securities are restricted pursuant to Rule 144.

| Date | Number of Shares of Common Stock | Value | Comment |
|---|---|---|---|
| Fourth Quarter of 2004 | 104,000 | $ 52,000 | Shares issued in payment of consulting services. |
| Fourth Quarter of 2004 | 250,000 | $ 75,000 | To settle a dispute with a former consultant. |
| Fourth Quarter of 2004 | 400,000 | $ 200,000 | Shares for cash. |
| Third Quarter of 2004 | 30,000 | $ 15,000 | Shares issued in payment of a future fundraising effort. |
| Third Quarter of 2004 | 300,000 | $ 213,000 | Shares issued in lawsuit settlement. |
| February 2004 | 300,000 | $ 1,920,000 | Shares issued in payment of outstanding obligations to Mr. Landers for technology fees. |
| September 2003 | 500,000 | $ 2,275,000 | Shares issued in exchange for amendment to Landers licensing agreement. |
| July 2003 | 125,000 | $ 250,000 | Shares issued in payment of note payable to Mr. Landers. |

*Other Sales*

In January 2005, we issued 16,000 shares of our common stock for the payment of leasing fees valued at approximately $8,000 and 10,666 shares of our common stock to settle unpaid compensation issues with two former AgZone employees. We also issued 388,502 shares of our common stock under a program to compensate our directors, employees, contractors and former employees for unpaid wages, commissions and director fees incurred in 2004. Additionally, 500,000 shares of common stock were issued to Edge under the final terms of the lawsuit settlement agreement.

In October 2004, we issued 750,000 shares of our common stock in a move to settle outstanding litigation matters. In a Settlement Agreement and Mutual Release ("Agreement") between Edge, Eric McAfee and us, the parties would release each other from any claims upon the completion of the terms of the Agreement. As a part of this Agreement, 250,000 shares of our common stock were placed in escrow for the benefit of Edge. In October 2004, we entered into an agreement with Berg McAfee Companies, Energy 2000 and Eric McAfee (collectively, "McAfee Group") to settle several outstanding legal issues. Under this agreement, 500,000 shares of our common stock were placed in escrow for the benefit of the McAfee Group. In return, the McAfee Group contributed 875,000 shares of NGS. Further detail on these agreements can be found in the "litigation" section of this Form 10-KSB. The shares of stock were issued in transactions we believe to be exempt from registration under Section 4(2) of the Securities Act. The recipient of our stock was an accredited investor as defined in Rule 501 of Regulation D promulgated under Section 4(2) of the Securities Act and had access to information concerning us and our business prospects. Furthermore, no advertisements were made and the securities are restricted pursuant to Rule 144.

On October 23, 2003, we sold 833,333 shares of our common stock to Gryphon Master Fund, L.P. at $6.00 per share for total proceeds of $5,000,000. Since the 30 day average closing price of our common stock dropped below $6.00 per share in the ten months subsequent to the agreement, we were required to issue 277,778 additional shares of common stock in the fourth quarter of 2004 for no additional compensation. Therefore a total of 1,111,111 common shares were issued for an average price of $4.50 per share under this transaction. Stonegate Securities, Inc. served as our placement agent and offering costs associated with the sale were $420,000 in cash, warrants to purchase 83,334 shares of our common stock at $6.00 per share expiring October 24, 2008 and 20,000 shares of our common stock. The warrants are exercisable until October 24, 2008 by paying cash at the exercise price or by electing a cashless exercise. The transaction was a private offering we believe to be exempt from registration under Regulation D promulgated under Section 4(2) of the Securities Act. The sales of stock were to individuals or entities, each of whom was an accredited investor, as that term is defined in Rule 501 of Regulation D promulgated under Section 4(2) of the Securities Act and had adequate access to information pertaining to us. Furthermore, no advertisements were made and the securities are restricted pursuant to Rule 144.

On July 18, 2003, we, as RDGI, executed an Agreement and Plan of Merger with Verdisys whereby the shareholders of Verdisys received 25,103,223 shares of our common stock in exchange for all of the 25,103,223 shares of Verdisys common stock then outstanding. The operations and management of Verdisys became our own, and we changed our name to Verdisys Inc. The shares of stock were issued in the transaction we believe to be exempt from registration under Regulation D promulgated under Section 4(2) of the Securities Act. The issuances were a share for share exchange resulting in a similar investment to that originally contemplated due to the continuation of management and business plan; the recipients in the exchange were accredited investors as defined in Rule 501 of Regulation D promulgated under Section 4(2) of the Securities Act, and took their shares for investment purposes without a view to distribution; they had access to information concerning us and our business prospects; there was no general solicitation or advertising for the purchase of our shares; there were no commissions paid; and the securities are restricted pursuant to Rule 144.

*Common Stock Issued Upon Exercise of Options*

| Date | Shares Issued Upon Exercise | Value | Comment |
|---|---|---|---|
| Second Quarter of 2004 | 344,583 | $ 34,458 | |
| First Quarter of 2004 | 25,000 | $ 2,500 | |
| Fourth Quarter of 2003 | 100,000 | $ 10,000 | |
| Second Quarter of 2003 | 2,409,291 | $ 240,929 | In lieu of cash, we agreed to expense the exercise price. |

*Common Stock Issued Upon Exercise of Warrants*

| Date | Shares Issued Upon Exercise | Value | Comment |
|---|---|---|---|
| Second Quarter of 2004 | 57,658 | $ 5,766 | |
| First Quarter of 2004 | 779,597 | $ 38,494 | Includes cash less exercise of 400,000 warrants for 395,022 shares of common stock. |
| Fourth Quarter of 2003 | 245,631 | $ 29,564 | |
| Third Quarter of 2003 | 269,547 | $ 177,751 | |
| Second Quarter of 2003 | 430,000 | $ 56,500 | |
| Second Quarter of 2003 | 950,000 | $ 95,000 | Accounts payable reduced in lieu of cash for exercise. |
| Second Quarter of 2003 | 200,000 | $ 20,000 | Note payable reduced in lieu of cash for exercise. |

18

*Options*

The following table summarizes option grants for the last three years:

| Date | Number of Shares | Exercise Price | Market Price | Vesting | Term (years) | Fair Value | To Whom Issued |
|---|---|---|---|---|---|---|---|
| July 2004 | 770,000 | $ 0.90 | $ 0.90 | Quarterly over 3 years | 10 | $ 689,232 | Officers |
| May 2004 | 72,000 | $ 2.20 | $ 2.20 | Quarterly over 1 year | 10 | $ 156,913 | Non-employee directors |
| Jan 2004 | 230,000 | $ 4.28 | $ 4.28 | Quarterly over 1 year | 10 | $ 890,785 | Officers |
| Jan 2004 | 80,000 | $ 4.28 | $ 4.28 | Immediate | 10 | $ 309,840 | Non-employee directors |
| Dec 2003 | 500,000 | $ 9.55 | $ 9.55 | 10% immediate, 80% over 12 months, 10% on performance | 10 | $ 4,061,703 | Officer/director |
| Aug 2003 | 100,000 | $ 4.10 | $ 4.10 | Quarterly over 1 year | 5 | $ 321,024 | Employee |
| April 2003 | 750,000 | $ 0.10 | $ 0.50 | Quarterly over 3 years | 10 | N/A | Officer |
| April 2003 | 250,000 | $ 0.10 | $ 0.50 | Quarterly over 1 year | 10 | N/A | Non-employee directors |
| April 2003 | 250,000 | $ 0.10 | $ 0.50 | Quarterly over 1 year | 10 | N/A | Officer/director |
| April 2003 | 30,000 | $ 0.10 | $ 0.50 | Over 4 months | 10 | N/A | Officer |
| Dec 2002 | 3,450,000 | $ 0.10 | $ 0.50 | Quarterly over 4 years | 10 | N/A | Officers and employees |
| June 2002 | 350,000 | $ 0.10 | $ 0.50 | Quarterly over 1 year | 10 | N/A | Officers and directors |
| April 2002 | 105,000 | $ 0.10 | $ 0.50 | Quarterly over 1 year | 10 | N/A | Employees |
| April 2002 | 2,000,000 | $ 0.10 | $ 0.50 | | 10 | N/A | Officer |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| | | | | Quarterly over 2 years | | | |
| April 2002 | 200,000 | $ 0.10 | $ 0.50 | Quarterly over 3 years | 10 | N/A | Employee |
| 2002 | 1,050,000 | $ 0.10 | $ 0.50 | Over 12 months | 10 | N/A | Officers |

We recorded expense of $245,829 and $714,524 for the intrinsic value associated with the options vesting in 2004 and 2003, respectively. The expense is included in selling, general & administrative expense on the statement of operations.

*Warrants*

The following table summarizes warrants granted for the last three years:

| Date | Number of Shares | Exercise Price | Term (years) | Other |
|---|---|---|---|---|
| Jan & Feb 2005 | 408,000 | $ 1.00 | 2 | Issued in connection with Private Placement. |
| Jan & Feb 2005 | 15,800 | $ 1.00 | 2 | Offering costs of Private Placement. |
| October 2004 | 100,000 | $ 0.001 | 1 | Issued in connection with aggregate convertible notes of $200,000 to Berg McAfee and Eric McAfee. The notes have been discounted for the relative fair value of the warrants. |
| October 2004 | 250,000 | $ 0.50 | 3 | Issued to Alberta as part of a licensing agreement. The fair value of $199,750 was expensed in 2004. |
| August 2004 | 140,000 | $ 0.80 | 2 | Issued to certain subcontractors and the fair value of $98,000 was expensed in 2004. 20% of the warrants vest immediately and the balance vest 20% every 90 days thereafter. |
| July 2004 | 100,000 | $ 0.001 | 1 | Issued in connection with $200,000 in convertible notes to third party lenders. The notes have been discounted for the relative fair value of the warrants. |
| July 2004 | 75,000 | $ 0.01 | 2 | Issued in connection with $150,000 in convertible notes to third party lenders. The notes have been discounted for the relative fair value of the warrants. |
| May & June 2004 | 71,800 | $ 2.00 | 2 | Issued in connection with Private Placement. |

| | | | | | |
|---|---|---|---|---|---|
| June 2004 | 7,180 | $ | 2.00 | 2 | Offering costs of Private Placement. |
| May 2004 | 37,000 | $ | 2.00 | 1 | Issued in connection with $185,000 in promissory notes to third party lenders. The notes have been discounted for the relative fair value of the warrants. |
| Fall 2003 | 92,835 | $ | 6.00 | 5 | Issued in connection with raising $5,000,000 from Gryphon and the fair value of $822,738 has been treated as a cost of fundraising. |
| Fall 2003 | 9,501 | $ | 2.00 | 5 | |
| Summer 2003 | 150,000 | $ | 0.10 | 1 | Part of a settlement, along with $28,000 in cash, with the two original founders for various debts recorded on the books at $576,000. The warrants were valued at $0.40 per share or $60,000, resulting in a contribution to capital of $488,000. |

| | | | | | |
|---|---|---|---|---|---|
| May 2003 | 2,644,438 | $ | 0.10 | Var | Issued to former employees and the fair value of $1,050,687 were expensed in 2003. |
| April 2003 | 200,000 | $ | 0.10 | 4 | Issued to consultants and the fair value of $80,000 was expensed in 2003. |
| April 2003 | 232,334 | $ | 0.75 | 1 | Previously expired warrants were extended. |
| 2002 | 120,000 | $ | 0.10 | 4 | Issued to investors and fair value of $4,800 expensed in 2002. |
| 2002 | 980,000 | $ | 0.10 | 5 | Issued to consultants and the fair value of $392,000 was expensed in 2002. |

**Item 6. Management's Discussion and Analysis or Plan of Operation**

The following discussion does not purport to be complete and should be read in conjunction with the Financial Statements and Notes thereto included in this report. This discussion contains certain forward-looking statements that involve substantial risks and uncertainties. When used in this report the words "anticipate," believe," "estimate," "expect" and similar expressions as they relate to our management or us are intended to identify such forward-looking statements. Our actual results, performance or achievements could differ materially from those expressed in, or implied by, these forward-looking statements. Historical operating results are not necessarily indicative of the trends in operating results for any future period.

Our mission is to substantially improve the economics of existing oil and natural gas operations through the application of our licensed and proprietary technologies. We have been striving to develop a commercially viable lateral drilling technology with the potential to penetrate through well casing and into reservoir formations to stimulate oil and gas production. In 2003, with the acquisition of exclusive rights to a proprietary horizontal drilling process we began to deploy lateral drilling services in the field. In mid 2004, it became apparent that this process was limited in its application to various types of oil and gas formations. After redesigning and improving the existing process and designing and testing some newer technologies, we now believe that we can deliver a valuable and cost effective production enhancement service to onshore oil and gas producers, particularly operators of marginally producing fields. The goal is to make this new service reliably predictable and consistently dependable for our customers. Our next step is to build our first new generation lateral drilling rig with the capability of abrasive fluid jetting and generating much higher hydraulic horsepower. Following favorable results and customer acceptance of this initial rig's capabilities, we intend to order the construction of additional rigs and significantly grow the deployment of our abrasive jetting service. Funding for developing this abrasive cutting capability into a lateral drilling application is expected to come from current and future capital commitments as well as from the proceeds of the assignment of the exclusive rights acquired in 2003. No assurances can be given that the capital from these sources will be adequate. If this is the case, we will be required to obtain additional capital from equity markets. No assurances can be given that such capital will be available or that the terms will be acceptable.

*Risk factors*

Although we believe that our expectations regarding future events are based on reasonable assumptions, we cannot assure you that such expectations regarding future developments will be realized. Actual results could differ materially from those discussed in the forward-looking statements as a result of certain factors, including the risk factors described below. The risks and uncertainties described below are not the only ones we face; there may be additional risks and uncertainties not presently known to us or those we currently believe are immaterial which could also have a negative impact on our business, financial condition and operating results.

## GENERAL RISKS RELATING TO OUR COMPANY

**1. We have a limited operating history, which makes it difficult to evaluate our business performance.**

We have been in existence for a few years, but we have been conducting drilling operations using the proprietary lateral drilling technology only since June 2003 and satellite services to the oil and gas industry only since June 2002. We have commenced the construction of our first rig utilizing the abrasive jetting technology to the down-hole milling and lateral jetting techniques. Abrasive jetting has been successfully commercialized in several industries but is not yet proven in the energy drilling industry. Because we have a limited operating history, there is little historical financial data upon which an investor may evaluate our business performance. Our revenue and income potential are unproven. An investor must consider the risks, uncertainties, expenses and difficulties frequently encountered by companies in their early stages of development, particularly companies with limited capital in a rapidly evolving market. These risks and difficulties include our ability to develop our infrastructure, reliability in the milling process in our lateral drilling technology, attract and maintain a base of customers, provide customer support, personnel, and facilities to support our business, and respond effectively to competitive and technological developments. Our business strategy may not be successful or may not successfully address any of these risks or difficulties. While we believe our business model will permit us to generate substantial revenues, there is no guarantee that the revenues will be realized. Failure to realize the revenue may have a material adverse effect on our financial condition.

**2. We are an investment risk because business and marketing strategies planned are not proven.**

We have no established basis to assure investors that business or marketing strategies will be successful. We are highly dependent upon the acquisition of subscribers for our satellite division; selection of, and productivity from, appropriate oil and gas wells; as well as the effective application of technologies and services within operations. Our business model and marketing strategies anticipate such application and productivity, yet are unproven by a significant history of business operations. Failure to prove that our business model and strategies work through continued operations may have a material adverse effect on our business and financial condition.

**3. We may require additional capital in the future, which may not be available to us.**

We may need to raise additional funds through public or private debt or equity financing or other various means. Adequate funds may not be available when needed or may not be available on favorable terms. If we raise additional funds by issuing equity securities, dilution to existing stockholders will result, and such equity may have rights, preferences and privileges senior to those of our common stock. If we raise additional funds by issuing debt securities, we may be required to agree to covenants that may restrict our ability to expend or raise capital in the future. If funding is insufficient at any time in the future, we may be unable to fund acquisitions, take advantage of business opportunities or respond to competitive pressures. Failure to raise additional capital in the future may have a material adverse effect on our financial condition.

**4. Our auditors have expressed doubt as to our ability to continue as a going concern.**

As noted in the Independent Auditors Report (See Financial Note 2), our continued substantial operating losses raise substantial doubt as to our ability to continue as a going concern. We are in an early stage of development and are rapidly depleting our cash resources, therefore we have determined that we will need to raise additional financing in the short term to continue in operation and fund future growth. We incurred liquidated damages claimed by an investor of $500,000 related to the timing of providing registration rights for the private financing that it arranged in November 2003. We also have significant contingent liabilities, which may be determined adversely to us. If we are unable to raise additional financing to satisfy these obligations this would have a material adverse effect on our operations.

We currently plan to raise additional financing. The use of stock for currency in financing or making acquisitions may be heavily curtailed while we are under SEC investigation. (See Financial Note 17) If we are unable to arrange new financing or generate sufficient revenue from new business arrangements, we will be unable to continue in our current form and will be forced to restructure or seek creditor protection.

**5. We experienced operating losses in 2002, 2003 and 2004, and this trend may continue.**

We suffered net losses of $3,128,782 for the year ended December 31, 2002, $7,356,045 for the year ended December 31, 2003, and $8,766,108 for the year ended December 31, 2004. The volatility underlying the early stage nature of our business and our industry prevents us from accurately predicting future operating conditions and results, and we could continue to have losses. It is uncertain when, if ever, we will have significant operating income or cash flow from operations sufficient to sustain operations. If cash needs exceed available resources, there can be no assurances that additional capital will be available through public or private equity or debt financings. Sustained losses will continue to have a material adverse effect on our business.

**6. Significant amounts of our outstanding common shares are restricted from immediate resale but may be available for resale into the market in the near future, possibly causing the market price of our common stock to drop significantly.**

As of February 28, 2005, we had 34,973,673 shares of common stock issued, outstanding and held by 481 shareholders of record.

As restrictions on resale for outstanding shares end, the market price could drop significantly if the holders of these restricted shares sell them or are perceived by the market as intending to sell them in an excessive amount relative to the market demand for our shares. An excessive sale of our shares may result in a material adverse effect on the price of our common stock, and our ability to raise capital.

**7. One principal stockholder can influence the corporate and management policies of our company.**

Berg McAfee Companies, and its affiliates, effectively control approximately 30% of the outstanding common stock. Therefore, Berg McAfee Companies, and its affiliates, may have the ability to substantially influence all decisions made by us. Additionally, Berg McAfee Companies, and its affiliates, control could have a negative impact on any future takeover attempts or other acquisition transactions. Furthermore, certain types of equity offerings require stockholder approval depending on the exchange on which shares of a company's common stock is

traded. In the event we are required to obtain stockholder approval of a financing, Berg McAfee Companies, and its affiliates ownership, could block such a financing. The control by one principal stockholder results in less control by our board of directors, management and the remaining stockholders. Please read 'Certain Relationships and Related Transactions.'

**8. We may sustain losses resulting from our extension of credit to non-paying customers.**

We have, prior to February 2004, conducted much of our drilling activities for related parties, and we did not require collateral in support of our account receivables. This resulted, on occasion, in an impediment to us obtaining full payment for accounts receivable. Although we are implementing procedures to combat this credit risk, there can be no assurance that our efforts will be successful. Failure to guard against credit risk may have a material adverse effect on our financial condition.

**9. Securities and Exchange Investigation Inquiries may continue to draw on our limited financial resources and continue to negatively impact our ability to raise additional capital.**

We received notice that the Securities and Exchange Commission has initiated a formal investigation into our reporting practices and public statements about the company in 2003.

The SEC has requested substantiation and documentary evidence from us concerning the performance of certain lateral drilling services by subcontractors in the period from May 2003 to September 2003, supervision of such services by our executive management at the time, revenue recognition related to the performance of such services, the third quarter 2003 earnings restatement, public statements concerning the services performed, and related matters. The SEC has also requested information and documentary evidence related to our acquisition of certain assets of QuikView, Inc., a related party company, in June 2003. In its letters to us requesting documents, the SEC stated that the staff's inquiry should not be construed as an indication that any violations of securities laws have occurred or as an adverse reflection on any persons, company or security.

Since December 2003, we have taken several steps to address issues related to the SEC's inquiries, including the termination and replacement of the previous Chief Executive Officer and Chief Operating Officer. Two directors have resigned from our board and we have appointed a new CFO. Internal controls have been strengthened overall, particularly with respect to the public release of information and the recognition of revenue. We also initiated an internal investigation of the matters of concern to the SEC. Consequently, we restated our second and third quarter financial statements for 2003 and decided to defer all revenue related to the aforementioned period until such time that we can substantiate whether or not the services were performed.

We are cooperating fully with the SEC, including the provision of numerous documents and voluntary testimony by our current executives. In December 2004, the staff of the SEC notified us that it was considering recommending that the SEC bring a civil injunction (including a possible permanent injunction and a civil penalty) against us alleging violations of provisions of the Sections 10(b), 13(b)(2)(A), 13(b)(2)(B) and 15(d) of the Securities Exchange Act of 1934 and rules promulgated thereunder in connection with the purchase and sale of our securities, recordkeeping, internal controls, certification and disclosure obligations. We were notified of our right to make a Wells submission. We have provided information to the SEC setting forth the specific steps we have taken to upgrade the quality and effectiveness of our board of directors, replace the previous management team with industry experts, improve our recordkeeping, internal and disclosure controls, and revenue recognition procedures. Although we are working to bring the matter to a prompt conclusion, we cannot make any assurance that the investigation will be resolved positively or that it will not have negative effects on our limited resources or our ability to raise capital and use our stock as acquisition currency during the period of the investigation.

**10. We have entered into a settlement agreement relating to the litigation with Edge. If we do not perform certain obligations under the settlement agreement, the lawsuit could be reinstituted. An adverse finding the in the lawsuit would have a material adverse effect on our financial condition.**

We initiated a lawsuit against Edge in Montgomery County, Texas in February 2004 that requested a declaratory judgment that a purported agreement between us and Edge was not enforceable. The lawsuit arose from Edge's contention that one of our ex-officers committed the company to purchase certain alleged oil and gas properties from Edge. Edge filed a counterclaim against us and asserted claims against new parties including persons related to Edge's financing source and current and our former officers and directors. Edge sought to enforce the agreement we challenge, and alleged several causes of action including claims for fraud, breach of contract, negligence, and conspiracy and claimed actual and punitive damages in excess of $85 million.

Effective January 19, 2005, we, Edge, certain entities affiliated with Edge, and Eric McAfee (our former Vice-Chairman) entered into a Settlement Agreement and Mutual Release to fully settle and resolve the disputes between Edge and its affiliated entities, us and our directors, and Mr. McAfee. As part of the settlement, we issued to Edge Capital an aggregate of 750,000 shares of its common stock, along with warrants to purchase 750,000 shares of common stock. In addition, we also agreed to provide to Edge a drilling rig to provide certain lateral drilling services. As part of the drilling services, Edge has agreed to provide a fee per well, along with a share of the revenues generated from each well drilled. Also, as part of the settlement, at closing, we agreed to sublicense its Landers horizontal drilling technology to Edge on a non-exclusive basis to enable Edge to develop fields in which it has an economic interest. Under the sublicense, Edge will be prohibited from performing services for others, except that it will have a limited right of first refusal to perform such services in the event we elect to not perform such services. The sublicense will have a 5-year term and be limited to the United States and Canada. As part of the settlement, the parties to the agreement have agreed to a mutual release and have agreed to dismiss all pending claims and litigation between them upon performance of the obligations in the settlement agreement. If we do not perform our remaining obligations under the settlement agreement, this would cause the release to not be effective and could lead to the underlying lawsuit being reinstituted. An adverse finding in such lawsuit against us would have a material adverse effect on our financial condition. See "Legal Proceedings."

**11. We are subject to certain additional lawsuits. If these lawsuits are successful and substantial damages are awarded, these damages would have a material adverse effect on our financial condition.**

In February 2005, we entered into an Agreed Judgment and Order of Severance with Gryphon as to all breach of contract claims related to our delay in registering common stock acquired by Gryphon in October 2003. Under the terms of the Agreed Judgment, we are obligated to pay liquidated damages and attorney fees of $500,000 to Gryphon on or before September 30, 2005. Additionally, Gryphon has agreed to abate their remaining claims and related discovery in the lawsuit against us until after September 30, 2005. We agreed to register the shares issued to Gryphon on or before March 2004 or be subject to certain liquidated damages. Gryphon made a claim against us for the maximum liquidated damages in an amount of $400,000. Gryphon has also claimed that it has sustained actual damages in excess of $6.2 million. In July 2004, Gryphon filed a lawsuit in state district court in Dallas, Texas against us, alleging, among other things, breach of contract and securities fraud by us. In connection with the lawsuit, Gryphon requested liquidated damages, actual damages, punitive damages, interest, cost and attorneys' fees among other claims. We intend to vigorously defend ourselves in this matter with respect to the remaining claims of Gryphon.

In July, 2004 we were informed that our former Chief Executive Officer filed a lawsuit against us for breach of contract and wrongful discharge. These claims seek relief in excess of $500,000 related to an alleged employment agreement and damages related to an excess of 4 million stock options claimed due pursuant to the alleged agreement. The lawsuit was filed in state court in San Diego, California. We intend to vigorously defend ourselves.

An adverse outcome in any of the above litigation would have a material adverse effective on our financial condition and result of operations. Please see the section 'Legal Proceedings.'

**12. Our common stock is currently traded over the counter on the Over-the-Counter market and is considered a "penny stock" resulting in potential illiquidity and high volatility in the market price of our common stock.**

The market price of our common stock is likely to be highly volatile as is the stock market in general as well as the capital stock of most small cap companies. Our common stock currently trades over the counter on the OTC Bulletin Board, where stocks typically suffer from lower liquidity. This may lead to depressed trading prices, greater price volatility and difficulty in buying or selling shares in large quantities. Currently, there is a limited trading market for our common stock, and we cannot predict when, if ever, a fully developed public market for the common stock will occur.

**13. Because our common stock is considered a "penny stock," certain rules may impede the development of increased trading activity and could affect the liquidity for stockholders.**

Penny stocks generally are equity securities with a price of less than $5.00 per share other than securities registered on certain national securities exchanges or quoted on the NASDAQ stock market, subject to certain exceptions for companies which exceed certain minimum tangible net worth requirements.

Our common stock is subject to the SEC's "penny stock rules". The rules impose additional sales practice requirements on broker-dealers who sell penny stock securities to persons other than established customers and accredited investors. For transactions covered by these rules, the broker-dealer must make a special suitability determination for the purchase of penny stock securities and have received the purchaser's written consent to the transaction prior to the purchase. Additionally, for any transaction involving a penny stock, unless exempt, the "penny stock rules" require the delivery, prior to the transaction, of a disclosure schedule relating to the penny stock market. The broker-dealer also must disclose the commissions payable to both the broker-dealer and the registered representative and current quotations for the securities. And, monthly statements must be sent disclosing recent price information on the limited market in penny stocks. These rules may restrict the ability of broker-dealers to sell our securities and may have the effect of reducing the level of trading activity of our common stock in the secondary market. In addition, the penny-stock rules could have an adverse effect on our ability to raise capital in the future from offerings of our common stock.

On January 12, 2004, the SEC proposed amendments to the penny stock rules to ensure that investors continue to receive the protections of those rules. The SEC also is proposing that broker-dealers be required to enhance their disclosure schedule to investors who purchase penny stocks, and that those investors have an explicit "cooling-off period" to rescind the transaction. These amendments could place further constraints on broker-dealers' ability to sell our securities.

**14. Our operations are subject to inherent risks that are beyond our control and these risks may not be fully covered under our insurance policies.**

Our operations are subject to hazards inherent in the oil and gas industry, such as accidents, blowouts, explosions, craterings, fires and oil spills. These conditions can cause:

- personal injury or loss of life;
- damage to or destruction of property, equipment and the environment; and
- suspension of operations.

In addition, claims for loss of oil and gas production and damage to formations can occur in the well service industry. Litigation arising from a catastrophic occurrence at a location where our equipment and services are being used may result in us being named as a defendant in lawsuits asserting large claims.

We maintain insurance coverage that we believe to be customary in the industry against these hazards. However, we may not be able to maintain adequate insurance in the future at rates we consider reasonable. In addition, our insurance is subject to coverage limits and some policies exclude coverage for damages resulting from environmental contamination. The occurrence of a significant event or adverse claim in excess of the insurance coverage that we maintain or that is not covered by insurance could have a materially adverse effect on our financial condition and results of operations.

**15. We are subject to various operational and performance risks related to projects that we undertake and services that we provide.**

We are subject to various operational and performance risks related to projects that we undertake and services that we provide. These risks include:

- changes in the price or the availability of commodities that we use;
- non-performance, default or bankruptcy of key suppliers or subcontractors;
- cost over-runs and operating cost inflation resulting from fixed-price projects; and
- failure by one or more parties to perform a complex business arrangement for technically demanding projects.

Failure to guard against operational and performance risks may have a material adverse effect on our financial condition.

**16. Our markets may be adversely affected by oil and gas industry conditions that are beyond our control.**

Oil and gas industry conditions are influenced by numerous factors over which we have no control, such as the supply of and demand for oil and gas, domestic and worldwide economic conditions, political instability in oil producing countries and merger and divestiture activity among oil and gas producers. Those conditions could adversely impact the level of drilling and workover activity by some of our customers. This reduction in activity may cause a decline in the demand for our services or adversely affect the price of our services. We cannot accurately predict either the future level of demand for our services or future conditions of the well service industry. A decline in the demand for our services may have a material adverse effect on our business.

**17. Our success depends on key members of our management, the loss of whom could disrupt our business operations.**

We depend to a large extent on the services of some of our executive officers and directors. The loss of the services of either John O'Keefe, or David Adams could disrupt our operations. We have entered into employment agreements with several of our key executives that contain non-compete provisions. Notwithstanding these agreements, we may not be able to retain our executive officers and may not be able to enforce the non-compete provisions in the employment agreements. Failure to retain key members of our management may have a material adverse effect on our business.

## RISKS RELATED TO OUR ABRASIVE JETTING DRILLING BUSINESS

**1. We currently have no active customers and in the past were highly dependent on a small number of customers, two of whom are related parties.**

We have no active customers for our abrasive jetting lateral drilling services since we are in the construction mode. We currently have only indications of interest in the new AFJ drill rig once it is placed into service. We can give no assurance that these indications of interest will turn into actual customers.

In the past a relatively limited number of customers has accounted for a substantial portion of our revenue. One customer accounted for 14%, 38% and 87% of total revenues in 2004, 2003 and 2002, respectively. In the second half of 2003, 53% of our revenue was derived from services provided to three customers. Of those three customers, two may be considered related parties. In the same period, 52% of our revenue was derived from services provided to the two related parties. In addition, Edge, our only non-related customer in that period, has refused to pay for wells drilled in the second half of 2003, resulting in a total of $1,993,000 being reversed or deferred.

We expect that a high percentage of our revenue from our AFJ services will be provided by a limited number of customers for the near term or until we can deploy additional AFJ drill rigs.

**2. We may not be able to protect our abrasive jetting lateral drilling technology which could result in competition with service providers utilizing an infringing technology.**

The license agreement allocates responsibility in maintaining the status of the patents underlying the technology we license with the U.S. Patent and Trademark Office to the licensor. Although the licensor has performed this obligation in the past, there can be no assurance that the licensor will have the ability to continue to maintain the patents. In the event we had to assume these responsibilities additional pressure on our financial resources would result. An inability to continue operations under the exclusivity granted by the licensing agreement may have a material adverse effect on our business.

**3. Our customers may not realize the expected benefits from our abrasive jetting lateral drilling technology, which may impair market acceptance of our lateral drilling services.**

Our lateral drilling business is heavily dependent upon our clients achieving enhanced production, or lower costs, from certain types of existing oil and gas wells. Many of the wells for which the abrasive jetting lateral drilling technology will be used on have been abandoned for some time due to low production volumes or other reasons. In some cases, we have experienced difficulty in having the enhanced production reach the market due to the gathering field pipeline system's disrepair resulting from the age of the fields and the reliability of the milling process. There can be no assurance that our abrasive jetting lateral drilling technology will achieve enhanced production from every well drilled, or that, if enhanced production is achieved initially, it will continue for the duration necessary to achieve payout or that it will reach the market on a timely basis. The failure to achieve projected enhancements could result in making the application of the technology uneconomic for our clients. Please see the section 'Abrasive Jetting Lateral Drilling Services' for an explanation on how we will attempt to achieve an economic benefit for our clients. Failure to achieve an economic benefit for our clients in the provision of this service may have a material adverse effect on our business.

**4. We may be unable to accurately identify oil and gas wells on which our abrasive jetting lateral drilling technology will enhance oil and gas recovery, which may impair the market acceptance of our lateral drilling services.**

Our lateral drilling business is heavily dependent on our ability to correctly identify with our clients, the appropriate oil and gas wells that will produce the enhanced revenues or lower costs. Certain subsurface conditions are not conducive to the use of our high pressure abrasive jetting lateral drilling technology, and certain wells may have been severely depleted or otherwise negatively impacted in some manner by the operator. While we have added an evaluation screening technique and other new technology and improvements relating to analysis of depleted fields, the failure to identify the correct types of oil and gas wells could result in not realizing the expected economic returns which could initially have a material adverse effect on our business, financial condition and operating results.

**5. Competition within the well service industry may adversely affect our ability to market our services.**

The well service industry is highly competitive and includes several large companies, such as Halliburton, Baker Hughes, Schlumberger and other independent drilling companies that possess substantially greater financial and other resources than we do. These greater resources could allow those competitors to compete more effectively than we can. Additionally, the number of rigs available continues to exceed demand, resulting in active price competition. Moreover, many contracts are awarded on a bid basis, which further increases competition based on price. Failure to successfully compete within our industry may have a material adverse effect on our business.

**6. We may be subject to environmental requirements which may increase our costs or liabilities related to our lateral drilling operations.**

Given the manner in which we currently operate our business, we are not regulated to the extent that an oil and gas company is with respect to environmental laws, rules and regulations in the U.S. and other countries, including those covering hazardous materials, because we generally do not own the properties we service. However, environmental requirements generally are becoming increasingly strict. In the future, we may be held liable for certain failures relating to environmental regulations. Sanctions for failure to comply with these requirements, many of which may be applied retroactively, may include:

- administrative, civil and criminal penalties;
- revocation of permits; and
- corrective action orders, including orders to investigate and/or clean up contamination.

Liability for damages arising as a result of environmental laws could be substantial and could have a material adverse effect on our results of operations. The liabilities incurred as a result of complying with environmental requirements or failure on our part to comply with applicable environmental requirements may have a material adverse effect on our financial condition. There can be no assurance that governmental laws will not broaden in scope in the future to cover the types of services that we currently provide. Failure to comply with environmental laws could have a material negative impact on our financial condition.

**7. Changes in environmental laws may decrease demand for our services.**

Changes in environmental laws may negatively impact demand for our services. Activity by oil and gas exploration and production companies may decline if, for example, the Environmental Protection Agency promulgates more stringent environmental regulations such as land use policies. If oil and gas exploration and production activities decline, this could have a material adverse effect on our operating results.

## RISKS RELATED TO OUR SATELLITE BUSINESS

**1. We are highly dependent upon a few key providers who furnish satellite networking components, hardware, and technological services.**

Our satellite business is heavily dependent on agreements with Spacenet, ViaSat and other equipment and service providers. These strategic relationships provide key network technology, satellite data transport, hardware and software. Failure of Spacenet, ViaSat or other key relationships to meet our expectations or termination of a relationship with one of our key providers may have a material adverse effect on our business.

**2. We depend upon our vendors and their affiliates to provide services that we require to operate the network we use to provide services to our customers.**

We are not and do not plan to become a licensee of the Federal Communications Commission ("FCC") and do not hold any authorization to operate satellite communications facilities. We depend upon licenses held by Spacenet and ViaSat and their subsidiaries for our satellite communications. If the licenses held by Spacenet and ViaSat are limited or revoked, if the FCC limits the number of its customer premises earth stations or if Spacenet or ViaSat fails to operate the earth stations providing service to us and our subscribers in a satisfactory manner, our operating results may be materially adversely affected.

**3. We rely on third-party independent contractors to install our customer premises equipment at new subscribers' businesses and homes.**

We do not control the hiring, training, certification and monitoring of the employees of our third-party independent contractors. If growth of our new subscriber base outpaces growth of our installer base or if the installers fail to provide the quality of service that our customers expect, our operating results may be materially adversely affected.

**4. The service we provide is entirely dependent on the functionality of satellites on which we lease transponders and on our computer and communications hardware and software.**

Our ability to provide service is entirely dependent on the functionality of satellites on which we lease transponders. These satellites may experience failure, loss, damage or destruction from a variety of causes, including war, anti-satellite devices and collision with space debris. If this occurs, we are likely to suffer:

- permanent loss of service;
- temporary gaps in service availability; or
- decreased quality of service.

Such a failure in the service we provide may have a material adverse effect on our business, financial condition and operating results.

The ability to provide timely information and services depends also on the efficient and uninterrupted operation of our computer and communications hardware and software systems. These systems and operations are vulnerable to damage or interruption from human error, natural disasters, telecommunication failures, break-ins, sabotage, computer viruses, intentional acts of vandalism and similar events. We are in the process of designing and plan to implement a disaster recovery plan. Despite precautions, there is always the danger that human error or sabotage could substantially disrupt the system. Any such failure may have a material adverse effect on our business.

**5. We may be unable to attract or retain subscribers.**

If we are unable to attract or retain subscribers, our telecommunications business will be harmed. Our success depends upon our ability to rapidly grow our subscriber base. Several factors may negatively impact this ability, including:

- loss of our existing sales employees, resulting in our lack of access to potential subscribers;
- failure to establish and maintain the Verdisys brand through advertising and marketing, or erosion of our brand due to misjudgments in service offerings;

- failure to develop or acquire technology for additional value added services that appeals to the evolving preferences of our subscribers;

- failure to meet our expected minimum sales commitments to Spacenet and ViaSat; and

- failure to provide the minimum transmission speeds and quality of service our customers expect.

In addition, our service may require customers to purchase our satellite system equipment and to pay our monthly subscriber fees. The price of the equipment and the subscription fees may be higher than the price of many dial-up, DSL and cable modem internet access services, where available. In some instances, we expect to subsidize our subscribers' customer premises equipment to encourage the purchase of our service and to offset our higher relative costs but such subsidy may not be possible. Failure to attract or retain subscribers may have a material adverse effect on our business.

**6. We may fail to manage any potential growth or expansion, negatively impacting our quality of service or overcapacity impacting profitability.**

If we fail to manage our potential rapid growth and expansion effectively or expand and allocate our resources efficiently, we may not be able to retain or grow our subscriber base. If our assumptions regarding the usage patterns of our subscribers are wrong or if our subscribers' usage patterns change, we will have either too little or too much satellite capacity, both of which could harm our business.

If we achieve the substantial subscriber growth that we anticipate, we will need to procure additional satellite capacity. If we are unable to procure this capacity, we may be unable to provide service to our subscribers or the quality of service we provide may not meet their expectations. Failure to manage any potential growth may have a material adverse effect on our business.

**7. Our current services may become obsolete due to the highly competitive and continued advancement of the satellite industry. Larger service providers may provide services reduced pricing.**

Intense competition in the internet services market and inherent limitations in existing satellite technology may negatively affect the number of our subscribers. Competition in the market for consumer internet access services is intense, and we expect the level of competition to intensify in the future. We compete with providers of various high-speed communications technologies for local access connections such as cable modem and DSL. We also may face competition from traditional telephone companies, competitive local exchange carriers and wireless communication companies. As our competitors expand their operations to offer high speed internet services, we may no longer be the only high-speed service available in certain markets. We also expect additional competitors with satellite-based networks to begin operations soon. In particular, some satellite companies have announced that in the future they may offer high-speed internet service at the same price or at a lower price than we currently intend to offer and are offering our services. Many of our current and potential competitors have longer operating histories, greater brand name recognition, larger subscriber bases and substantially greater financial, technical, marketing and other resources than we have. Therefore, they may be able to respond more quickly than we can respond to new or changing opportunities, technologies, standards or subscriber requirements. Any such competition may have a material adverse effect on our business.

**8. We may be mistaken in our belief as to future growth of the satellite broadband market.**

While we believe that the trend toward satellite broadband information services in the energy market will continue to develop, our future success is highly dependent on increased use of these services within the sector. The number of satellite broadband users willing to pay for online services and information may not continue to increase. A failure in the market for satellite broadband services to develop as expected may have a material adverse effect on our business.

**9. We may be subject to significant liability for our products.**

If our products contain defects, we may be subject to significant liability claims from subscribers and other users of our products and incur significant unexpected expenses or lost revenues. Our telecommunications products are complex and may contain undetected errors or failures. If this happens, we may experience delay in or loss of market acceptance and sales, products returns, diversion of research and development resources, injury to our reputation or increased service and warranty costs. We also have exposure to significant liability claims from our customers because our products are designed to provide critical communications services. Although we attempt to limit such exposure through product liability insurance and through contractual limitations in our customer agreements, such precautions may not cover all potential claims resulting from a defect in one or more of our products. Failure of our products to perform satisfactorily may have a material adverse effect on our operating results.

**Critical Accounting Policies**

The following is a discussion of our critical accounting policies pertaining to accounts receivable, equipment, license, revenue recognition and the use of estimates.

*Accounts Receivable*

Trade accounts receivable are recorded at the invoiced amount and do not bear interest. The allowance for doubtful accounts represents our estimate of the amount of probable credit losses existing in our accounts receivable. We determine the allowance based on management's estimate of likely losses based on a review of current open receivables and our historical write-off experience. We review the adequacy of our allowance for doubtful accounts quarterly. Significant individual accounts receivable balances and balances which have been outstanding greater than 90 days are reviewed individually for collectibility. Account balances, when determined to be uncollectible, are charged against the allowance.

*Equipment*

Equipment, including betterments which extend the useful life of the asset, are stated at cost. Maintenance and repairs are charged to expense when incurred. We provided for the depreciation of our equipment using the straight-line method over the estimated useful lives. Our method of depreciation does not change when equipment becomes idle; we continue to depreciate idled equipment on a straight-line basis. No provision for salvage value is considered in determining depreciation of our equipment. We review our assets for impairment when events or changes in circumstances indicate that the carrying values of certain assets either exceed their respective fair values or may not be recovered over their estimated remaining useful lives. Provisions for asset impairment are charged to income when estimated future cash flows, on an undiscounted basis, are less than the asset's net book value. Impairment charges are recorded based on discounted cash flows. There were no impairment charges to equipment during the years ended December 31, 2004 and 2003.

*License*

In March 2005, we entered into an agreement to sell our lateral drilling license for $1.3 million and have fully impaired the asset while creating an account receivable for the sales value. We provide for amortization of our license using the straight-line method over the estimated useful lives. We review our carrying value of the license for impairment on an annual basis or when events or changes in circumstances indicate that the carrying values may no longer be appropriate. We assess recoverability of the carrying value of the asset by estimating the future net cash flows expected to result from the asset, including eventual disposition. If the future net cash flows are less than the carrying value of the asset, an impairment loss is recorded equal to the difference between the asset's carrying value and fair value. There were no impairment charges to the lateral drilling license during the years ended December 31, 2003 but we charged $3.2 million to impairment expense at December 31, 2004.

*Revenue Recognition*

All revenue is recognized when persuasive evidence of an arrangement exists, the service or sale is complete, the price is fixed or determinable and collectibility is reasonably assured. Revenue is derived from sales of satellite hardware, satellite bandwidth, satellite service and lateral drilling services. Revenue from satellite hardware is recognized when the hardware is installed. Revenue from satellite bandwidth is recognized evenly over the term of the contract. Revenue from satellite service is recognized when the services are performed. We provide no warranty but sell commercially obtained 3 to 12 month warranties for satellite hardware. We have a 30 day return policy. Revenue for lateral drilling services is recognized when the services are performed and collectibility is reasonably assured and when collection is uncertain, revenue is recognized when cash is collected. In accordance with Emerging Issues Task Force Issue No. 00-14, we recognize reimbursements received from third parties for out-of-pocket expenses incurred as revenues and account for out-of-pocket expenses as direct costs.

*Use of Estimates*

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets during the reporting period. Actual results could differ from such estimates.

Estimates are used by management in the following financial reporting areas:

- Allowance for doubtful accounts,
- Depreciation and amortization,

- Asset impairment,
- Income taxes and
- Stock option disclosures.

For additional information on our accounting policies, see Note 1 of Notes to Financial Statements included as part of Item 7 of this Report.

**Fiscal Year ended December 31, 2004 Compared to the Fiscal Year Ended December 31, 2003**

*Lateral Drilling Services*

Lateral Drilling Services' revenues increased by $273,000 to $739,000 for the year ended December 31, 2004 compared to $466,000 for the year ended December 31, 2003. The operating margin from Lateral Drilling Services improved by $419,000 to a loss of $129,000 for the year ended December 31, 2004 compared to a loss of $548,000 for the year ended December 31, 2003. We have had mixed results using the Landers technology and therefore have been unable to generate a profit during either year. The 2003 results were also negatively affected by the initial start-up costs of the lateral drilling service.

Effective as of October 27, 2004, we entered into a licensing agreement to develop a new generation of lateral drilling technology using the AFJ process. In the short term, the development activity will decrease lateral drilling revenues until such time as the new technology rigs are deployed into commercial operations.

*Satellite Communications Services*

Satellite Communication Services' revenues increased by $296,000 to $715,000 for the year ended December 31, 2004 compared to $419,000 for the year ended December 31, 2003. The operating margin from Satellite Communication Services improved by $163,000 to a loss of $6,000 for the year ended December 31, 2004 compared to a loss of $169,000 for the year ended December 31, 2003. As this segment of our business grows it becomes more efficient and realizes economies of scale.

As hardware is sold, we recognize the revenue in the period it is delivered to the customer. We bill some of our bandwidth contracts in advance, but recognize revenue over the period benefited. At December 31, 2004, there was $317,615 reflected in the balance sheet as deferred revenue relating to Satellite Communication Services.

*Selling, General and Administrative*

Selling, general and administrative ("SG&A") expenses decreased by $1.9 million to $4.7 million for the year ended December 31, 2004 compared to $6.6 million for the year ended December 31, 2003. The following table details the major components of SG&A expense over the periods.

| | 2004 | 2003 | Increase (Decrease) |
|---|---|---|---|
| Payroll and related costs | $ 773,538 | $ 828,117 | $ (54,579) |
| Option and warrant expense | 747,480 | 2,392,291 | (1,644,811) |
| License fee | 735,192 | — | 735,192 |
| Legal fees | 718,678 | 518,077 | 200,601 |
| External services | 567,883 | 446,606 | 121,277 |
| Insurance | 447,109 | 157,254 | 289,855 |
| Liquidated damages | 500,000 | — | 500,000 |
| Travel & entertainment | 139,627 | 193,393 | (53,766) |
| Office rent | 66,777 | 42,325 | 24,452 |
| Communications | 55,842 | 60,935 | (5,093) |
| Expired purchase option | — | 620,000 | (620,000) |
| Purchase guarantee | — | 300,000 | (300,000) |
| Impairment on software | — | 1,000,000 | (1,000,000) |
| Miscellaneous | 265 | 55,541 | (55,276) |
| | $ 4,752,391 | $ 6,614,539 | $ (1,862,148) |

31

The decrease in option and warrant expense can be attributed to the fact that in 2004, we started issuing options at market price and therefore recognized no expense under our accounting policy (see Financial Note 14). The license fee is related to the lateral drilling license and note payable with Carl Landers. We issued 300,000 shares of our common stock with a value of $1.9 million to reduce the then outstanding note balance by $1.2 million and record expense of $0.7 million. Legal fees continue to increase due to the level of legal activity we have experienced over the last two years. Our external services have increased due to greater reliance on independent contractors instead of employees and rising audit fees. The increase in the cost of insurance was primarily attributable to the increase in the directors and officers liability policy premium due to legal activity. The liquidated damages relate to our delay in registering shares that we sold (see Financial Note 13). In 2003, we paid $0.5 million for a sixteen day option to purchase a large gas field with significant gas production. The purchase option expired and we incurred additional fees of $120,000 related to the transaction. In 2003, we guaranteed Edge's purchase of oil and gas properties from another entity (see Financial Note 17). In 2003, we issued 2 million shares of common stock for what management believed was satellite communications management software pursuant to an asset purchase agreement with a related party. Subsequently, management determined that the software was impaired by $1.0 million.

*Depreciation and Amortization*

Depreciation and amortization expense increased by $293,000 to $0.5 million for the year ended December 31, 2004 compared to $220,000 for the year ended December 31, 2003. This increase can be attributed to the depreciation on the four drilling rigs in service for 2004, compared to only two rigs in service for three months of 2003 and the amortization on the drilling license acquired in late 2003.

*Debt Forgiveness Income*

In 2003, we negotiated settlements with 9 vendors for various debts originally recorded on the books at $0.5 million for $44,000 cash and 33,333 shares of stock valued at $.50 resulting in debt forgiveness income of $460,000. There was no similar event in 2004.

*Gain or Loss on Sale of Property*

In 2004, we had a net loss from the sale and or disposition of equipment in the normal course of business of $11,000. In 2003, we recognized a gain of $120,000 from the assignment of a 75% net revenue interest in property located in Monroe, Louisiana. We received the net revenue interest from a third party in exchange for agreeing to perform lateral drilling services on the property. In October 2003, we assigned the net revenue interest to Edge for $200,000. Edge paid us $120,000 and agreed to pay the balance of $80,000 by March 31, 2004. The $80,000 was not collected and under terms of the Settlement Agreement and Mutual Release entered into with Edge, we have relinquished our right to these funds (See Item 3. Legal Proceedings).

*Asset Impairment Expense*

We charged $3,175,000 to impairment expense at December 31, 2004 to recognize the difference in the carrying value and the market price when we entered into the sale of the Landers license to Maxim for $1.3 million.

*Interest Expense*

Interest expense decreased by $108,000 to $105,000 for the year ended December 31, 2004 compared to $213,000 for the year ended December 31, 2003. The decrease in expense can be attributed to an average debt outstanding for the year ended December 31, 2004 of approximately $0.7 million compared to average debt outstanding of approximately $1.9 million for the year ended December 31, 2003.

*Net Loss*

The net loss for the year ended December 31, 2004 increased to $8.8 million from $7.4 million for the year ended December 31, 2003. The increase is attributable to the major items explained above. The tax benefit associated with our loss has been fully reserved as we have recurring net losses and it is more likely than not that tax benefits will not be realized.

**Liquidity and Capital Resources**

As of December 31, 2004 and 2003, our cash balance was $267,000 and $1.4 million, respectively. The cash balance at December 31, 2003 was generated by an equity offering and was utilized to pay debt and to fund operations. We have $185,000 of debt that becomes due on May 14, 2005, $350,000 of convertible notes that becomes due on December 31, 2005 and a $50,000 note that is due on demand. In addition, we have $200,000 of convertible notes with related parties that mature on May 31, 2006. Both sets of convertible notes are convertible into common stock at the rate of one share for each $2.00 of principal and interest outstanding.

In February 2005, we entered into an Agreed Judgment and Order of Severance with Gryphon as to all breach of contract claims related to our delay in registering common stock acquired by Gryphon in October 2003. Under the terms of the Agreed Judgment, we are obligated to pay liquidated damages of $0.5 million to Gryphon on or before September 30, 2005. In March 2005, we agreed to sell our master license for the Landers lateral drilling technology and retain a sub-license for $1.3 million in cash and the release of $270,000 of supplier obligations. The 1.3 million will be collected over the course of 2005.

We are also subject to significant contingent liabilities as more fully described in the Notes to the Financial Statements (See Financial Note 17).

As noted in the Independent Auditors Report (See Financial Note 2) due to the continued substantial operating losses that we have incurred raises substantial doubt as to our ability to continue as a going concern. We are in an early stage of development and are rapidly depleting our cash resources, therefore we have determined that we will need to raise additional financing in the short term to continue in operation and fund future growth. We currently plan to raise additional financing in the quarter ending March 31, 2005. The use of stock for currency in financing or making acquisitions has been heavily curtailed while we have been under SEC investigation. (See Financial Note 17) If we are unable to arrange new financing or generate sufficient revenue from new business arrangements, we will be unable to continue in our current form and will be forced to restructure or seek creditor protection.

**Capital Expenditures**

We expect to spend approximately one million dollars in 2005 for the building of the first rig utilizing the AFJ cutting technology. As of December 31, 2004, we had no commitments towards this project. The project will be financed either through the issuance of stock, debt, project equity or from the proceeds of the license sold in March of 2005. Capital expenditures for 2004 were $3,705 as compared to $799,493 from 2003. Capital expenditures for 2003 include the purchase of four drilling rigs for $737,720.

**Research and Development, Patents and Licenses**

We believe our future success depends on the ability to effectively utilize the lateral drilling technology obtained in a license granted by Mr. Landers and the AFJ technology currently under development. See "Patents and Licenses" in the Description of Business section of this Form 10-KSB.

**Item 7. Financial Statements**

**Index to Financial Statements**

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors
Verdisys, Inc.
Houston, Texas

We have audited the accompanying balance sheet of Verdisys, Inc. as of December 31, 2004 and the related statements of operations, stockholders' equity (deficit) and cash flows for each of the two years then ended. These financial statements are the responsibility of Verdisys' management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits 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 financial statements referred to above present fairly, in all material respects, the financial position of Verdisys, Inc. as of December 31, 2004 and the results of its operations and cash flows for each of the two years then ended in conformity with accounting principles generally accepted in the United States of America.

The accompanying financial statements have been prepared assuming that Verdisys will continue as a going concern. As discussed in Note 2 to the financial statements, Verdisys suffered recurring losses from operations and has a working capital deficiency, which raises substantial doubt about its ability to continue as a going concern. Management's plans regarding those matters also are described in Note 2. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

As described in Note 23, the accompanying financial statements as of December 31, 2004 and the year then ended have been restated to reflect the impairment of the carrying value of the Company's intellectual property as of December 31, 2004.

MALONE & BAILEY, PC

www.malone-bailey.com

Houston, Texas

March 21, 2005 (March 29, 2006 as to the effects of the restatement as described in Note 23)

**VERDISYS, INC.**
BALANCE SHEET
December 31, 2004

| | | |
|---|---|---|
| **ASSETS** | | (Restated) |
| | | |
| Current Assets | | |
| Cash | $ | 266,917 |
| Accounts receivable, net of allowance for doubtful accounts of $30,000 | | 58,726 |
| Lease receivable | | 125,000 |
| License receivable | | 1,300,000 |
| Other current assets | | 44,076 |
| Total Current Assets | | 1,794,719 |
| | | |
| Equipment, net of accumulated depreciation of $130,467 | | 447,401 |
| License, net of accumulated amortization of $549,167 | | - |
| Total Assets | $ | 2,242,120 |
| | | |
| **LIABILITIES AND STOCKHOLDERS' DEFICIT** | | |
| | | |
| Current Liabilities | | |
| Accounts payable | $ | 738,442 |
| Accrued expenses | | 1,270,732 |
| Deferred revenue | | 254,726 |
| Customer deposit | | 276,850 |
| Notes payable - related parties, net of unamortized discount of $7,674 | | 102,326 |
| Notes payable, net of unamortized discount of $74,148 | | 400,852 |
| Total Current Liabilities | | 3,043,928 |
| | | |
| Long Term Liabilities | | |
| Notes payable - related parties, net of unamortized discount of $50,622 | | 149,378 |
| Deferred revenue, less current portion | | 81,878 |
| Total Liabilities | | 3,275,184 |
| | | |
| Commitments & Contingencies | | |
| | | |
| Stockholders' Deficit | | |
| Common Stock, $.001 par value, 50,000,000 shares authorized, 33,443,691 shares issued and outstanding | | 33,444 |
| Additional paid-in capital | | 26,000,119 |
| Accumulated deficit | | (27,066,627) |
| Total Stockholders' Deficit | | (1,033,064) |
| Total Liabilities and Stockholders' Deficit | $ | 2,242,120 |

See accompanying summary of accounting policies and notes to financial statements.

36

**VERDISYS, INC.**
STATEMENTS OF OPERATIONS
Years Ended December 31, 2004 and 2003

| | 2004 | 2003 |
|---|---|---|
| **Revenue** | (Restated) | |
| Satellite Service - third parties | $ 714,634 | $ 419,247 |
| | | |
| Drilling Services | | |
| Third parties | 716,163 | 7,444 |
| Related parties | 22,547 | 458,750 |
| Total Revenue | 1,453,344 | 885,441 |
| | | |
| **Cost of Services Provided** | | |
| Satellite Services | | |
| Third parties | 720,912 | 588,498 |
| Drilling Services | | |
| Third parties | 868,160 | 787,560 |
| Related parties | — | 226,611 |
| Total Cost of Services Provided | 1,589,072 | 1,602,669 |
| **Gross Loss** | (135,728) | (717,228) |
| | | |
| **Operating Expenses** | | |
| Selling, general & administrative | 4,752,391 | 6,614,539 |
| Depreciation and amortization | 512,706 | 219,692 |
| Bad debts | 73,249 | 172,003 |
| Asset Impairment | 3,175,833 | — |
| **Operating Loss** | (8,649,907) | (7,723,462) |
| | | |
| **Other (Income) Expense** | | |
| Debt forgiveness income | — | (460,235) |
| Loss (gain) on sale of property | 11,237 | (120,000) |
| Interest income | (89) | (417) |
| Interest expense | 105,053 | 213,235 |
| Total other (income) expense | 116,201 | (367,417) |
| **Net Loss** | $ (8,766,108) | $ (7,356,045) |
| Basic and diluted net loss per share | $ (.28) | $ (.33) |
| Weighted average shares outstanding | 31,415,041 | 22,180,185 |

See accompanying summary of accounting policies and notes to financial statements.

**VERDISYS, INC.**
STATEMENT OF STOCKHOLDERS' EQUITY (DEFICIT)
Years Ended December 31, 2003 and 2004 (Restated)

| | Preferred Stock | | Common Stock | |
|---|---|---|---|---|
| | **Shares** | **Amount** | **Shares** | **Amount** |
| Balances, December 31, 2002 | 1,410,000 | $ 705,000 | 13,553,139 | $ 13,553 |
| | | | | |
| Series B preferred stock exchanged for common stock | (1,410,000) | (705,000) | 1,410,000 | 1,410 |
| | | | | |
| Stock issued for: | | | | |
| Cash, net of fundraising costs | | | 2,740,733 | 2,741 |
| Services | | | 4,679,194 | 4,679 |
| Accounts payable | | | 33,333 | 33 |
| Notes payable and accrued interest | | | | |