

TIDELANDS OIL & GAS CORP/WA
Form 10-Q
November 19, 2008

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

Form 10-Q

(MARK ONE)

QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2008

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT
For the transition period from _____ to _____

Commission File Number: 0-29613

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

Nevada
(State of incorporation)

66-0549380
(IRS Employer ID Number)

1862 West Bitters Rd., San Antonio, TX 78248
(Address of principal executive offices)

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

Check whether the issuer has (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 the Company was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller

Reporting Company

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

As of November 14, 2008, there were 217,754,324 shares of Common Stock issued and outstanding.

Transitional Small Business Disclosure Format: Yes o No x

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FORM 10-Q

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PART I – FINANCIAL INFORMATION

Item 1. Financial Statements

TIDELANDS OIL & GAS CORPORATION
CONSOLIDATED BALANCE SHEETS
(UNAUDITED)

ASSETS

| | September 30, 2008 | December 31, 2007 |
|--|-----------------------|----------------------|
| Current Assets: | | |
| Cash | \$ 8,628 | \$ 5,794 |
| Accounts and Other Receivable | 93,222 | 7,116 |
| Note Receivable | 800,000 | - |
| Prepaid Expenses | 114,599 | 177,099 |
| Current Portion of Assets of Discontinued Operations | - | 734,713 |
| Total Current Assets | 1,016,449 | 924,722 |
| Property Plant and Equipment, Net of Accumulated Depreciation of \$95,677 and \$81,202, Respectively – Continuing Operations | | |
| Property Plant and Equipment, Net – Discontinued Operations-Held for Sale | 3,152,845 | 2,953,661 |
| Total Property, Plant and Equipment, Net | - | 4,118,666 |
| Investment in Affiliate – Cost Method | 3,152,845 | 7,072,327 |
| Other Assets: | | |
| Deposits | 250,000 | 2,809,801 |
| Cash Restricted | 146,724 | 200,379 |
| Deferred Charges | - | 43,467 |
| Goodwill | 181,333 | - |
| Non-Current Portion of Assets of Discontinued Operations-Held for Sale | - | 800,428 |
| Total Other Assets | 328,057 | 1,430,322 |
| Total Assets | \$ 4,747,351 | \$ 12,237,172 |

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TIDELANDS OIL & GAS CORPORATION
CONSOLIDATED BALANCE SHEETS
(CONTINUED)
(UNAUDITED)

LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)

| | September 30, 2008 | December 31, 2007 |
|--|--------------------------|-------------------------|
| Current Liabilities: | | |
| Current Maturities – Note Payable | \$ 1,192,277 | \$ 7,533,039 |
| Accounts Payable and Accrued Expenses | 866,333 | 1,985,829 |
| Accrued Expenses – Due to Related Parties | 1,500,000 | - |
| Reserve for Litigation | - | 2,250,000 |
| Current Portion of Liabilities of Discontinued Operations | - | 743,380 |
| Due to Related Party | 172,375 | - |
| Total Current Liabilities | 3,730,985 | 12,512,248 |
| Long-Term Debt | 1,000,000 | - |
| Total Liabilities | 4,730,985 | 12,512,248 |
| Commitments and Contingencies | - | - |
| Stockholders' Equity (Deficit): | | |
| Common Stock, \$.001 Par Value per Share, 250,000,000 Shares Authorized, 214,999,909 and 108,226,836 Shares Issued and Outstanding at September 30, 2008 and December 31, 2007, Respectively | 215,001 | 108,227 |
| Additional Paid-in Capital | 60,964,482 | 55,868,098 |
| Accumulated Deficit | (61,163,117) | (56,251,401) |
| Total Stockholders' Equity (Deficit) | 16,366 | (275,076) |
| Total Liabilities and Stockholders' Equity (Deficit) | \$ 4,747,351 | \$ 12,237,172 |

See Accompanying Notes to Consolidated Financial Statements

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

| | Three Months Ended September 30, 2008 | Three Months Ended September 30, 2007 |
|--|--|--|
| Revenues: | | |
| Consulting Fees | \$ 30,000 | \$ - |
| Total Revenues | 30,000 | - |
| Costs and Expenses: | | |
| Depreciation | 6,050 | 6,242 |
| Selling, General and Administrative | 1,263,816 | 638,416 |
| Impairment – Investment in Affiliate | 2,559,801 | - |
| Total Costs and Expenses | 3,829,667 | 644,658 |
| Loss From Operations | (3,799,667) | (644,658) |
| Other Income (Expenses) | | |
| Gain on the Sale of Assets | 900 | 156,480 |
| Interest Expense | (59,029) | (245,357) |
| Interest and Dividend Income | 10,211 | 167 |
| Reduction of Reserve for Litigation | 2,239,600 | - |
| Miscellaneous | (8,803) | 93,390 |
| Total Other Income | 2,182,879 | 4,680 |
| Net Loss from Continuing Operations | (1,616,788) | (639,978) |
| Net Loss from Operations of Discontinued Segments Including Loss on Disposal of Equipment \$179,443 at September 30, 2007 | - | (237,797) |
| Net Loss | \$ (1,616,788) | \$ (877,775) |
| Loss Per Common Share: Basic and Diluted | | |
| Loss from Continuing Operations | \$ (0.01) | \$ (0.01) |
| Loss from Discontinued Operations | 0.00 | (0.00) |
| Total | \$ (0.01) | \$ (0.01) |
| Weighted Average Number of Common Shares Outstanding, Basic and Diluted | 196,869,627 | 106,425,046 |

See Accompanying Notes to Consolidated Financial Statements

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

| | Nine Months Ended September 30, 2008 | Nine Months Ended September 30, 2007 |
|---|---|---|
| Revenues: | | |
| Consulting Fees | \$ 105,000 | \$ - |
| Total Revenues | 105,000 | - |
| Costs and Expenses: | | |
| Depreciation | 18,152 | 18,770 |
| Selling, General and Administrative-Related Parties | - | 3,638,000 |
| Selling, General and Administrative | 5,175,506 | 3,766,691 |
| Impairment – Investment in Affiliate | 2,559,801 | - |
| Total Costs and Expenses | 7,753,459 | 7,423,461 |
| Loss From Operations | (7,648,459) | (7,423,461) |
| Other Income (Expenses) | | |
| Gain on Sale of Assets | 900 | 156,480 |
| Interest Expense | (238,425) | (772,304) |
| Interest and Dividend Income | 21,145 | 752 |
| Reduction of Reserve for Litigation | 2,239,600 | |
| Miscellaneous | 7,751 | 93,390 |
| Total Other Income (Expenses) | 2,030,971 | (521,682) |
| Net Loss from Continuing Operations | (5,617,488) | (7,945,143) |
| Net Income (Loss) from Operations of Discontinued Segments Including Gain on Disposal of Equipment of \$847,087 at September 30, 2008 and Loss on Disposal of Equipment of \$179,443 and an Impairment Loss – Long Lived Assets of \$2,605,061 at September 30, 2007 | 705,772 | (2,717,072) |
| Net Loss | \$ (4,911,716) | \$ (10,662,215) |
| Loss Per Common Share: Basic and Diluted | | |
| Loss from Continuing Operations | \$ (0.03) | \$ (0.08) |
| Loss from Discontinued Operations | 0.00 | (0.03) |
| Total | \$ (0.03) | \$ (0.11) |
| Weighted Average Number of Common Shares Outstanding, Basic and Diluted | 165,928,519 | 97,199,835 |

See Accompanying Notes to Consolidated Financial Statements

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

| | Nine Months Ended September 30, 2008 | Nine Months Ended September 30, 2007 |
|--|--|--|
| Cash Flows From Operating Activities: | | |
| Net Income/(Loss) | | |
| From Continuing Operations | \$ (5,617,488) | \$ (7,945,143) |
| From Discontinued Operations | 705,772 | (2,717,072) |
| Adjustments to Reconcile Net Loss To Net Cash Used In Operating Activities: | | |
| Depreciation | | |
| From Continuing Operations | 18,152 | 18,770 |
| From Discontinued Operations | 43,764 | 314,444 |
| Impairment Loss | 2,559,801 | 2,605,061 |
| Reversal of Litigation Reserve | (2,239,600) | - |
| (Gain) Loss on Disposal of Assets | (418,162) | 179,443 |
| (Gain) on Sale of Subsidiary | (429,825) | (156,480) |
| Issuance of Common Stock: | | |
| For Services Provided – Related Parties | - | 5,011,763 |
| For Services Provided – Other | 3,218,963 | 1,049,791 |
| Changes in: | | |
| Accounts Receivable | 264,183 | (33,708) |
| Inventory | 224,132 | (18,285) |
| Prepaid Expenses | 142,613 | (153,974) |
| Deferred Charges | (181,333) | 565,221 |
| Deposits | 54,013 | (65,438) |
| Accounts Payable and Accrued Expenses | 840,201 | 1,272,791 |
| Customer Deposits | (10,800) | 10,350 |
| Net Cash (Used) In Operating Activities | (825,614) | (62,466) |
| Cash Flows From Investing Activities: | | |
| Proceeds – Sale of Subsidiary and Other Assets | 5,205,595 | 1,310,236 |
| Investment in Affiliate | - | (62,601) |
| (Increase) Decrease in Restricted Cash | 70,648 | (1,478) |
| Acquisitions of Property, Plant and Equipment | (217,336) | (1,774,175) |
| Net Cash Provided (Used) In Investing Activities | 5,058,907 | (528,018) |

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

| | Nine Months Ended September 30, 2008 | Nine Months Ended September 30, 2007 |
|--|--|--|
| Cash Flows From Financing Activities: | | |
| Cost of Warrant Buy-Backs | (20,714) | - |
| Proceeds from Exercise of Stock Options | - | 790,000 |
| Proceeds from Short-Term Loan | - | 251,220 |
| Proceeds from Long-Term Loan | 200,000 | - |
| Repayment of Convertible Debentures and Loan | (4,662,299) | - |
| Loan from Related Party | 172,375 | - |
| Net Cash Provided (Used) by Financing Activities | (4,310,638) | 1,041,220 |
| Net Increase (Decrease) in Cash | (77,345) | 450,736 |
| Cash at Beginning of Period | | |
| From Continued Operations | 5,794 | 367,437 |
| From Discontinued Operations | 80,179 | - |
| Total | 85,973 | 367,437 |
| Cash at End of Period | | |
| From Continued Operations | 8,304 | 795,559 |
| From Discontinued Operations | 324 | 22,614 |
| Total | \$ 8,628 | \$ 818,173 |
| Supplemental Disclosures of Cash Flow Information: | | |
| Cash Payments for Interest | \$ 165,223 | \$ 125,817 |
| Cash Payments for Income Taxes | \$ - | \$ - |

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

| | Nine Months Ended September 30, 2008 | Nine Months Ended September 30, 2007 |
|--|--|--|
| Non-Cash Activities: | | |
| Issuance of Common Stock: | | |
| Operating Activities | \$ 3,218,963 | \$ 2,423,554 |
| Payments of Accrued Expenses & Accounts Payable | - | 343,244 |
| Conversion of Debentures | - | 2,000,000 |
| Payment of Note Payable | 1,994,509 | - |
| Cashless Warrant Exercise | 24,761 | - |
| Conversion of Accounts Payable to Notes Payable | 1,192,277 | - |
| Legal Fee – Retainer | - | 130,616 |
| Prepaid Legal Fees | - | 27,083 |
| Litigation Settlement | 10,400 | - |
| Assumption of Note Payable by Third Party | 876,231 | - |
| Long-Term Loan Payable | 800,000 | - |
| Less Related Long-Term Loan Receivable | (800,000) | - |
| Cancellation of Common Stock: In Settlement of Stock | | |
| Subscriptions | - | (220,000) |
| Total Non-Cash Activities | \$ 7,317,141 | \$ 4,704,497 |

See Accompanying Notes to Consolidated Financial Statements

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TIDELANDS OIL & GAS CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2008
(UNAUDITED)

NOTE 1 –BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements for the nine-month periods ended September 30, 2008, and 2007, have been prepared in conformity with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Regulation S-X. Please note that the prior year's presentations for the Consolidated Statement of Operations and the Consolidated Statements of Cash Flows were changed to conform to current year's presentation. The financial information as of December 31, 2007, is derived from the registrant's Form 10-K for the year ended December 31, 2007. Certain information or footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America that would substantially duplicate the disclosures contained in the registrant's Form 10-K for the year ended December 31, 2007, have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission.

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. In the opinion of management, the accompanying financial statements include all adjustments necessary (which are of a normal and recurring nature) for the fair presentation of the results of the interim periods presented. While the registrant believes that the disclosures presented are adequate to keep the information from being misleading, it is suggested that these accompanying financial statements be read in conjunction with the registrant's audited consolidated financial statements and notes for the year ended December 31, 2007, included in the registrant's Form 10-K for the year ended December 31, 2007.

Operating results for the nine-month period ended September 30, 2008, are not necessarily indicative of the results that may be expected for the remainder of the fiscal year ending December 31, 2008. The accompanying unaudited consolidated financial statements include the accounts of the registrant and its wholly-owned subsidiary, Esperanza Energy, LLC. All significant inter-company accounts and transactions have been eliminated in consolidation. The accounts of Sonterra Energy Corporation, Reef International, LLC, and Reef Marketing, LLC, are shown up through their dates of sale. The accounts of Reef Ventures, LP, and Arrecefe Management, LLC, its General Partner, are shown up through the sale of their assets with the exception of continuing incidental expenses.

NOTE 2 – GOING CONCERN

The Company has sustained recurring losses and negative cash flows from operations. Over 2007, the Company's growth had been funded through issuance of convertible debentures. As of September 30, 2008, the Company had approximately \$8,628 of unrestricted cash. However, the Company has experienced and continues to experience negative cash flows from operations, as well as an ongoing requirement for substantial additional capital investment. The Company needs to raise substantial additional capital to accomplish its business plan this year and over the next several years. The Company is seeking to obtain such additional funding through private equity sources, from financial partners for some of its projects and from continued reduction of operating expenses. There can be no assurance as to the availability or terms upon which such financing and capital might be available.

The Company's ability to continue as a going concern will depend on management's ability to successfully implement a business plan which will increase revenues, control costs, and obtain additional forms of debt and/or equity financing or financial partners. These financial statements do not include any adjustments that might be necessary if the Company is unable to continue as a going concern.

NOTE 3 – SALE OF SONTERRA ENERGY CORPORATION

On January 9, 2008, the Company sold its wholly-owned subsidiary, Sonterra Energy Corporation ("Sonterra"), to Bentley Energy Corporation, a company controlled by our former CEO. Sonterra is a propane distribution company operating in Central Texas.

The sales price for Sonterra was \$3 million of which \$2,925,000 was paid at closing. The remaining \$75,000 is due on or before January 9, 2009, and is subject to use to defend and pay possible claims from previous legal actions against Sonterra. (See NOTE 12 – Litigation)

The proceeds of the transaction were primarily utilized to repay all the outstanding principal balance on the Company's convertible debentures totaling \$2,374,291.

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TIDELANDS OIL & GAS CORPORATION
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 SEPTEMBER 30, 2008
 (UNAUDITED)

NOTE 4 – SALE OF THE ASSETS OF REEF VENTURES, LP

On March 25, 2008, Reef Ventures, L.P. ("Reef Ventures"), a subsidiary of Tidelands Oil & Gas Corporation (the "Company"), entered into and consummated a Purchase and Sale Agreement (the "Purchase and Sale Agreement") with West Texas Gas, Inc. ("WTG") for the sale of all of the issued and outstanding membership interests of Reef International, LLC ("Reef International") and Reef Marketing, LLC ("Reef Marketing", and collectively with Reef Ventures and Reef International, the "Reef Entities"), both of which were wholly-owned subsidiaries of Reef Ventures, and all the assets of the Reef Entities, which consist of assets related to the "River Crossing Project", the "Carrizo Springs Pipeline System", the "Peña Creek Gathering System" and the "Chittim Gas Plant" (collectively referred to as the "Assets").

The total purchase price for the Assets, after adjustments required by the Purchase and Sale Agreement, was \$2,484,262 (the "Purchase Price") in cash, and the execution by WTG of a Throughput Payment Agreement (the "Throughput Payment Agreement") with Impact International, LLC ("Impact").

The Company caused Reef Ventures to deliver \$2,436,825 of the Purchase Price to Impact on behalf of the Company, as partial repayment of the outstanding principal and interest of a promissory note made by the Company to Impact dated May 25, 2004, in the original principal amount of \$6,523,773 (the "Note"). The Company repaid the remainder of the outstanding principal and interest on the Note by requiring WTG to enter into the Throughput Payment Agreement with Impact for which Impact credited the outstanding Note balance \$876,231, and by issuing 39,890,180 shares (the "New Shares") of the Company's common stock valued at \$0.05 per share, for a total of \$1,994,509, to Impact upon the closing of the Purchase and Sale Agreement. The total consideration described above of \$5,307,505 liquidated the outstanding Note balance in full. The remaining \$47,437 of the Purchase Price received by Reef Ventures was used to pay legal fees associated with the transaction and for working capital purposes.

NOTE 5 – DISCONTINUED OPERATIONS AND ASSETS HELD

Sonterra Energy Corporation

The sale of the Company's wholly-owned subsidiary, Sonterra Energy Corporation, resulted in gain of \$429,825 which was subject to possible future reduction (See NOTE 12 – Litigation) for the fiscal period ended September 30, 2008.

Reef Ventures, LP

The sale of the assets of Reef Ventures, LP, the Company's 97% owned subsidiary, resulted in a gain of \$417,262 for the fiscal period ended September 30, 2008.

We have accounted for the sale of these assets in accordance with FAS 144 – Accounting for the Impairment or Disposal of Long-Lived Assets. Pursuant to FAS 144, we have separated the detail of the individual assets, liabilities and results from operations of these projects from our consolidated balance sheet and statement of operations at September 30, 2008, as follows:

| September | December |
|-----------|----------|
| 30, | 31, |
| 2008 | 2007 |

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| Assets of Discontinued Subsidiaries: | | |
|---|----|----------------|
| Cash | \$ | - \$ 80,179 |
| Accounts and Other Receivables | | - 350,289 |
| Inventory | | - 224,132 |
| Prepaid Expenses | | - 80,113 |
| Property, Plant and Equipment, Net | | - 4,118,666 |
| Other Assets | | - 386,048 |
| Total Assets | \$ | - \$ 5,239,427 |
| Liabilities of Discontinued Subsidiaries: | | |
| Accounts Payable and Accrued Expenses | \$ | - \$ 732,580 |
| Customer Deposits | | - 10,800 |
| Total Liabilities | \$ | - \$ 743,380 |

| | Nine Months Ended | |
|---|--------------------------|-----------------------|
| | September 30, 2008 | September 30, 2007 |
| Revenues of Discontinued Subsidiaries | \$ 1,397 | \$ 1,992,898 |
| Costs and Expenses | (142,712) | (2,097,908) |
| Impairment Loss | 0 | (2,605,061) |
| Gain (Loss) on Sale of Reef Ventures, LP's Assets | 417,262 | (7,001) |
| Gain on Sale of Sonterra Energy Corporation | 429,825 | - |
| Net Income from Discontinued Operations | \$ 705,772 | \$ (2,717,072) |

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TIDELANDS OIL & GAS CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2008
(UNAUDITED)

NOTE 6 – FINANCING TRANSACTION - GOLDEN GATE INVESTORS, INC.

On May 9, 2008, the Company completed a financing transaction in which it entered into a Securities Purchase Agreement ("Purchase Agreement") with Golden Gate Investors, Inc. ("Golden Gate") which provided for the issuance and sale by the Company of up to \$3 million of 6% convertible debentures, with the initial issuance of a \$1 million debenture ("Debenture") and the payment of cash by Golden Gate of \$200,000 and issuance by Golden Gate to the Company of a \$800,000 promissory note ("Note"). The Purchase Agreement provides Golden Gate with the right to lend, in two separate transactions, an additional \$1 million of funding to the Company, in its sole discretion, through advancing cash of \$200,000 and issuing a note for the balance, similar to the Note. The Company had the right until August 8, 2008, to redeem, at a price equal to the principal and accrued interest, the Debenture provided that no event of default had occurred. This redemption did not occur.

The Debenture is unsecured and bears interest at the annual rate of 6%, payable monthly, in cash or, at Golden Gate's election, in shares of the Company's stock valued at the applicable conversion price described further below, with the principal amount due on May 9, 2011. The Debenture may not be prepaid without the written consent of Golden Gate. The Debenture is convertible, either in whole or in part, at any time at a per share price equal to the lesser of \$.50 or 80% of the average of the three lowest volume weighted average prices during the twenty trading days prior to Golden Gate's election to convert. If Golden Gate elects to convert a portion of the Debenture, and on the date of the election, the volume weighted average price per share of the Company's common stock is below \$0.07, the Company has the right to prepay the portion of the Debenture that Golden Gate elected to convert, plus any accrued and unpaid interest, at 100% of the amount due and the conversion notice will be withdrawn.

In the event the Company's stock trades at a price that is less than \$0.01 per share at any time during the nine-month period following May 9, 2008, the interest rate on the Debenture will increase to 9 ³/₄ % for the remaining term of the Debenture. In the event this provision is triggered, within three business days of a written request from Golden Gate, the Company is required to prepay the amount of interest that would otherwise be due from the date of the request through the maturity date. If any portion of the Debenture is converted into the Company's common stock prior to maturity, the Company will be entitled to a refund of the pro rata portion of the interest prepayment attributable to the portion of the principal amount converted. On August 26, 2008, the Company received notice from Golden Gate that effective July 28, 2008, the interest rate on the Debenture was increased to 9 ³/₄ % pursuant to the terms of Debenture and that the Interest Prepayment amount of \$270,328.77 was due to Golden Gate within three days of the notice. To date, the Company has not made such prepayment of interest to Golden Gate and Golden Gate has not given notice of default on the Debenture to the Company.

In accordance with the terms of the Debenture, the Company has reserved 35,000,000 shares of its common stock for possible conversion. The Company's stock transfer agent has received irrevocable instructions regarding the shares reserved.

The Note is secured and bears interest at the annual rate of 6.25%, payable monthly, with the principal amount due on May 31, 2011. Golden Gate has the option to prepay this note, subject to the satisfaction of certain conditions. On August 26, 2008, Golden Gate gave notice that the interest rate on the Note was decreased to 4³/₄%, effective as of July 28, 2008 in accordance with the terms of the Note which provides for such reduction in the event that the Company's common stock trades at a price that is less than \$0.01 per share at any time during the nine-month period

after May 9, 2008.

The Company analyzed the provision of the Debenture in accordance with the provisions of SFAS 133, "Accounting for Derivative Instruments and Hedging Activities" and EITF 00-19, "Accounting for Derivative Financial Instruments Indexed to and Potentially Settled in, a Company's Own Stock" and determined that the Debenture did not contain any derivative features that would require separate accounting under this literature.

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TIDELANDS OIL & GAS CORPORATION
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 SEPTEMBER 30, 2008
 (UNAUDITED)

NOTE 7 – PROPERTY, PLANT AND EQUIPMENT

A summary of property, plant and equipment at September 30, 2008 and December 31, 2007 is as follows:

| | September 30, 2008 | December 31, 2007 | Estimated Economic Life |
|---|--------------------------|-------------------------|-------------------------------|
| Pre-Construction Costs: | | | |
| Domestic LNG System | \$ 3,115,882 | \$ 2,898,546 | N/A |
| Total | 3,115,882 | 2,898,546 | |
| Office Furniture, Equipment and Leasehold Improvements | 132,640 | 136,317 | 5 Years |
| Total | 3,248,522 | 3,034,863 | |
| Less: Accumulated Depreciation | 95,677 | 81,202 | |
| Net Property, Plant and Equipment | \$ 3,152,845 | \$ 2,953,661 | |

Depreciation expense for the nine months ended September 30, 2008 and 2007 was \$18,152, and \$18,770, respectively.

A summary of property, plant and equipment at September 30, 2008 and December 31, 2007 for Discontinued Operations is as follows:

| | September 30, 2008 | December 31, 2007 | Estimated Economic Life |
|---|-----------------------|----------------------|-------------------------------|
| Office Furniture, Equipment and Leasehold Improvements | \$ - | \$ 55,086 | 5 Years |
| Pipeline – Eagle Pass, TX to Piedras Negras, Mexico | - | 3,501,194 | 20 Years |
| Tanks & Lines – Propane Distribution System | - | 1,942,936 | 5 Years |
| Machinery and Equipment | - | 71,580 | 5 Years |
| Trucks, Autos and Trailers | - | 126,464 | 5 Years |
| Total | - | 5,697,260 | |
| Less: Accumulated Depreciation | - | 1,578,594 | |
| Net Property, Plant and Equipment | \$ - | \$ 4,118,666 | |

Depreciation expense for the nine months ended September 30, 2008 and 2007 was \$43,764 and \$314,444 respectively, and has been included in Net Income from Operations of Discontinued Segments.

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TIDELANDS OIL & GAS CORPORATION
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NOTE 8 – LONG-TERM DEBT

A summary of long-term debt at September 30, 2008 and December 31, 2007 is as follows:

| | September 30, 2008 | December 31, 2007 |
|---|-----------------------|----------------------|
| Note Payable, Secured by Reef International Pipeline, Interest Bearing at 2% Over Prime Rate Per Annum, Maturing May 25, 2008 | \$ - | \$ 5,158,748 |
| Convertible Debentures, Unsecured, Including Prepaid Interest at 9% Per Annum, Maturing January 20, 2008 | - | 2,374,291 |
| Convertible Debentures, Unsecured, Interest Bearing at 6% Per Annum, Maturing May 9, 2011 | 1,000,000 | - |
| Note Payable, Unsecured, Interest Bearing at 10% Per Annum, Maturing March 31, 2009 (see below) | 1,192,277 | - |
| | 2,192,277 | 7,533,039 |
| Less: Current Maturities | 1,192,277 | 7,533,039 |
| Total Long-Term Debt | \$ 1,000,000 | \$ - |

On January 21, 2008, the Company issued notes totaling \$1,192,277 in payment of accounts payable and accrued interest due to entities providing various services to its Port Esperanza LNG Project. These notes, bearing interest at 10% per annum, were originally due April 30, 2008 and have been extended until March 31, 2009. The Company has paid all interest due as of August 31, 2008, a total of \$72,516 of which \$40,178 was paid on October 15, 2008.

NOTE 9 – COMMON STOCK TRANSACTIONS

A summary of common stock transactions for the three months ended March 31, 2008 is as follows:

The Company issued 245,252 shares of its common stock valued at \$15,816 for preparation of a study of internal controls and procedures.

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TIDELANDS OIL & GAS CORPORATION
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NOTE 9 – COMMON STOCK TRANSACTIONS (CONTINUED)

The Company issued 3,083,333 shares each of its common stock to two of its Directors for Directors Fees valued at \$385,417 each.

The Company issued 3,083,333 shares of its common stock to the President for a Directors Fee valued at \$385,417.

The Company issued 2,302,217 shares of its common stock for past consulting services valued at \$138,384.66 regarding the Port Esperanza project and in payment of \$27,767 transaction costs.

The Company issued 5,300,000 shares of its restricted common stock for consulting services valued at \$386,900.

The Company issued 211,134 shares of its restricted common stock valued at \$16,680 to two holders of the Company's Stock Warrants under cashless exercise provisions which reduced the total number of warrant shares outstanding by 243,616 for purpose of cancellation (See NOTE 10 – Stock Options...).

The Company cancelled 2,071,407 Stock Warrants for \$20,714, which reduced additional paid-in capital (See NOTE 10 – Stock Options...).

The Company issued 2,599,440 shares of its common stock to settle debts of \$46,400 and in payment of an \$87,471 financing fee.

The Company issued 39,890,180 shares of its restricted common stock valued at \$1,994,509 in payment of the balance due Impact International, LLC, after remitting the net proceeds from the sale of its International Pipeline between the United States and Mexico to West Texas Gas, Inc.

The Company issued 3,571,429 shares each of its restricted common stock valued at \$250,000 to two of its Directors in payment of consulting fees for the three months ended March 31, 2008.

The Company issued 3,571,429 shares of its common stock valued at \$250,000 to the President pursuant to his employment contract.

A summary of common stock transactions for the three months ended June 30, 2008 is as follows:

The Company issued 3,600,689 shares of its common stock for consulting services valued at \$118,133 regarding the Port Esperanza project and in payment of \$23,626 transaction costs.

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TIDELANDS OIL & GAS CORPORATION
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NOTE 9 – COMMON STOCK TRANSACTIONS (CONTINUED)

The Company issued 217,391 shares of its common stock for consulting services valued at \$7,609 and in payment of \$2,391 transaction costs.

The Company issued 230,905 shares of its restricted common stock valued at \$8,082 to a holder of the Company's Stock Warrants under cashless exercise provisions. There are no further Stock Warrants outstanding (See NOTE 10 – Stock Options...).

The Company issued 850,000 shares of its common stock for consulting services valued at \$25,000 regarding the Port Esperanza project and in payment of \$5,000 transaction costs.

The Company issued 1,074,695 shares of its common stock for legal services valued at \$30,170 and in payment of \$9,205 transaction costs.

The Company issued 280,715 shares of its common stock for corporate secretary services and related costs valued at \$5,813 and in payment of \$1,163 transaction costs.

The Company issued 434,706 shares of its common stock to an Officer for salary valued at \$9,196 and in payment of \$1,839 transaction costs.

The Company issued 875,720 shares of its common stock to an Officer for salary valued at \$18,525 and in payment of \$3,705 transaction costs.

A summary of common stock transactions for the three months ended September 30, 2008 is as follows:

The Company issued 666,667 shares of its common stock for consulting services valued at \$10,000 regarding the Port Esperanza project and in payment of \$2,000 transaction costs.

The Company issued 1,111,111 shares of its common stock for legal services valued at \$6,980 and in payment of \$13,020 transaction costs.

The Company issued 200,000 shares of its common stock for corporate secretary services and related costs valued at \$2,500 and in payment of \$500 transaction costs.

The Company issued 2,060,577 shares of its common stock to an Officer for salary valued at \$29,056 and in payment of \$7,811 transaction costs.

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TIDELANDS OIL & GAS CORPORATION
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NOTE 9 – COMMON STOCK TRANSACTIONS (CONTINUED)

The Company issued 2,887,835 shares of its common stock to an Officer for salary valued at \$38,992 and in payment of \$8,481 transaction costs.

The Company issued 3,769,553 shares of its common stock to three employees for salaries and related expenses valued at \$26,665 and in payment of \$41,189 transaction costs.

The Company issued 16,000,000 shares of its common stock to settle debts of \$31,598 and in payment of a \$108,102 financing fee.

The Company issued 1,000,000 shares of its restricted common stock valued at \$5,200 in partial payment of the settlement of litigation with Betty Sheerin et al regarding the ZG Pipeline.

The Company executed a Stop Payment Cancellation which released 1,000,000 shares of its restricted common stock valued at \$5,200 as the final payment of the settlement of litigation with Betty Sheerin et al regarding the ZG Pipeline.

NOTE 10 – STOCK OPTIONS, STOCK WARRANTS AND SHARES RESERVED FOR CONVERTIBLE DEBENTURES

The following table presents the activity for options, warrants and shares reserved for issuance upon conversion of outstanding convertible debentures for the nine months ending September 30, 2008:

| | Stock Options | Stock Warrants | Shares Reserved for Convertible Debentures | Total Shares | Weighted Average Exercise Price |
|---------------------------------|------------------|-------------------|--|-----------------|--|
| Outstanding – December 31, 2007 | 20,380,953 | 2,545,928 | 2,729,068 | 25,655,949 | \$ 0.324 |
| First Quarter | | | | | |
| Granted / Issued | - | - | - | - | - |
| Exercised/Converted | - | (243,616) | - | (243,616) | 0.935 |
| Expired | - | - | (2,729,068) | (2,729,068) | 0.870 |
| Cancelled/Extinguished | - | (2,071,407) | - | (2,071,407) | 0.935 |
| Outstanding – March 31, 2008 | 20,380,953 | 230,905 | - | 20,611,858 | \$ 0.183 |
| Second Quarter | | | | | |
| Granted / Issued | - | - | 35,000,000 | 35,000,000 | 0.285 |
| Exercised/Converted | - | (230,905) | - | (230,905) | 0.935 |
| Expired | - | - | - | - | - |
| Cancelled/Extinguished | - | - | - | - | - |

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| | | | | | | |
|-----------------------------|------------|---|------------|------------|----|-------|
| Outstanding – June 30, 2008 | 20,380,953 | - | 35,000,000 | 55,380,953 | \$ | 0.823 |
|-----------------------------|------------|---|------------|------------|----|-------|

There were no changes in options, warrants and shares reserved for issuance upon conversion of outstanding convertible debentures for the three months ending September 30, 2008.

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TIDELANDS OIL & GAS CORPORATION
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NOTE 10 – STOCK OPTIONS, STOCK WARRANTS AND SHARES RESERVED FOR CONVERTIBLE DEBENTURES (CONTINUED)

Summary of Outstanding Stock Options and Stock Warrants

| | Stock Options | Shares Reserved for Convertible Debenture | Exercise Price |
|--|-------------------|---|----------------------|
| Stock Options | | | |
| Expiration Date | | | |
| February 28, 2017 | 12,380,953 | - | \$ 0.210 |
| May 23, 2017 | 8,000,000 | - | 0.120 |
| Shares Reserved for Convertible Debenture | | | |
| Expiration Date | | | |
| May 11, 2011 | - | 35,000,000 | 0.286 |
| Outstanding – September 30, 2008 | 20,380,953 | 35,000,000 | Avg. \$ 0.823 |

Outstanding stock options had zero intrinsic value at September 30, 2008.

NOTE 11 – RELATED PARTY TRANSACTIONS

Loan from President

During the three months ended March 31, 2008, the Company borrowed \$27,258 from its President. Subsequently through May 12, 2008, the Company borrowed an additional \$122,742 from its President bringing the total to \$150,000. The Company executed a promissory note due August 31, 2008, bearing an 8% annual interest rate. From May 12, 2008 through September 30, 2008, the Company borrowed \$22,375 from its President. The Company executed an additional promissory note due August 31, 2008, bearing an 8% interest rate. On October 15, 2008, the Company paid the notes and all accrued interest.

Consulting Agreement

On January 26, 2008, the Company entered into a consulting agreement with two directors to provide business development, merger and acquisition capital raising and other services to the Company. The term of the agreement is five years. Services to be provided are compensated under the agreement at a rate of \$1 million per annum which may be paid in shares of stock. During the three months ended September 30, 2008, fees of \$250,000 were accrued for each of the two directors and are included in 'Accounts Payable and Accrued Liabilities' at September 30, 2008.

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TIDELANDS OIL & GAS CORPORATION
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NOTE 12 – LITIGATION

On January 6, 2003, we were served as a third party defendant in a lawsuit titled Northern Natural Gas Company vs. Betty Lou Sheerin vs. Tidelands Oil & Gas Corporation, ZG Gathering, Ltd. and Ken Lay, in the 150th Judicial District Court, Bexar County, Texas, Cause Number 2002-C1-16421. The lawsuit was initiated by Northern Natural Gas (“Northern”) when it sued Betty Lou Sheerin (“Sheerin”) for her failure to make payments on a note she executed payable to Northern in the original principal amount of \$1,950,000.

On May 9, 2008, the Company received a Compromise Settlement Agreement and Mutual Release of All Claims from Betty Lou Sheerin which ended litigation between Mrs. Sheerin and the Company.

On February 26, 2008, ZG Gathering, Ltd., which has the sole remaining non-adjudicated claims in this litigation, filed a Notice of Removal to the Federal Bankruptcy Court of the remaining claims between Tidelands and ZG Gathering, Ltd.

Based on prior negotiations, the Company has reserved \$2,250,000 as an estimated litigation settlement. The Company reached a settlement with all parties on September 8, 2008. The Settlement required the Company to lift its previous stop transfer order on 1,000,000 shares of its restricted common stock valued at \$5,200 and issue an additional 1,000,000 shares of its restricted common stock similarly valued at \$5,200. These actions occurred on September 12, 2008. As a result of the settlements \$2,239,600 of the litigation reserve was reversed.

All remaining matters regarding litigation against Sonterra Energy Corporation (“Sonterra”) followed Sonterra when the Company sold the subsidiary on January 9, 2008. At the closing of the sale, the Company agreed to escrow \$75,000 with the buyer to cover legal costs plus adjudicated and/or settlement amounts along with other contingencies. As of September 30, 2008, \$49,365 remained in escrow after deducting \$25,635 for legal costs and other chargeable costs. All remaining funds as of January 9, 2009, will be returned to the Company.

NOTE 13 - SUBSEQUENT EVENTS

On October 14, 2008, the Company sold its 20% interest in Frontera Pipeline, LLC (“Frontera”) for \$250,000. During this reporting period, the Company reduced its carry cost of its investment in Frontera by \$2,559,801 thereby reducing the value of its investment to \$250,000.

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

Forward-Looking Statements

We have included forward-looking statements in this report. For this purpose, any statements contained in this report that are not statements of historical fact may be deemed to be forward-looking statements. Without limiting the foregoing, words such as "may", "will", "expect", "believe", "anticipate", "estimate", "plan" or "continue" or the negative or other variations thereof or comparable terminology are intended to identify forward-looking statements. These statements by their nature involve substantial risks and uncertainties, and actual results may differ materially depending on a variety of factors. Factors that might cause forward-looking statements to differ materially from actual results include, among other things, overall economic and business conditions, demand for the Company's products, competitive factors in the industries in which we compete or intend to compete, natural gas availability and cost and timing, impact and other uncertainties of our future acquisition plans.

Business Overview

Our primary business operations are focused on the development of the Port Esperanza liquefied natural gas ("LNG") receiving facility in the offshore waters of Southern California.

Given the large capital requirements for the construction of new midstream energy assets, we anticipate that funding of any such projects will be derived primarily through joint ventures with strategic partners or the issuance of stock by the Company. Additionally, management will evaluate related acquisition opportunities that compliment our current business strategy. The completion of any such acquisition will be conditioned upon obtaining requisite financing.

Frontera Pipeline, LLC and the Burgos Hub Project

Previously, the Company had been developing a natural gas pipeline system (the "Burgos Hub Project") project with its own resources through its subsidiary in the United States, Sonora Pipeline, LLC ("Sonora") and its subsidiary in Mexico, Terranova Energia, S. de R.L. de C.V. ("Terranova"). In September 2007, the Company and Terranova entered into an agreement (the "Purchase Agreement") with Grand Cheniere Pipeline, LLC ("Cheniere"), pursuant to which the Company conveyed an 80% interest in the Company's Burgos Hub Project, which involved the development and construction of an integrated pipeline project traversing the United States and Mexico border and the construction of a related subterranean storage facility in Mexico. On October 14, 2008, the Company sold its remaining 20% interest in Frontera Pipeline, LLC ("Frontera") to Cheniere, effectively ending its participation in the development of the Burgos Hub project. Management arrived at the divestment decision based upon a number of factors, including the increasing perception by both partners in Frontera that commercial development of the project would not be adequately supported by capacity commitments from either the Comision Federal de Electricidad ("CFE") or Monterrey industrial customers, a lack of clear commitment by PGPB ("Pemex Gas") to a timeline or method of utilization of the existing pipeline entitlements or the proposed storage facility development proposals put forth by Terranova and Sonora, the financial and operational reorganization occurring within the parent company of the controlling majority partner of Frontera, a lack of substantive legal reform within the recent Mexican energy legislation which would have further enabled Frontera to acquire exclusivity or other valuable contract rights with Pemex in the development of the proposed storage facility in Mexico, and the need for working capital to sustain the Company as a going concern.

Esperanza Energy, LLC and the Port Esperanza Project

Esperanza Energy, LLC ("Esperanza") was formed as a wholly-owned subsidiary of the Company in March 2006 to evaluate the feasibility of developing an offshore, deep-water LNG receiving and regasification terminal near Long Beach, California. The expected timeline for development of the Port Esperanza project is influenced by the

preparation of the application in a form sufficient to be “deemed complete” by the Maritime Administration and Coast Guard which are the principal Federal agencies with permit jurisdiction for LNG terminal development in the offshore United States of America waters. After an application is deemed complete, the process of obtaining the approvals is often longer than the statutory time period of approximately one year due to “time out” or suspension of the running of the clock on the application process due to issues raised during the review of the permit application or due to resource constraints present at the Maritime Administration and Coast Guard. California state and local agency approvals can also impact the permit approval process beyond the normal time expectations. Progress on the project is also dependent upon the Company securing additional funding for the permit application process and complying with state and federal regulations, including environmental laws. The Company does not expect to receive any revenues or cash flow from the Esperanza project in the foreseeable future, if at all, and the Company will be required to expend additional capital in order to further this project. For the nine months ended September 30, 2008, the Company incurred approximately \$217,000 of development costs related to the Port Esperanza project. On January 21, 2008, the Company issued notes totaling \$1,192,277 in payment of accounts payable and accrued interest due to entities providing various services to its Port Esperanza LNG Project. These notes, bearing interest at 10% per annum, were originally due April 30, 2008, and were subsequently extended until August 31, 2008 and then again extended for a new maturity date of March 31, 2009. The Company has paid all interest due at August 31, 2008.

The Company has entered into a letter of intent with a California based firm to provide financing on a best efforts basis for a portion of the development cost of the Port Esperanza project through the issuance of convertible preferred stock of the Company in a Regulation D offering to accredited investors. Management is currently seeking bridge funding for the costs of this offering and the operations of the Company until the offering minimum is sold and closed. The Regulation D offering would be subject to the prior approval of the majority vote of the Company’s common shares and would be highly dilutive to existing shareholders; thus, there is no assurance that the requisite capital structure proposed in the offering would be approved by the existing shareholders. Furthermore, no assurance can be given that bridge funding can be obtained to initiate the Regulation D offering process, nor can there be any assurance that the minimum offering amount under the proposed Regulation D private placement can be sold and closed.

The Company is also continuing to cooperate with the due diligence process initiated by two potential industry joint venture investors in the Port Esperanza project. A decision by these parties to invest or to decline to participate is not expected until 2009.

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Reef Ventures, LP International Pipeline

The assets of this business originally consisted of two different pipelines: (1) an 8-mile twelve-inch diameter natural gas pipeline with metering and dehydration facilities and (2) a two-mile segment of six-inch diameter pipeline to be used in a future LPG project. These assets were impaired in 2006 with a significant charge to earnings and contributed approximately 4 % of the Company's revenues in 2007. The Chittim Gas Processing plant, which had been inactive since 2002 and was formerly owned by Rio Bravo Energy, LLC (a 100% owned subsidiary of the Company), was conveyed to Reef International, LLC in 2007 along with the Carrizo Springs Pipeline System that was also inactive and formerly held by Sonora. During 2007, we attempted to negotiate for capacity reservation charges with potential shippers of natural gas to obtain commitments that would service existing indebtedness on the Reef Ventures' International Pipeline, but we were unsuccessful in obtaining any new commitments. In fact, revenues from this business unit declined from the prior years. During the quarter ended March 31, 2008, no gas was transported for a fee and no revenues were earned by the Reef Ventures, LP ("Reef") business unit. In March 2008, we sold our international pipeline system, the Chittim Gas Plant and the Carrizo Springs pipeline system owned by Reef to West Texas Gas, Inc. ("WTG") and utilized the proceeds of sale along with an associated issuance of our common stock to retire over \$5,300,000 of indebtedness owed to Impact International, LLC ("Impact").

Sonterra Energy Corporation Business

The assets of our Sonterra Energy Corporation ("Sonterra") subsidiary consisted of propane distribution systems, including gas mains, yard lines, meters and storage tanks, serving certain residential subdivisions in the Austin, Texas area. During 2007, we attempted to negotiate a restructuring of the existing convertible debenture indebtedness of \$2,374,291 to a group of investors led by Palisades Master Fund, LP. We were unable to come to mutually acceptable terms in that restructuring effort and in January 2008, we sold the stock of Sonterra for \$3,000,000 and utilized the proceeds from that sale to retire the convertible debentures and repurchase certain outstanding warrants. All remaining matters regarding litigation against Sonterra followed Sonterra when the Company sold the subsidiary on January 9, 2008. At the closing of the sale, the Company agreed to escrow \$75,000 with the buyer to cover legal costs plus adjudicated and/or settlement amounts along with other contingencies. As of September 30, 2008, \$49,365 remained in escrow after deducting \$25,635 for legal costs and other chargeable costs. All remaining funds as of January 9, 2009, will be returned to the Company pursuant to the escrow agreement.

Golden Gate Investors, Inc. Financing

On May 9, 2008, the Company completed a financing transaction in which it entered into a Securities Purchase Agreement ("Purchase Agreement") with Golden Gate Investors, Inc. ("Golden Gate") which provided for the issuance and sale by the Company of up to \$3 million of 6% convertible debentures, with the initial issuance of a \$1 million debenture ("Debenture") and the payment of cash by Golden Gate of \$200,000 and issuance by Golden Gate to the Company of a \$800,000 promissory note ("Note"). The Purchase Agreement provides Golden Gate with the right to lend, in two separate transactions, an additional \$1 million of funding to the Company, in its sole discretion, through advancing cash of \$200,000 and issuing a note for the balance, similar to the Note. The Company had the right until August 8, 2008, to redeem, at a price equal to the principal and accrued interest, the Debenture provided that no event of default had occurred. This redemption did not occur.

The Debenture is unsecured and bears interest at the annual rate of 6%, payable monthly, in cash or, at Golden Gate's election, in shares of the Company's stock valued at the applicable conversion price described further below, with the principal amount due on May 9, 2011. The Debenture may not be prepaid without the written consent of Golden Gate. The Debenture is convertible, either in whole or in part, at any time at a per share price equal to the lesser of \$.50 or 80% of the average of the three lowest volume weighted average prices during the twenty trading days prior to Golden Gate's election to convert. If Golden Gate elects to convert a portion of the Debenture, and on the date of the

election, the volume weighted average price per share of the Company's common stock is below \$0.07, the Company has the right to prepay the portion of the Debenture that Golden Gate elected to convert, plus any accrued and unpaid interest, at 100% of the amount due and the conversion notice will be withdrawn.

In the event the Company's stock trades at a price that is less than \$0.01 per share at any time during the nine-month period following May 9, 2008, the interest rate on the Debenture will increase to 9 ³/₄ % for the remaining term of the Debenture. In the event this provision is triggered, within three business days of a written request from Golden Gate, the Company is required to prepay the amount of interest that would otherwise be due from the date of the request through the maturity date. If any portion of the Debenture is converted into the Company's common stock prior to maturity, the Company will be entitled to a refund of the pro rata portion of the interest prepayment attributable to the portion of the principal amount converted. On August 26, 2008, the Company received notice from Golden Gate that effective July 28, 2008, the interest rate on the Debenture was increased to 9 ³/₄% pursuant to the terms of Debenture and that the Interest Prepayment amount of \$270,328.77 was due to Golden Gate within three days of the notice. To date, the Company has not made such prepayment of interest to Golden Gate and Golden Gate has not given notice of default on the Debenture to the Company.

In accordance with the terms of the Debenture, the Company has reserved 35,000,000 shares of its common stock for possible conversion. The Company's stock transfer agent has received irrevocable instructions regarding the shares reserved.

The Note is secured and bears interest at the annual rate of 6.25%, payable monthly, with the principal amount due on May 31, 2011. Golden Gate has the option to prepay this note, subject to the satisfaction of certain conditions. On August 26, 2008, Golden Gate gave notice that the interest rate on the Note was decreased to 4³/₄%, effective as of July 28, 2008 in accordance with the terms of the Note which provides for such reduction in the event that the Company's common stock trades at a price that is less than \$0.01 per share at any time during the nine-month period after May 9, 2008.

The Company analyzed the provision of the Debenture in accordance with the provisions of SFAS 133, "Accounting for Derivative Instruments and Hedging Activities" and EITF 00-19, "Accounting for Derivative Financial Instruments Indexed to and Potentially Settled in, a Company's Own Stock" and determined that the Debenture did not contain any derivative features that would require separate accounting under this literature.

On November 6, 2008, Golden Gate converted \$2,000 of the Debenture into 781,250 shares of common stock pursuant to the terms of the Debenture. On November 13, 2008, Golden Gate converted \$5,000 of the Debenture into 1,973,165 shares of common stock pursuant to the terms of the Debenture.

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Results of Operations

THREE MONTHS ENDED SEPTEMBER 30, 2008 COMPARED TO THREE MONTHS ENDED SEPTEMBER 30, 2007

REVENUES: The Company reported revenues of \$30,000 for the three months ended September 30, 2008 compared to revenues of \$0 for the three months ended September 30, 2007. The revenue increase resulted from the receipt of consulting fees from Frontera during the period ended September 30, 2008 whereas no such fees were received during the period ended September 30, 2007.

TOTAL COSTS AND EXPENSES: Total Costs and Expenses for the three months ended September 30, 2008 were \$3,829,667 versus \$644,658 for the three months ended September 30, 2007 which is an increase of 594% in Total Costs and Expenses for the three months ended September 30, 2008 versus the three months ended September 30, 2007. The primary reason for the increase in Total Expenses was the Impairment – Investment in Affiliate charge to record the write down in value of the Company’s investment in Frontera during the three months ended September 30, 2008 versus the absence of an impairment charge during the three months ended September 30, 2007.

SELLING, GENERAL AND ADMINISTRATIVE: Selling, General and Administrative costs for the three months ended September 30, 2008 were \$1,263,816 compared to \$638,416 for the three months ended September 30, 2007. Most of the increase in these expenses was attributable to increases in non-cash compensation paid to directors and officers.

OTHER INCOME (EXPENSE): Total Other Income (Expense) for the three months ended September 30, 2008 was \$2,182,879 versus \$4,680 for the three months ended September 30, 2007. The primary reason for the increase in Other Income is the Reduction of Reserve for Litigation in the amount of \$2,239,600 during the three months ended September 30, 2008 as a result of the settlement of litigation with Northern Natural Gas (“Northern”), Betty Lou Sheerin (“Sheerin”) and ZG Gathering, Ltd (“ZG”). A secondary factor in the increase in Total Other Income was the decrease in Interest Expense to \$59,029 for the three months ended September 30, 2008 versus \$245,357 for the three months ended September 30, 2007.

NET LOSS FROM CONTINUING OPERATIONS: Net Loss from Continuing Operations was (\$1,616,788) for the three months ended September 30, 2008 compared to (\$639,978) for the three months ended September 30, 2007 which is an increase in Net Loss from Continuing Operations of \$976,810. This increase is due primarily to the impairment loss on the Company’s investment in Frontera combined with increases in non-cash compensation to directors and officers during the period ended September 30, 2008 versus the three months ended September 30, 2007.

NET INCOME FROM OPERATIONS OF DISCONTINUED SEGMENTS: Net Income from Operations of Discontinued Segments was \$0 for the three months ended September 30, 2008 versus (\$237,797) for the three months ended September 30, 2007. There were no discontinued operations originating in the three months ended September 30, 2008.

NET LOSS: Net Loss for the three months ended September 30, 2008 was (\$1,616,788) versus the Net Loss of (\$877,775) for the three months ended September 30, 2007, which is an increase in Net Loss of \$739,013 for the three months ended September 30, 2008 versus the three months ended September 30, 2007.

NINE MONTHS ENDED SEPTEMBER 30, 2008 COMPARED TO NINE MONTHS ENDED SEPTEMBER 30, 2007

REVENUES: The Company reported revenues of \$105,000 for the nine months ended September 30, 2008 compared to revenues of \$0 for the nine months ended September 30, 2007. The revenue increase resulted from the receipt of consulting fees from Frontera during the period ended September 30, 2008 whereas no such fees were received during the period ended September 30, 2007.

TOTAL COSTS AND EXPENSES: Total Costs and Expenses for the nine months ended September 30, 2008 were \$7,753,459 versus \$7,423,461 for the nine months ended September 30, 2007 which is an increase of 4.45% in Total Costs and Expenses for the nine months ended September 30, 2008 versus the nine months ended September 30, 2007. The primary reason for the small increase in Total Expenses was the Impairment – Investment in Affiliate charge of \$2,559,801 in the nine months ended September 30, 2008 versus the nine months ended September 30, 2007.

SELLING, GENERAL AND ADMINISTRATIVE – RELATED PARTIES: Selling, General and Administrative – Related Parties for the nine months ended September 30, 2008 was \$0 compared to \$3,638,000 for the nine months ended September 30, 2007. The decrease was due to the absence of stock option issuances in the nine months ended September 30, 2008 versus the nine months ended September 30, 2007.

SELLING, GENERAL AND ADMINISTRATIVE: Selling, General and Administrative costs for the nine months ended September 30, 2008 were \$5,175,506 compared to \$3,766,691 for the nine months ended September 30, 2007. Most of the increase in these expenses was attributable to increases in non-cash compensation paid to directors and officers.

OTHER INCOME (EXPENSE): Total Other Income (Expense) for the nine months ended September 30, 2008 was \$2,030,971 versus (\$521,682) for the nine months ended September 30, 2007. The primary reasons for the increase in Total Other Income are: (a) the decrease in interest expense to (\$238,425) for the nine months ended September 30, 2008 versus (\$772,304) for the nine months ended September 30, 2007 which reflects the payoff of the convertible debentures in the amount of \$2,374,291 in January 2008, and (b) the Reduction of Reserve for Litigation income increase in the amount of \$2,239,600 which reflects settlement of the final litigation matter outstanding between the Company and Northern, Sheerin and ZG.

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NET LOSS FROM CONTINUING OPERATIONS: Net Loss from Continuing Operations was (\$5,617,488) for the nine months ended September 30, 2008 compared to (\$7,945,143) for the nine months ended September 30, 2007 which is a decrease in Net Loss from Continuing Operations of \$2,327,655. This decrease in Net Loss from Continuing Operations is due primarily to the \$2,239,600 of income from Reduction of Reserve for Litigation during the period ended September 30, 2008 versus the nine months ended September 30, 2007.

NET INCOME FROM OPERATIONS OF DISCONTINUED SEGMENTS: Net Income from Operations of Discontinued Segments was \$705,772 for the nine months ended September 30, 2008 versus (\$2,717,072) for the nine months ended September 30, 2007 which is an increase of \$3,422,844 in Net Income from Operations of Discontinued Segments. The increase resulted from Gains on Disposal of the assets and reduction in the operating losses originating from Reef and Sonterra as further detailed in Note 5 of the Consolidated Financial Statements.

NET LOSS: Net Loss for the nine months ended September 30, 2008 was (\$4,911,716) versus the Net Loss of (\$10,662,215) for the nine months ended September 30, 2007. The primary reasons for the substantial reduction in loss for the nine months ended September 30, 2008 versus the nine months ended September 30, 2007 were: (a) the income from Reduction of Reserve for Litigation in the amount of \$2,239,600, and (b) the income from the difference in Net Income from Operations of Discontinued Segments as noted above in the amount of \$3,422,844.

Liquidity and Capital Resources

The Company is not currently generating any revenues and has incurred significant operating losses. The Company's financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in the Company's financial statements, the Company's absence of revenues, recurring losses from operations, and its need for additional financing in order to fund its working capital needs in 2008 raise substantial doubt about its ability to continue as a going concern.

At September 30, 2008, we had current assets of \$1,016,449, current liabilities of \$3,730,985 and working capital deficit of \$2,714,536. After giving effect to the Sonterra transaction in January 2008, the WTG transaction in March 2008, the financing with Golden Gate and the sale of the Company's interest in Frontera, the Company currently has approximately \$2,005,000 of current notes payable, accounts payable and accrued expenses that require payment or other satisfaction during 2009. We will need to raise capital to discharge these obligations. Additionally, we believe that after taking into account the recent financing sale of the Company's interest in Frontera, we will require approximately \$300,000 of additional capital between the present time and March 31, 2009. Accordingly, we will be reliant upon best efforts debt and/or equity financings to fund the payment of current liabilities and working capital needs. We cannot give any assurance that this additional needed financing could be obtained on attractive terms or at all. The Company's viability is contingent upon its ability to receive external financing. Failure to obtain sufficient working capital may result in management resorting to the additional sale of assets or otherwise curtailing operations.

Contractual Commitments

A tabular disclosure of our contractual obligations at September 30, 2008, is as follows:

| | Payments due by period | | | |
|---|------------------------|---------------------|---------------------|-------------------|
| | 1 year or less | 2 – 3 Years | 4 – 5 Years | More than 5 Years |
| Credit Facilities | \$ 1,192,277 | \$ 1,000,000 | \$ -- | \$ -- |
| Operating Leases | -- | -- | -- | -- |
| Employment and consulting contracts (1) | 2,825,000 | 5,250,000 | 3,200,000 | -- |
| Total | \$ 4,017,277 | \$ 6,250,000 | \$ 3,200,000 | \$ -- |

(1) Does not include perquisites.

Off Balance-Sheet Arrangements

As of September 30, 2008 and 2007, the Company did not have any significant off balance-sheet arrangements.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Cash and Cash Equivalents

We have historically invested our cash and cash equivalents in short-term, fixed rate, highly rated and highly liquid instruments which are reinvested when they mature throughout the year. Although our existing investments are not considered at risk with respect to changes in interest rates or markets for these instruments, our rate of return on short-term investments could be affected at the time of reinvestment as a result of intervening events. As of September 30, 2008, we had cash of \$8,628.

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

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Debt

The interest rate on our promissory note debt obligations at September 30, 2008 is a fixed rate of 10% per annum. The interest rate on our convertible debenture obligation at September 30, 2008 is a fixed rate of 9¾% per annum.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the Securities Exchange Act of 1934, as amended (the "Act") is accumulated and communicated to the issuer's management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure. It should be noted that the design of any system of controls is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions, regardless of how remote. For the quarter ended September 30, 2008, we carried out an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures. Based on this evaluation, management has concluded that the Company's disclosure controls and procedures are not effective because of the identification of a material weakness in our internal control over financial reporting which is identified below, which we view as an integral part of our disclosure controls and procedures. A material weakness is a deficiency, or a combination of control deficiencies, in internal control over financial reporting such that there is a reasonable possibility that a material misstatement of the Company's annual or interim financial statements will not be prevented or detected on a timely basis.

The material weakness relates to certain errors in accounting for equity-based compensation that were reported for the three month period ended March 31, 2007 and six month period ended June 30, 2007. The errors were discovered in connection with the preparation of the Company's September 30, 2007 unaudited financial statements. Upon reviewing and updating our accounting and disclosures related to equity-based compensation for the nine months ended September 30, 2007, the Company discovered its errors. Upon this determination, management and the Board of Directors were alerted to the facts and circumstances regarding the errors in accounting for the equity-based compensation. As a result, we determined that our disclosure controls were not effective.

Based on the impact of the aforementioned accounting error, we determined to restate our consolidated financial statements as of three month period ended March 31, 2007 and six month period ended June 30, 2007. Subsequent thereto, we implemented the following remedial measures to address the identified material weaknesses:

- We reviewed all equity-based compensation agreements to assure the issuance of the equity instruments have been properly accounted for and disclosed in our financial statements in accordance with generally accepted accounting principles.
- We have improved the supervision and training of our accounting staff to understand and implement accounting requirements, policies and procedures applicable to the accounting and disclosure of equity based instruments.

This quarterly report does not include an attestation report of the Company's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to the attestation by the Company's registered public accounting firm pursuant to temporary rules of the SEC that permit the Company to provide only management's report in this annual report.

Changes in Internal Controls over Financial Reporting

During the quarter ended September 30, 2008, we did not make any changes in our internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II - OTHER INFORMATION

Item 1. Legal Proceedings

Other than as set forth below and in the prior reports filed with the Securities and Exchange Commission pursuant to the Securities Exchange Act of 1934, the Company is not a party to any material pending legal proceeding.

Matter No. 1

As described in the Company's prior reports, the Company was a party to a pending lawsuit titled Northern Natural Gas Company vs. Betty Lou Sheerin vs. Tidelands Oil & Gas Corporation, ZG Gathering, Ltd. and Ken Lay, in the 150th Judicial District Court, Bexar County, Texas, Cause Number 2002-C1-16421. A trial date was set for January 7, 2008. On December 3, 2007, ZG filed a Suggestion of Bankruptcy which stayed the case. On December 13, 2007, Sheerin non-suited with prejudice all of her claims against Tidelands Oil & Gas Corporation ("Tidelands") and Tidelands non-suited with prejudice all of its claims against Sheerin. On May 9, 2008 the Company received a Compromise Settlement Agreement and Mutual Release of All Claims from Sheerin ratifying the actions taken December 13, 2007. The claims between Northern, Sheerin, the Estate of Kenneth Lay, and the Estate of Charlton Hadden were severed from the claims between Northern, ZG, and Tidelands. The claims between Northern and Sheerin then proceeded to trial on January 7, 2008 in the State District Court. The jury in that case concluded, among other things, that Northern is the owner of the note in question, that Sheerin agreed to be obligated on the note, that she failed to comply with the note, and that the unpaid principal and accrued interest on the note was \$1,950,000.00. The jury's complete findings are on file in the court's record in Cause No. 2002-CI-16421. No final Judgment has been entered in this matter. On February 26, 2008, ZG filed a Notice of Removal to the Federal Bankruptcy Court of the remaining claims between Northern, Tidelands and ZG. On July 18, 2008, ZG and Tidelands executed a Compromise Settlement Agreement and Mutual Release of All Claims under which the Company removed the stop transfer order on 1,000,000 shares of previously issued common stock of the Company, executed a quit claim deed with respect to the 225 mile gathering system owned by ZG, and further issued 1,000,000 shares of common stock to ZG in exchange for the settlement of all claims by ZG. No further legal actions are expected between the Company and any of the above parties.

Other Legal Matters

All remaining matters regarding litigation against Sonterra followed Sonterra when the Company sold the subsidiary on January 9, 2008. At the closing of the sale, the Company agreed to escrow \$75,000 with the buyer to cover legal costs plus adjudicated and/or settlement amounts along with other contingencies. As of September 30, 2008, \$49,365 remained in escrow after deducting \$25,635 for legal costs and other chargeable costs. All remaining funds as of January 9, 2009, will be returned to the Company.

Item 1A. Risk Factors

During the nine months ended September 30, 2008, there were no material changes to the risk factors described in Part I, Item 1A "Risk Factors" of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2007.

Item 2. Unregistered Sales of Equity Securities and Equity Repurchases

Set forth below is certain information concerning issuances of common stock during the nine months ended September 30, 2008, and to the date of this report, that were not registered under the Securities Act of 1933 ("Securities Act"):

The Company issued 5,300,000 shares of its restricted common stock for consulting services valued at \$386,900.

The Company issued 211,134 shares of its restricted common stock valued at \$16,680 to two holders of the Company's Stock Warrants under cashless exercise provisions which reduced the total number of warrant shares outstanding by 243,616 for purpose of cancellation.

The Company issued 39,890,180 shares of its restricted common stock valued at \$1,994,509 in payment of the balance due Impact, after remitting the net proceeds from the sale of its International Pipeline between the United States and Mexico to WTG.

The Company issued 3,571,429 shares each of its restricted common stock valued at \$250,000 to two of its directors in payment of consulting fees for the three months ended March 31, 2008.

The Company issued 230,905 shares of its restricted common stock valued at \$8,082 to a holder of the Company's Stock Warrants under cashless exercise provisions.

The Company issued 1,000,000 shares of its restricted common stock valued at \$5,200 in partial payment of the settlement of litigation with Northern, Sheerin and ZG.

The Company executed a Stop Payment Cancellation which released 1,000,000 shares of its restricted common stock valued at \$5,200 as the final payment required in settlement of litigation with Northern, Sheerin and ZG.

The issuances referenced above were consummated pursuant to Section 4(2) of the Securities Act and the rules and regulations promulgated thereunder on the basis that such transactions did not involve a public offering and the offerees were sophisticated, accredited investors with access to the kind of information that registration would provide. The recipients of these securities represented their intention to acquire the securities for investment only and not with a view to or for sale in connection with any distribution thereof and appropriate legends were affixed to the share certificates and other instruments issued in such transactions. No sales commissions were paid.

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Item 3. Defaults Upon Senior Securities

None.

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

None.

Item 5. Other Information

None.

Item 6. Exhibits

| Exhibit | Description | Location of Exhibit |
|---------|--|----------------------------|
| 31.1 | <u>Chief Executive Officer and Chief Financial Officer Section 302 Certification pursuant to Sarbanes - Oxley Act.</u> | Included with this filing. |
| 32.1 | <u>Chief Executive Officer-Section 906 Certification pursuant to Sarbanes-Oxley Act</u> | Included with this filing. |

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