

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

FORM 10-KSB/A  
AMENDMENT NO. 1

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES ACT OF  
1934  
For The Fiscal Year Ended June 30, 2005

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

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

Commission File Number 000-27862

NATURAL GAS SYSTEMS, INC.  
(Exact name of registrant as specified in charter)

Nevada 41-1781991  
(State of incorporation) (I.R.S. employer identification number)

820 Gessner, Suite 1340, Houston, Texas 77024  
(Address of principal executive offices and zip code)

Registrant's telephone number, including area code: (713) 935-0122

Securities registered pursuant to Section 12(b) of the Exchange Act:

Securities registered pursuant to Section 12(g) of the Exchange Act:

Common Stock, \$0.001 Par Value  
(Title of class and shares outstanding)

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-B is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB.

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 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:  No

Issuer's revenues for its most recent fiscal year: 1,635,187

As of August 1, 2005, the aggregate market value of common stock held by non-affiliates of the registrant was approximately \$15,015,900, assuming solely for purposes of this calculation that all directors and executive officers of the registrant and all stockholders beneficially owning more than 10% of the registrant's common stock are "affiliates." This determination of affiliate status is not necessarily a conclusive determination for other purposes.

The number of shares of common stock outstanding on August 01, 2005 was 24,774,606 shares.

DOCUMENTS INCORPORATED BY REFERENCE into Part III hereof Portions of the Proxy Statement to be filed with the Commission in connection with the Company's 2005 Annual Meeting.

Transitional Small Business Format (Check One): Yes  No

NATURAL GAS SYSTEMS, INC.

FORM 10-KSB/A

AMENDMENT NO. 1

FOR THE FISCAL YEAR ENDED JUNE 30, 2005

INDEX

PART II

	Page
Item 7. Financial Statements and Supplementary Data	1

PART III

Item 13. Exhibits and Reports	21
-------------------------------	----

EXPLANATORY NOTE

This amendment on Form 10-KSB/A is being filed solely to correct transcription errors in Part II, Item 7 of Natural Gas System, Inc.'s Annual Report on Form 10-KSB for the fiscal year ended June 30, 2005 filed with the Securities and Exchange Commission on September 28, 2005, and to add clarifying footnote disclosure in the table containing such errors.

Specifically, in a table in Note 10: "Supplemental Oil and Gas Disclosures (unaudited)" of the Notes to the Consolidated Financial Statements, under the

sub-heading "Proved Developed and Undeveloped Reserves Prepared by W.D. Von Gonten & Co. Petroleum Engineers", the Total Proved Developed Reserves as of July 1, 2005 for Oil was 540,360 barrels, not 771,800 barrels as originally reported; and for Gas, was 396,600 MCF, not 732,300 MCF as originally reported. "Total Proved Reserves" were accurately stated in the Form 10-KSB as originally filed as 771,800 barrels and 732,300 MCF at July 1, 2005. This amendment also adds additional footnote disclosure to the table under this sub-heading to clarify the conversion of barrels to MCF's and to explain upward and downward revisions of both "Proved Reserves" and "Proved Developed Reserves", by year. This amendment on Form 10-KSB does not change in any other way the financial statements and notes thereto included in Part II, Item 7 of the Form 10-KSB as originally filed.

In accordance with Rule 12b-15 under the Securities and Exchange Act of 1934, as amended (the "Exchange Act"), the complete text of Item 7 of the Form 10-KSB, which Item contained Note 10 - "Supplemental Oil and Gas Disclosures (unaudited)" of the Notes to the Consolidated Financial Statements, has been restated in its entirety in this amendment on Form 10-KSB/A. Under Rule 12b-15, the Company is restating in its entirety Part III, Item 13 of the Form 10-KSB to file as exhibits updated certifications pursuant to Rule 13a-15(d)/15d-15(e) under the Exchange Act and 18 U.S.C. Section 1350. The remainder of the Form 10-KSB is unchanged and is not reproduced in this amendment. This amendment on Form 10-KSB/A reflects only the changes discussed above and does not reflect any events occurring after the original filing of the Form 10-KSB. No other information included in the Form 10-KSB has been modified or updated in any way.

#### FORWARD LOOKING STATEMENTS

This Form 10-KSB/A includes certain statements that may be deemed to be "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Exchange Act. All statements included in this Form 10-KSB/A, other than statements of historical facts, address matters that the Company reasonably expects, believes or anticipates will or may occur in the future. Such statements are subject to various assumptions, risks and uncertainties, many of which are beyond the control of the Company. Investors are cautioned that any such statements are not guarantees of future performance and actual results or developments may differ materially from those described in the forward-looking statements. The Company bases its forward-looking statements on information currently available and it undertakes no obligation to update them

ITEM 7. FINANCIAL STATEMENTS

Index to Consolidated Financial Statements

Report of Independent Registered Public Accounting Firm

Consolidated Balance Sheets as of June 30, 2005, June 30, 2004 and December 31, 2003

Consolidated Statements of Operations for the Twelve Months ended June 30, 2005, the Six Months ended June 30, 2004 and the period from September 23, 2003 (inception) to December 31, 2003

Consolidated Statements of Stockholders' Equity for the Twelve Months ended June 30, 2005, the Six Months ended June 30, 2004 and the period from September 23, 2003 (inception) to December 31, 2003

Consolidated Statements of Cash Flows for the Twelve Months ended June 30, 2005, Six Months ended June 30, 2004 and the period from September 23, 2003 (inception) to December 31, 2003

Notes to Consolidated Financial Statements

NATURAL GAS SYSTEMS, INC. AND SUBSIDIARIES  
Consolidated Balance Sheets

	June 30, 2005	June 30, 2004	December 31, 2003
	-----	-----	-----
<b>Assets</b>			
<b>Current Assets:</b>			
Cash	\$ 2,548,688	\$ 367,831	\$ 830,312
Accounts receivable, trade	300,761	24,387	56,837
Inventories	222,470	115,859	109,216
Prepaid expenses	84,304	69,067	25,930
Retainers and deposits	56,335	5,000	210,000
	-----	-----	-----
Total current assets	3,212,558	582,144	1,232,295
Oil & Gas properties - full cost	5,276,303	3,075,438	2,971,468
Oil & Gas properties - not amortized	61,887	105,225	--
Less: accumulated depletion	(313,391)	(55,509)	(13,960)
	-----	-----	-----
Net oil & gas properties	5,024,799	3,125,154	2,957,508
Furniture, fixtures and equipment, at cost	12,113	3,091	3,091
Less: accumulated depreciation	(3,401)	(1,159)	(386)
	-----	-----	-----
Net furniture, fixtures, and equipment	8,712	1,932	2,705
Restricted deposits	863,089	301,835	301,835
Other assets	356,066	--	--
	-----	-----	-----
Total assets	\$ 9,465,224	\$ 4,011,065	\$ 4,494,343
	=====	=====	=====
<b>Liabilities and Stockholders' Equity</b>			
<b>Current liabilities:</b>			
Accounts payable	\$ 240,389	\$ 139,188	\$ 114,188
Accrued liabilities	176,470	50,073	41,118
Registration costs	100,000	0	0
Notes payable, current	6,754	776,235	1,500,000
Discount on notes payable	0	0	(62,927)
Royalties payable	89,713	0	665
	-----	-----	-----
Total current liabilities	613,326	965,496	1,593,044
<b>Long term liabilities:</b>			
Notes payable	4,000,000	0	0
Discount on notes payable	(1,093,452)	0	0
Asset retirement obligations	433,250	311,442	305,004
	-----	-----	-----
Total liabilities	3,953,124	1,276,938	1,898,048
<b>Stockholders' equity:</b>			
Common Stock, par value \$0.001 per share; 100,000,000 shares authorized, 24,774,606, 22,945,406 and 21,772,362 issued and outstanding as of June 30, 2005, June 30, 2004, and December 31, 2003, respectively	24,774	22,945	21,772
Additional paid-in capital	9,611,767	4,453,905	3,398,178
Deferred stock based compensation	(595,283)	(378,136)	(486,750)
Accumulated deficit	(3,529,158)	(1,364,587)	(336,905)
	-----	-----	-----
Total stockholders' equity	5,512,100	2,734,127	2,596,295
	-----	-----	-----
Total liabilities and stockholders' equity	\$ 9,465,224	\$ 4,011,065	\$ 4,494,343
	=====	=====	=====

See accompanying notes to consolidated financial statements.

NATURAL GAS SYSTEMS, INC. AND SUBSIDIARIES  
Consolidated Statements of Operations

	Twelve Months Ended June 30, 2005 -----	Six Months Ended June 30, 2004 -----	For the Period from September 23, 2003 (inception) to December 31, 2003 -----
<b>Revenues:</b>			
Oil sales	\$ 1,335,288	\$ 117,509	\$ 24,229
Gas sales	358,433	649	--
Price risk management activities	(58,534)	--	--
	-----	-----	-----
Total revenues	1,635,187	118,158	24,229
<b>Expenses:</b>			
Operating costs	874,876	134,420	76,303
Production taxes	68,386	14,581	3,002
Depreciation, depletion and amortization	260,124	41,549	13,960
Reverse merger fees and expenses	--	370,000	--
General and administrative (includes non-cash stock-based compensation expense of \$707,117, \$108,614 and \$50,400 the periods ending June 30, 2005, June 30, 2004 and December 31, 2003, respectively.)	2,220,780	542,761	239,093
	-----	-----	-----
Total expenses	3,424,166	1,103,311	332,358
	-----	-----	-----
Loss from operations	(1,788,979)	(985,153)	(308,129)
<b>Other revenues and expenses:</b>			
Interest income	11,709	4,093	1,148
Interest expense	(387,301)	(46,622)	(29,924)
	-----	-----	-----
Total other revenues and expenses	(375,592)	(42,529)	(28,776)
	-----	-----	-----
Net loss	\$ (2,164,571)	\$ (1,027,682)	\$ (336,905)
	=====	=====	=====
<b>Loss per common share:</b>			
basic and diluted	\$ (0.09)	\$ (0.05)	\$ (0.02)
	=====	=====	=====
<b>Weighted average number of common shares,</b>			
basic and diluted	23,533,922	22,057,614	20,091,720
	=====	=====	=====

See accompanying notes to consolidated financial statements.

NATURAL GAS SYSTEMS, INC. AND SUBIDIARIES  
Consolidated Statements of Changes in  
Stockholders' Equity For the twelve months ended June  
30, 2005, the six months ended June 30, 2004  
and the Period from September 23, 2003 (Inception) to December 31, 2003

	Shares	Dollars	Additional Paid-in Capital	Deferred Stock Based Compensation	Accumulated Deficit	Total Stockholders' Equity
Balances, September 23, 2003	--	\$ --	\$ --	\$ --	\$ --	\$ --
Sales of common stock	21,772,362	21,772	2,861,028	--	--	2,882,800
Stock-based compensation	--	--	537,150	(486,750)	--	50,400
Net loss	--	--	--	--	(336,905)	(336,905)
Balances, December 31, 2003	21,772,362	21,772	3,398,178	(486,750)	(336,905)	2,596,295
Sales of common stock before merger	923,377	923	825,977	--	--	826,900
Sales of common stock	249,667	250	229,750	--	--	230,000
Deferred compensation	--	--	--	108,614	--	108,614
Net loss	--	--	--	--	(1,027,682)	(1,027,682)
Balances, June 30, 2004	22,945,406	22,945	4,453,905	(378,136)	(1,364,587)	2,734,127
Sales of common stock	1,829,200	1,829	4,502,517	--	--	4,504,346
Fair value of warrants issued with debt	--	--	1,149,008	--	--	1,149,008
Transaction and registration costs	--	--	(493,663)	--	--	(493,663)
Deferred compensation	--	--	--	(217,147)	--	(217,147)
Net loss	--	--	--	--	(2,164,571)	(2,164,571)
Balances, June 30, 2005	24,774,606	\$ 24,774	\$ 9,611,767	\$ (595,283)	\$ (3,529,158)	\$ 5,512,100

See accompanying notes to consolidated financial statements.

NATURAL GAS SYSTEMS, INC. AND SUBIDIARIES  
Consolidated Statements of Cash Flows

	Twelve Months Ended June 30, 2005 -----	Six Months Ended June 30, 2004 -----	For the Period from September 23, 2003 (inception) to December 31, 2003 -----
Cash flows from operating activities:			
Net loss	\$ (2,164,571)	\$ (1,027,682)	\$ (336,905)
Adjustments to reconcile net loss to net cash provided (used) by operating activities:			
Depletion	257,882	41,549	13,960
Depreciation	2,242	773	386
Non-cash stock-based compensation expense	707,117	108,614	50,400
Accretion of asset retirement obligations	21,824	6,438	3,169
Accretion of debt discount and non-cash interest	78,882	--	29,924
Changes in assets and liabilities:			
Accounts receivable, trade	(276,374)	32,450	(28,762)
Inventories	(106,611)	(6,643)	(109,216)
Accounts payable	101,201	24,999	114,188
Royalties payable	89,713	--	--
Accrued liabilities	226,397	8,289	41,783
Prepaid expenses	(15,237)	(43,137)	(25,930)
Net cash used by operating activities	(1,077,535)	(854,350)	(247,003)
Cash flows from investing activities:			
Capital expenditures for oil and gas properties	(2,057,543)	(209,194)	(1,290,560)
Capital expenditures for furniture, fixtures and equipment	(9,022)	--	(3,090)
Restricted deposits and retainers	(612,589)	205,000	(511,835)
Other assets	(99,469)	--	--
Net cash used in investing activities	(2,778,623)	(4,194)	(1,805,485)
Cash flow from financing activities:			
Payments on notes payable	(1,725,167)	(710,327)	--
Proceeds from notes payable	3,806,678	49,490	--
Deferred financing costs	(279,924)	--	--
Proceeds from issuance of common stock and fair value of warrants issued with debt	4,729,091	1,056,900	2,882,800
Transaction and registration costs	(493,663)	--	--
Net cash provided by financing activities	6,037,015	396,063	2,882,800
Increase (decrease) in cash and cash equivalents	2,180,857	(462,481)	830,312
Cash and cash equivalents, beginning of period	367,831	830,312	--
Cash and cash equivalents, end of period	\$ 2,548,688	\$ 367,831	\$ 830,312
	=====	=====	=====
Supplemental disclosure of cash flow information:			
Interest paid	\$ 308,419	\$ 46,622	\$ --
Income taxes paid	\$ --	\$ --	\$ --
Non-cash transactions:			
Seller note issued to acquire properties, net of discount	\$ --	\$ --	\$ 1,407,049
Assumption of asset retirement obligations	\$ 99,984	\$ --	\$ 301,835

See accompanying notes to consolidated financial statements.

NATURAL GAS SYSTEMS, INC. AND SUBSIDIARIES

1. Company's Business

Reality Interactive, Inc. (" Reality "), a Nevada corporation that traded on the OTC Bulletin Board under the symbol RLYI.OB, and the predecessor of Natural Gas Systems, Inc., was incorporated on May 24, 1994 for the purpose of developing technology-based knowledge solutions for the industrial marketplace. On April 30, 1999, Reality ceased business operations, sold substantially all of its assets and terminated all of its employees. Subsequent to ceasing operations, Reality explored other potential business opportunities to acquire or merge with another entity, while continuing to file reports with the SEC. During the two years prior to May 26, 2004, Reality represented that it had not conducted any operations and had minimal assets and liabilities.

On May 26, 2004, Natural Gas Systems, Inc., a privately owned Delaware corporation formed in September of 2003 (" Old NGS "), was merged into a wholly owned subsidiary of Reality and Reality changed its name to Natural Gas Systems, Inc. On the effective date of the merger, Laird Q. Cagan was elected as Chairman of the Board of Directors of Reality and Robert S. Herlin and Sterling H. McDonald, the CEO and CFO of Old NGS, were elected CEO and CFO of Reality, respectively. The corporation was renamed Natural Gas Systems, Inc. ("we", "us", "our", "our company", "Company" or "NGS") and adopted a June 30 fiscal year end.

Headquartered in Houston, Texas, Natural Gas Systems, Inc. is a petroleum company engaged primarily in the acquisition, exploitation and development of properties for the production of crude oil and natural gas from underground reservoirs. NGS acquires established oil and gas properties and exploits them through the application of conventional and specialized technology to increase production, ultimate recoveries, or both. At June 30, 2005, NGS conducted operations through its 100% working interest in the Delhi, Tullos Urania, Crossroads, and Colgrade fields in Louisiana. Tullos Urania, Crossroad and Colgrade are referred to collectively herein as the "Tullos Field (Area)".

All regulatory filings and other historical information prior to May 26, 2004 apply to Reality, the predecessor of the Company. NGS trades on the OTC Bulletin Board under the symbol NGSY.OB. All stock information is adjusted to reflect Reality's 40:1 reverse stock split effected prior to the merger with NGS.

2. Significant Risks and Uncertainties

Preparation of the Company's financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities and contingencies as of the balance sheet date, and the reported amount of revenues and expenses during the reporting period. On an ongoing basis, management reviews its estimates, including those related to litigation, environmental liabilities, income taxes, abandonment costs and the determination of proved reserves. Changes in circumstances may result in revised estimates and actual results may differ from those estimates.

The Company's business makes it vulnerable to changes in crude oil and natural gas prices. Such prices have been volatile in the past and can be expected to be volatile in the future. This volatility can dramatically affect cash flows and proved reserves, since price declines reduce the estimated quantity of proved reserves and increase annual amortization expense (which is based on proved reserves), or could potentially result in an impairment charge. Other risks related to proved reserves, revenues, and cash flows include the Company's current reliance on the concentration of a few wells. The reserve report dated July 1, 2005, identified twelve wells that make up approximately 60% of the Company's PV-10 proved reserves, as compared to six wells at July 1, 2004. For the production month of June 2005, approximately 29% of the Company's production was derived from three wells, as compared to 85% in June 2004.

3. Summary of Significant Accounting Policies

Principles of Consolidation -- The consolidated financial statements include the Company and its subsidiaries. All material inter-company accounts and transactions have been eliminated.

Oil and Gas Properties and Furniture, Fixtures and Equipment --The Company follows the full cost method of accounting for its investments in oil and natural gas properties. All costs incurred in the acquisition, exploration and development of oil and natural gas properties, including unproductive wells, are capitalized. Proceeds from the sale of oil and natural gas properties are credited to the full cost pool, unless the sale involves a significant quantity of reserves, in which case a gain or loss is recognized. Under the rules of the Securities and Exchange Commission ("SEC") for the full cost method of accounting, the net carrying value of oil and natural gas properties is limited to the sum of the present value (10% discount rate) of the estimated future net cash flows from proved reserves based on current prices as of the balance sheet date, and excluding future cash outflows associated with settling asset retirement obligations, plus the lower of cost or estimated fair market value of unproved properties adjusted for related income tax effects.

Capitalized costs of proved oil and natural gas properties are depleted on a unit of production method using proved oil and natural gas reserves. Costs depleted include net capitalized costs subject to depletion and estimated future dismantlement, restoration and abandonment costs.

The costs of certain unevaluated leasehold acreage and wells being drilled are not being amortized. Costs not being amortized are periodically assessed for possible impairments or reductions in value. If a reduction of value has occurred, the amount of the impairment is transferred to costs being amortized.

Equipment, which includes computer equipment, hardware and software and furniture and fixtures, is recorded at cost and is generally depreciated on a straight-line basis over the estimated useful lives of the assets, which range from two to five years.

Repairs and maintenance are charged to expense as incurred.

Statement of Cash Flows -- For purposes of the statements of cash flows, cash equivalents include highly liquid financial instruments with maturities of three months or less as of the date of purchase.

Concentrations of Credit Risk -- Financial instruments which potentially expose the Company to concentrations of credit risk consist primarily of trade accounts receivable. The Company's customer base includes multiple purchasers of our oil and gas products. Although the Company is directly affected by the well-being of the oil and gas industry, management does not believe a significant credit risk exists at June 30, 2005.

Revenue Recognition -- The Company recognizes oil and natural gas revenues from its interests in producing wells as oil and natural gas is sold. As a result, the Company accrues revenues related to production sold for which the Company has not received payment.

Accounts Receivable, trade - Accounts receivable, trade consists of uncollateralized accrued oil and gas revenues due under normal trade terms, generally requiring payment within 30 days of production. Management reviews receivables periodically and reduces the carrying amount by a valuation allowance that reflects management's best estimate of the amount that may not be collectible. As of June 30, 2005 and 2004, the valuation allowance was \$0.

Accounting for Reverse Merger -- The Company accounted for its reverse-merger in accordance with Staff Accounting Bulletin ("SAB") Topic 2A. Generally, the staff of the Division of Corporate Finance considers reverse-mergers into public shells to be capital transactions in substance, rather than business combinations. That is, the transaction is equivalent to the issuance of stock by the private company for the net monetary assets of the shell corporation, accompanied by a recapitalization.

Under this treatment, post reverse-acquisition comparative historical financial statements are those of the "legal acquiree" (i.e., the "accounting acquirer"), with appropriate disclosure concerning the change in the capital structure effected at the acquisition date. In the Company's case, the historical financial statements are those of the oil and gas operations of Old NGS, and the Consolidated Statement Of Changes in Stockholder's Equity reflects the activity of Old NGS prior to the merger. All share and per share amounts have been adjusted to reflect the conversion ratio of shares exchanged between Reality and Old NGS.

Also, in accordance with SAB Topic 2A, transaction costs incurred for the reverse-merger, such as legal fees, investment banking fees and the like, may be charged directly to equity only to the extent of the cash received, while all costs in excess of cash received should be charged to expense. Accordingly, since no cash was received, \$370,000 in transaction fees was expensed in the Company's financial statements.

Stock Options -- SFAS 123, "Accounting for Stock-Based Compensation," as amended by SFAS 148, "Accounting for Stock-Based Compensation--Transition and Disclosure," established accounting and disclosure requirements using a fair value-based method of accounting for stock-based employee compensation plans. The Company accounts for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board Opinion 25, "Accounting for Stock Issued to Employees" ("APB 25").

Fair Value of Financial Instruments -- Our financial instruments consist of cash and cash equivalents, accounts receivable, accounts payable, notes payable and seller notes. The carrying amounts of cash and cash equivalents, accounts receivable and accounts payable approximate fair value due to the highly liquid nature of these short-term instruments. The fair value of the notes payable to Prospect Energy approximates the carrying value of the notes as the effective interest rates applicable to the notes approximates current rates available to us for comparable financing arrangements. The fair values of the seller notes approximate their carrying amounts as of June 30, 2004, based upon interest rates then available to us for borrowings with similar terms.

Income taxes - Income taxes are provided for the tax effects of transactions reported in the financial statements and consist of taxes currently due, if any, plus net deferred taxes related primarily to differences between basis of assets and liabilities for financial and income tax reporting. Deferred tax assets and liabilities represent the future tax return consequences of those differences, which will either be taxable or deductible when the assets and liabilities are recovered or settled. Deferred tax assets include recognition of operating losses that are available to offset future taxable income and tax credits that are available to offset future income taxes. Valuation allowances are recognized to limit recognition of deferred tax assets where appropriate. Such allowances may be reversed when circumstances provide evidence that the deferred tax assets

will more likely than not be realized.

Accounting for Price Risk Management activities - The Company enters into certain financial derivative contracts utilized for non-trading purposes to minimize the impact of market price fluctuations on contractual commitments and forecasted transactions related to its oil and gas production. The Company follows the provisions of the Statement of Financial Accounting Standards ("SFAS") No. 133, Accounting for Derivative Instruments and Hedging Activities, for the accounting of its hedge transactions. SFAS No. 133 establishes accounting and reporting standards requiring that all derivatives instruments be recorded in the consolidated balance sheet as either as an asset or liability measured at fair value and requires that the changes in the fair value be recognized currently in the earnings unless specific hedge accounting criteria is met.

Upon adoption, the Company did not have any financial derivative contracts utilized for non-trading purposes. Thus, the adoption of SFAS No. 133 had no impact upon the Company. The Company has entered into certain over-the-counter contracts to hedge the cash flow of part of the 2005 forecasted sale of oil and gas production. The Company will not elect to document and designate these as hedges. Thus, the changes in the fair value of these over-the-counter contracts will be reflected in the earnings in the period in which they occur.

New Accounting Pronouncements - In December 2004, the FASB issued Statement of Financial Accounting Standards No. 123R "Shared Based Payment" ("SFAS 123R"). This statement is a revision of SFAS Statement No. 123 "Accounting for Stock-Based Compensation" and supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees," and its related implementation guidance. SFAS 123R addresses all forms of shared based compensation ("SBP") awards, including shares issued under employee stock purchase plans, stock options, restricted stock and stock appreciation rights. Under SFAS 123R, SBP awards result in a cost that will be measured at fair value on the awards' grant date, based on the estimated number of awards that are expected to vest and will be reflected as compensation cost in the historical financial statements. This statement is effective for public entities that file as small business issuers as of the beginning of the first interim or annual reporting period that begins after December 15, 2005. The Company is in the process of evaluating whether SFAS No. 123R will have a significant impact of the Company's overall results of operations or financial position.

#### 4. Acquisitions

In September 2003, Old NGS completed the acquisition of a 100% working interest in the Delhi Field. The acquisition closed on September 25, 2003, whereby Old NGS paid \$995,000 in cash, issued a purchase money mortgage for \$1,500,000 (See Note 7, Notes Payable, for a description of the mortgage) and assumed a plugging and abandonment reclamation liability in the amount of approximately \$302,000 (see Note 5, Asset Retirement Obligations), in exchange for the conveyance of all the underlying leasehold interests. In addition to the mortgage, the property is burdened by an aggregate 20% royalty interest.

On May 26, 2004, Reality Interactive, Inc., a publicly traded Nevada corporation ("Reality"), executed an Agreement and Plan of Merger with Natural Gas Systems, Inc., a private Delaware corporation ("Old NGS"), whereby the shareholders of Old NGS received 21,749,478 shares of common stock of Reality, in exchange for all of the 21,749,748 shares of Old NGS common stock then outstanding. The operations and management of Old NGS became our own, and Reality's name was changed to Natural Gas Systems, Inc., a Nevada corporation (the "Company" or "NGS"). Immediately prior to the closing of the merger, Reality had virtually no operations, assets or liabilities.

On September 2, 2004, we purchased a 100% working interest in approximately 81 producing oil wells, 8 salt water disposal wells and 54 shut-in wells located in La Salle and Winn Parishes, Louisiana. The purchase included leases covering 386.04 gross and net acres, and fee ownership of 2.33 acres around certain of the wells. Fourteen of the 54 shut-in wells will require a new lease prior to restoration of production. The purchase price was \$725,000 less approximately \$20,000 in closing adjustments to reflect an effective date of July 1, 2004, paid in cash, part of which was provided by the Bridge Loan described under Note 5. The acquisition was accounted for under the purchase method of accounting. No goodwill arose from the purchase. Revenue and expense from the property was recognized beginning September 1, 2004.

On February 3, 2005, we completed the purchase of a 100% working interest in certain leases with approximately 65 producing oil wells, 9 salt water disposal wells and 56 shut-in wells located in the Tullos Urania and Colgrade Fields in La Salle and Winn Parishes, Louisiana. Four of the 56 shut-in wells required a new lease prior to restoration of production. The purchase price was \$812,733 less post-closing adjustments to reflect an effective date of December 1, 2004, paid in cash. The acquisition was accounted for under the purchase method of accounting. No goodwill arose from the purchase. Revenue and expense from the property is recognized beginning February 1, 2005.

We believe that the foregoing property acquisitions are consistent with our strategic business plan to acquire established oil and gas properties in order to exploit them through the application of conventional and specialized technology to increase production, ultimate recoveries, or both.

#### 5. Asset Retirement Obligations

In June 2001, the FASB issued SFAS No. 143, Accounting for Asset Retirement Obligations. SFAS No. 143 requires that an asset retirement obligation ("ARO") associated with the retirement of a tangible long-lived asset be recognized as a liability in the period in which a legal obligation is incurred and becomes determinable, with an offsetting increase in the carrying amount of the associated asset. The cost of the tangible asset, including the initially recognized ARO, is depleted such that the cost of the ARO is recognized over the

useful life of the asset. The ARO is recorded at fair value, and accretion expense will be recognized over time as the discounted liability is accreted to its expected settlement value. The fair value of the ARO is measured using expected future cash outflows discounted at the Company's credit-adjusted risk-free interest rate. Fair value, to the extent possible, should include a market risk premium for unforeseeable circumstances. Inherent in the fair value calculation of ARO are numerous assumptions and judgments including the ultimate settlement amounts, inflation factors, credit adjusted discount rates, timing of settlement, and changes in the legal, regulatory, environmental, and political environments. To the extent future revisions to these assumptions impact fair value of the existing ARO liability, a corresponding adjustment is made to the oil and gas property balance.

When an oil or gas property ceases economic production, we dismantle and remove all surface equipment, plug the wells and restore the property's surface in accordance with various regulations and agreements before abandoning the property. The state of Louisiana requires operators of oil and gas properties to secure plugging, abandonment and reclamation liabilities with financial collateral in favor of the state. In the case of the Delhi Field, the previous owner had established a Site Specific Trust Fund (SSTA Account) that is considered a fully funded liability by the state of Louisiana. Pursuant to our agreement to purchase the Delhi Field in September of 2003, we agreed to replace the seller's collateral on the SSTA Account within 120 days of closing. During the six months ended June 30, 2004, we replaced the seller's collateral by posting a letter of credit in the face amount of \$301,835, fully collateralized by a certificate of deposit issued on Wells Fargo Bank. These restricted cash equivalents are carried as "Other Assets" in our balance sheet.

In accordance with FAS 143, we recorded an estimated asset retirement obligation ("ARO") for our Delhi Field of approximately \$302,000, of which \$274,000 relates to the Company's wells and \$28,000 relates to wells operated by us for a third party. Accordingly, we recorded an asset retirement obligation in the amount of \$302,000, with an offsetting \$274,000 charge to the full cost pool and a \$28,000 receivable due from the 3rd party at December 31, 2003. The receivable was collected during the six months ended June 30, 2004.

With respect to our property acquisitions in the Tullos Field Area in late 2004 and early 2005, we recorded an estimated combined ARO liability totaling \$99,984 based on the assessment we made during our fourth quarter of fiscal 2005.

The following table describes the change in our asset retirement obligations for the periods from September 23, 2003 (inception) to June 30, 2005:

Asset retirement obligation at September 23, 2003	\$301,835
Accretion expense for 2003	3,169
Asset retirement obligation at December 31, 2003	305,004
Accretion expense for 2004	6,438
Asset retirement obligation at June 30, 2004	311,442
Asset retirement costs in 2005	99,984
Accretion expense for 2005	21,824
Asset retirement obligation at June 30, 2005	\$433,250

#### 6. Oil and Gas Properties

Depletion expense for the period from September 23, 2003 (inception) to December 31, 2003, the six months ended June 30, 2004 and the twelve months ended June 30, 2005 totaled \$13,960, \$41,549 and \$257,882, respectively. During 2003, no costs were excluded from amortization. As of June 30, 2004 and June 30, 2005, \$105,225 and \$61,887 of costs, respectively, were not being amortized.

#### 7. Notes Payable

The following table sets forth the Company's notes payable balances as of the dates indicated:

Borrowing	June 30, 2005	June 30, 2004	December 31, 2003
-----	-----	-----	-----
Delhi Mortgage Notes	\$ --	\$ 732,807	\$ 1,436,973
AICCO Insurance Premium Loan	--	43,428	--
Cananwill Insurance Premium Loan (current)	6,754	--	--
Prospect Energy 5-Year Note	2,906,548	--	--
Bridge Loan by our Chairman of the Board	--	--	--
Herlin Loan	--	--	--
Total outstanding	\$ 2,913,302	\$ 776,235	\$ 1,436,973

DELHI MORTGAGE NOTES: In September 2003, we issued \$1,500,000 of notes payable in connection with our acquisition of the Delhi Field. The notes were collateralized by a first mortgage on our Delhi Field and were payable to the sellers in twelve equal monthly installments beginning on January 30, 2004 and ending December 2004. Although the notes did not bear any interest, we imputed interest at 8% per annum, thus resulting in an initial recorded principal amount of \$1,407,049. The Delhi Mortgage Notes were paid from a combination of loan proceeds from Bridge Loans and the Company's cash flow.

AICCO LOAN: In May 2004, we borrowed \$49,490 to finance 70% of our Director and Officer's liability insurance premiums. The loan required eight level mortgage-amortizing payments in the amount of \$6,350 per month, including 7% interest per annum. At June 30, 2005, there were no outstanding amounts owed under the AICCO Loan.

CANANWILL LOAN: In October 2004, we borrowed \$33,186 to finance 80% of our General Liability, Casualty and Well Control insurance premiums. The loan required ten level payments in the amount of \$3,399 per month, including 5.25% interest per annum. At June 30, 2005, \$6,754 was owed under the Cananwill Insurance Premium Loan.

BRIDGE LOAN: From August through December, 2004, Laird Q. Cagan, our Chairman and a major stockholder, loaned us, through a series of advances, \$920,000, pursuant to a secured note bearing interest at 10% per annum and a 5% origination fee (the "Bridge Loan") earmarked for our purchase of working interests in the Tullos Urania Field in Louisiana, working capital and certain costs related to the closing of the Prospect Facility described below. On February 15, 2005, we repaid the Bridge Loan, totaling \$953,589 with accrued interest, in full.

HERLIN LOAN: In December, 2004, Mr. Herlin advanced us \$3,000 for working capital, with interest payable at 10% per annum. At June 30, 2005, there were no amounts outstanding under the Herlin Loan.

PROSPECT FACILITY: On February 3, 2005, we closed the "Prospect Facility" (or "Facility") and drew down \$3,000,000, and on March 16, 2005 we drew down an additional \$1,000,000 on the total \$4,800,000 commitment. The draws were used to fund the February 2005 acquisition of properties in Louisiana, costs of the financing, funding of a debt service reserve fund, repayment of the Bridge Loan, immediate re-development of our existing properties and for working capital purposes. After taking into account the effect of the completion of the February 2005 acquisition of properties (see Note 2 to our consolidated financial statements), the closing of the Prospect Facility and our recent private placement of common stock described below, and before taking into account the effect of any new projects or acquisitions, we believed that our current liquidity and anticipated operating cash flows were sufficient to allow the remaining \$800,000 commitment under the Facility to expire on May 3, 2005.

At June 30, 2005, we owed \$2,906,548 on the Prospect Facility, including the accreted discount through such date. At maturity or, exclusive of any prepayment penalty, on early prepayment, the total amount owed under the Facility will be \$4,000,000 due to accretion of the original issue discount, which is described below.

Under the terms of the Prospect Facility, each advance required us to issue two securities, a debt security and an equity security (in the form of irrevocable and revocable warrants) as follows:

(i) The debt securities issued under the Facility (the "Prospect Loan(s)") are secured by all of our assets, bear an initial interest rate of 14% per annum payable in arrears on the "face" (the par or matured amount of the loan), mature on February 2, 2010 and do not require principal payments until the end of the term. The loans are subject to voluntary prepayment premiums equal to 9% of the face amount as of August 3, 2005, declining .5% for each three month period, thereafter. For each draw under the Facility, we recorded a loan with an imputed discount equivalent to the value of the Prospect Warrants described below. Through June 30, 2005, we had drawn \$4,000,000 under the Facility, crediting \$2,850,992 (net of the discount described below) to the Prospect Loan. The fair value of the Prospect Warrants of \$1,149,008 was recorded as a discount on the Prospect Loans with a corresponding credit to additional paid-in capital for the Prospect Warrants. The discount is accreted as additional loan interest expense using the interest rate method over the five-year life of the loan, yielding an annual effective interest rate of 27.26% and 24.87% for the first and second Prospect Loans, respectively.

(ii) The equity securities issued under the Facility consisted of irrevocable and revocable warrants (the "Prospect Warrants"). An irrevocable warrant to purchase one share of our common stock was issued to Prospect for each \$6.666667 drawn under the Facility, and a revocable warrant to purchase one share of our common stock was issued for each \$10 drawn under the Facility. Through June 30, 2005 we had issued to Prospect Energy irrevocable warrants to acquire up to 600,000 shares of common stock exercisable over a five-year term at a price of \$0.75 per common share, and revocable warrants to acquire up to 400,000 shares of common stock on the same terms, except that the revocable warrants will be automatically canceled if we attain certain financial targets by the end of February 2006, and such revocable warrants cannot be exercised prior to such date. As described under the Prospect Loan above, the Prospect Warrants have been credited to additional paid-in capital in the amount of \$1,149,008, based on their estimated fair value. The holder of the shares of common stock underlying the Prospect Warrants is the beneficiary of a registration rights agreement. Terms of the registration rights agreement and assumptions underlying fair value of the warrants are described in Note 8, "Common Stock, Stock Options and Warrants".

Among other restrictions and subject to certain exceptions, the Prospect Facility restricts us from creating liens, entering into certain types of mergers or consolidations, incurring additional indebtedness, the payment of dividends, changing the character of our business, or engaging in certain types of transactions. The Prospect Loan agreement also requires us to maintain specified financial ratios, including a 1.5:1 ratio of borrowing base to debt and, commencing not later than the three months ended January 31, 2006, a 2.0:1 ratio of EBITDA (earnings before interest, income tax and other non-cash charges such as depreciation, depletion and amortization) to interest.

At June 30, 2005, we were in compliance with the terms of the Facility. At May 31, 2005, we had however, not maintained a required performance milestone, thus causing us to increase our restricted cash account under the terms of the Facility from \$300,000 to \$560,000. The increased amount is reflected as restricted deposits in our balance sheet at June 30, 2005, although transfer of the additional \$260,000 is pending our receipt of further instructions from Prospect.

Looking forward, we are required to maintain an EBITDA to interest payable coverage of 2:1, beginning no later than the three month period ending January 31, 2006, in order to maintain compliance. Our ability to comply with this requirement is dependent on achieving certain operating results, especially with respect to our planned drilling program of proved undeveloped reserves at our Delhi Field beginning in May 2005. At September 27, 2005, our Delhi drilling program had not yet begun due to delays caused by casualty repairs sustained by the drilling contractor for the account of another customer. Due to these delays, we can give no assurance that the delayed results from this program will provide sufficient EBITDA to meet the required interest coverage ratio. If such a covenant breach occurs and is not waived by Prospect, the debt would become immediately due and payable. Since we do not have sufficient liquid assets to prepay our debt in full, we would be required to refinance all or a portion of our existing debt or obtain additional financing. If we were unable to refinance our debt or obtain additional financing, we would be required to curtail portions of our development program, sell assets, and/or reduce capital expenditures. Had we been subject to this requirement on June 30, 2005, we would not have been in compliance.

## 8. Common Stock, Stock Options and Warrants

### Common Stock

From September 23, 2003 (Inception) through December 31, 2003, Old NGS issued 18,000,000 common shares as founder's capital at \$0.001 per share, and sold 2,864,600 of its \$0.001 par value common shares at \$1.00 per share through a private equity offering to accredited investors. At December 31, 2003, Reality had issued and outstanding 256,598 shares of its \$0.001 par value common stock.

From January 1, 2004, up to, but not including, the merger closing on May 26, 2004, Reality issued 689,663 of its \$0.001 par value common shares, net of cancellations and redemptions. During the same period in 2004, Old NGS sold 884,878 of its \$0.001 par value common shares to accredited investors for \$886,900 gross proceeds, less \$60,000 in commissions equal to 8% of the gross cash proceeds and the issuance of 7 year term warrants equal to 8% of the shares issued, for the account of Chadbourn Securities, Inc. and Laird Q. Cagan, an affiliate of the Company as described in Note 9, "Related Party Transactions".

At the closing of the merger on May 26, 2004, Reality issued 21,749,478 of its \$0.001 par value common shares in exchange for all of the 21,749,478 issued and outstanding \$0.001 par value common shares of Old NGS.

Subsequent to the merger closing through June 30, 2004, we sold 249,667 shares of our \$0.001 par value common shares for gross proceeds of \$250,000, less \$30,000 in commissions and the same warrant structure described above for the account of Chadbourn Securities, Inc. and Laird Q. Cagan.

During the twelve months ended June 30, 2005, we raised gross proceeds of \$4,729,091 from the sale of our common stock, warrants to purchase our common stock and direct stock grants, less placement fees of \$257,840 to Chadbourn Securities and Laird Q. Cagan and warrants to purchase 108,536 shares. In addition, we also paid \$32,659 to unrelated third parties as finder's fees. Of the total, \$3,580,083 was received from the sale of 1,594,200 shares of our common stock and the issuance of 235,000 shares of our common stock upon the exercise of options and direct stock awards granted under our 2004 Stock Plan. The remaining \$1,149,008 was raised through the sale of warrants to Prospect Energy as described in Note 7, "Notes Payable".

### Options and Warrants issued to Employees

#### 2003 Stock Option Plan

Old NGS adopted a stock option plan in 2003 (the "2003 Plan"). The purpose of the 2003 Plan was to offer selected individuals an opportunity to acquire a proprietary interest in the success of Old NGS, or to increase such interest, by purchasing shares of the Old NGS common stock. The 2003 Plan provided both for the direct award or sale of shares and for the grant of options to purchase shares in an aggregate amount not to exceed 4,000,000 shares. Options granted under the Plan included non-statutory options as well as incentive stock options intended to qualify under Section 422 of the Internal Revenue Code. Of the options to purchase 600,000 shares granted under the 2003 Plan by Old NGS, all were assumed by Reality Interactive, Inc., predecessor to the Company. Of these, options to purchase 250,000 shares were granted to each of Messrs. Herlin and McDonald. These options were accounted for under APB 25, giving rise to \$437,250 of expense, spread over a four year vesting schedule.

#### 2004 Stock Plan

On August 3, 2004, we adopted our 2004 Stock Plan (the "2004 Plan"). The purpose of the 2004 Plan is to offer selected individuals an opportunity to acquire a proprietary interest in our success, or to increase such interest, by purchasing our shares of common stock. The 2004 Plan provides both for the direct award or sale of shares and for the grant of options or warrants to purchase shares in an aggregate amount not to exceed 4,000,000 shares. Options granted under the 2004 Plan may include non-statutory options as well as incentive stock options intended to qualify under Section 422 of the Internal Revenue Code.

No options were issued during the six months ended June 30, 2004. However, an aggregate 200,000 options had been authorized, but not issued, to two members of our Board of Directors, Messrs. DiPaolo and Stoeber.

During the twelve months ended June 30, 2005, there were 1,500,000 shares of common stock issued or issuable upon exercise of outstanding options, and 25,000 shares issued directly under the 2004 Stock Plan to employees, all subject to various vesting requirements, leaving 2,305,000 shares of common stock available for issuance under the 2004 Stock Plan, after taking into account awards to non-employees totaling 170,000 shares. Of these awards, options to purchase 100,000 shares were issued to each of our directors, E.J. DiPaolo and Gene Stoever, in consideration for their services; options to purchase 500,000, 350,000, 350,000 and 100,000 shares were granted to Messrs. Herlin, McDonald, Mazzanti and Joe; and a direct stock grant of 25,000 shares was made to Mr. Mazzanti. All of these options and grants were accounted for under APB 25, giving rise to \$44,000 of expense spread over a two year vesting period for Messrs. Stoever and DiPaolo, and \$40,225 of expense spread over a one year vesting period for Mr. Mazzanti.

#### Non-Plan Warrants to Employees

During the twelve months ended June 30, 2005, Mr. Herlin was granted revocable warrants to purchase 287,500 of common stock, and Mr. Mazzanti was granted revocable warrants to purchase 200,000 shares. These warrants were accounted for under APB 25, and gave rise to no Company expense during fiscal 2005, because the exercise price of Mr. Herlin's warrants exceeded fair value of the stock at June 30, 2005, and vesting of Mr. Mazzanti's warrants is based on a future specified event that has not yet occurred.

A reconciliation of reported loss as if the Company used the fair value method of accounting for stock-based compensation computed under FASB 123 as compared to the compensation expense we recorded under APB 25 follows:

	Twelve Months ended June 30, 2005	Six Months ended June 30, 2004	For the Period from September 23, 2003 (Inception) to December 31, 2003
-----			
Pro forma impact of Fair Value Method (SFAS 148):			
Net loss attributable to common stockholders, as reported	(\$2,164,571)	(\$1,027,682)	(\$336,905)
Plus share based compensation expense determined under APB 25	131,313	108,614	50,400
Less compensation expense determined under Fair Value Method	(359,457)	(110,978)	(51,858)
	-----	-----	-----
Pro forma net loss attributable to common stockholders	(\$2,392,715)	(\$1,030,046)	(\$338,363)
Loss per share (basic & diluted):			
As reported	(\$0.09)	(\$0.05)	(\$0.02)
Pro Forma	(\$0.10)	(\$0.05)	(\$0.02)
Weighted average Black-Scholes fair value assumptions:			
Risk free interest rate	4.18% - 4.93%	2.50%	2.50%
Expected life	3-4 years	3 years	3 years
Expected volatility	104% - 130%	131.0%	131.0%
Expected dividend yield	0.0%	0.0%	0.0%

Fair values were estimated at the date of grants using the Black-Scholes options pricing model, based on the assumptions above. For purposes of the pro forma disclosures, the estimated fair value is amortized to expense over the awards' vesting period. The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because the Company's employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a single measure of the fair value of its employee stock options. At June 30, 2005, 2,305,000 shares were available for grant under the plans.

A summary of option and warrant transactions issued to employees for the period from September 23, 2003 (inception) to June 30, 2005 follows:

	Number of Shares	Weighted average Exercise Price	Weighted average Grants Date Fair Value	Weighted average Remaining Contractual Life
For the Period from September 23, 2003 (Inception) to December 31, 2003				
Granted	500,000	\$0.13	\$0.94	
Exercised	0	--		
Canceled	0	--		
Outstanding at December 31, 2003	500,000	\$0.13		9.8 years
Six months ended June 30, 2004				
Granted	0			
Exercised	0			
Canceled	0			
Outstanding at June 30, 2004	500,000	\$0.13		9.3 years
Twelve months ended June 30, 2005				
Granted	2,012,500*	\$1.67	\$1.31*	
Exercised	0			
Canceled	0			
Outstanding at June 30, 2005	2,512,500	\$1.37		9.4 years

\* Mr. Mazzanti's revocable warrants to purchase 200,000 shares are included in the number of shares granted, but have not been used to calculate the weighted average grants date fair value since the award is contingent on a specified future event.

These options and warrants vest during the following fiscal years ended June 30 as follows: Vested at June 30, 2005 - 303,125; 2006 - 696,875; 2007 - 571,875; 2008 - 493,750 and 2009 - 446,875.

#### Options, Warrants and Grants to Non-Employees

At June 30, 2005, outstanding warrants and options, excluding employees, to purchase the Company's \$0.001 par value common shares were as follows:

#### Warrants and Options Outstanding (Excluding Employees)

Holder	Range of Exercisable Prices		Outstanding at June 30, 2005	Exercisable June 30, 2005
Cagan McAfee Capital Partners, LLC	\$ 1.00	\$ 1.00	165,000	165,000
Chadborn Securities, Inc.	\$ 1.50	\$ 2.50	8,574	8,574
Laird Q. Cagan	\$ 1.00	\$ 2.50	142,143	142,143
Tatum Partners	\$ .001	\$ 0.001	262,500	262,500
Prospect Energy	\$ 0.75	\$ 0.75	1,000,000	600,000
Steve Lee (counsel to the Company)	\$ .001	\$ 1.80	60,000	10,000
Other	\$ 1.00	\$ 2.00	146,750	146,750
Total			1,784,967	1,334,967

As of June 30, 2004, we issued warrants to purchase 240,000 shares of common stock to Cagan McAfee Capital Partners and their assigns in connection with arranging the merger, options to purchase 100,000 shares of common stock to Steve Lee under the 2003 Stock Plan (90,000 of which have been exercised) and a warrant to purchase 79,931 share of common stock in connection with Cagan McAfee's capital raising services, of which warrants to purchase 66,784 and 3,147 shares of common stock were issued to Laird Q. Cagan and Chadbourn Securities, Inc., respectively. Mr. Lee's award gave rise to \$99,900 of fair value expense under SFAS 123 over the one year vesting period, using the Black-Scholes model with the following assumptions: Volatility - 131%, Risk Free Rate - 5.0%, Estimated Term - 3 years, and Dividends - 0.

During fiscal year ended June 30, 2005, we issued warrants to purchase 142,536 shares of common stock in connection with capital raising services, of which we issued warrants to purchase 75,359 and 5,427 shares of common stock to Laird Q. Cagan and Chadbourn Securities, Inc., 61,750 to third parties and options to purchase 50,000 shares to Steve Lee under the 2004 Stock Plan.

During the fiscal year ended June 30, 2005, we also made a direct stock grant for 120,000 shares to Liviakis Communications (excluded from the table above) for investor relations services and issued options to purchase 50,000 shares of our stock to Mr. Lee under our 2004 Plan. Mr. Lee's grant gives rise to \$67,519 of fair value expense under SFAS 123, to be spread over a four year vesting schedule. Fair value was derived using the Black-Scholes model using the following assumptions: Volatility - 110%, Risk Free Rate - 4.18%, Estimated Term - 4 years, and Dividends - 0. The Liviakis stock grant gives rise to \$263,880 of expense, spread over a one year vesting schedule, beginning monthly in April 2005. The fair value of the Liviakis grant under SFAS 123 was equivalent to the fair value of our stock on the date of grant.

Also during the fiscal year ended 2005, we issued warrants to purchase 1,000,000 shares under the Prospect Facility, recording fair value in the amount of \$1,149,008 using the Black-Scholes model, using the following assumptions: Volatility - 102.8%, Risk Free Rate - 4.93%, Estimated Term - 3 years, Dividend - 0. Certain of these warrants will not vest if the Company reaches certain financial thresholds. As a result, those warrants were discounted in determining fair value. Finally, we issued warrants to purchase 262,500 shares to Tatum Partners, recognizing \$432,976 of SFAS 123 fair value expense in the current year, wherein fair value was equal to intrinsic value since there was no time value associated with the grant.

#### Registration Rights

Under the terms of our private placement of 1,200,000 shares of our common stock with the Rubicon Fund on May 6, 2005, we contemporaneously entered into a registration rights agreement (the "RRA"). The RRA requires us, among other things, to obtain and maintain an effective registration statement with the SEC for Rubicon's shares, failing which, subjects us to the payment of penalties not to exceed 1% of the share proceeds, or \$30,000, for each month of non-compliance. Penalties are incurred for each month for which a registration statement has not become effective, beginning October 6, 2005. Penalties may also be incurred for any month for which effectiveness has not been maintained prior to the shares becoming tradable under Rule 144, but in no event can the penalty cumulatively exceed 8% or \$240,000. The SEC is currently reviewing the registration statement we filed June 6, 2005 on Form SB-2, and we can give no assurance that our registration statement will become or be maintained effective after October 6, 2005. Accordingly, we have accrued, against our equity account \$100,000 for penalties and other transaction costs which may become due.

We have also entered into other registration rights agreements, the effect of which gives the holders the right to "piggyback" their shares, from time to time, as we register other shares.

#### 9. Related Party Transactions

Laird Q. Cagan, the Chairman of our Board of Directors, is a Managing Director of Cagan McAfee Capital Partners, LLC ("CMCP"). CMCP performs financial advisory services for us pursuant to a written agreement and is paid a monthly retainer of \$15,000. In addition, Mr. Cagan is a registered representative of Chadbourn Securities, Inc. ("Chadbourn"), our non-exclusive placement agent for private financings. Pursuant to the Agreement between Mr. Cagan, Chadbourn and us, we pay a cash fee equal to 8% of gross equity proceeds and warrants equal to 8% of the shares placed by CMCP. During 2003, we expensed and paid CMCP \$32,500 for monthly retainers.

In connection with the founding of the Company, 18,000,000 shares of Old NGS common stock were directly and indirectly purchased by various parties as founder's shares, including, 1,000,000 shares by Robert S. Herlin as an incentive to perform as the Company's President and CEO; 1,000,000 shares by Liviakis Financial Communications, Inc., the Company's investor relations firm; 7,500,000 shares by Laird Q. Cagan, the Company's Chairman and Managing Director of CMCP; and 5,700,000 by Eric M. McAfee, Managing Director of CMCP, and 450,000 by John Pimentel, a member of the Company's Board of Directors.

During the six months ended June 30, 2004 we expensed \$90,000 in monthly retainers, \$60,000 of which remained unpaid at June 30, 2004, and charged \$80,000 to stockholder's equity as a reduction of the proceeds from common stock sales in the amount of \$1,000,000. The \$80,000 paid to Chadbourn Securities and Laird Q. Cagan was for commissions from the sale of our common stock. Also during the six months ended June 30, 2004 we issued warrants to purchase 319,932 shares of Common Stock to CMCP, Chadbourn Securities and Laird Q. Cagan and their assigns in connection with arranging the merger, (240,000 warrants) and placement of 999,145 common shares (79,932 warrants). These warrants have a \$1.00 exercise price and a seven year term.

During the fiscal year ended June 30, 2005, we issued warrants to purchase 91,359 and 5,427 shares of common stock to Laird Q. Cagan and Chadbourn Securities, Inc., respectively, in connection with capital raising services. During the same period, we paid \$257,890 cash commissions to Laird Q. Cagan and Chadbourn Securities, Inc., in connection with capital raising activities. Further, during fiscal year ended June 30, 2005, the Company expensed and paid CMCP \$180,000 for monthly retainers earned in fiscal 2005, and paid \$60,000 for monthly retainers earned, but unpaid, during fiscal 2004.

Also during fiscal 2005, from August through December, 2004, Mr. Cagan loaned us, through a series of advances, \$920,000, pursuant to a secured promissory note bearing interest at 10% per annum and a 5% origination fee (the "Bridge Loan") earmarked for our purchase of working interests in the Tullos Urania Field in Louisiana, working capital and certain costs related to the closing of the Prospect Facility. On February 15, 2005, we repaid the Bridge Loan, totaling \$953,589 with accrued interest, in full.

Eric McAfee, also a Managing Director of Cagan McAfee Capital Partners, has served as Vice Chairman of the Board of Verdisys, Inc., the provider of certain horizontal drilling services to the Company. Subsequently in 2004, Mr. McAfee resigned from the Board of Directors of Verdisys, but continues to hold shares in both companies. Mr. McAfee has represented to the Company that he is also a 50% owner of Berg McAfee Companies, LLC, which owns approximately 30% of Verdisys, Inc. NGS paid \$130,000 to Verdisys (Blast Energy) during 2003 and \$25,960 during 2004 for horizontal drilling services.

#### 10. Supplemental Oil and Gas Disclosures (unaudited)

##### Costs Incurred in Oil and Gas Producing Activities

	Twelve Months Ended June 30, 2005	Six Months Ended June 30, 2004	For the Period From September 23, 2003 (Inception) to December 31, 2003
Property acquisition costs:			
Proved	\$ 1,554,149	\$ 6,855	\$ 2,363,716
P&A liability assumed	99,984	0	273,760
Unproved	61,887	105,225	0
Exploration costs	0	0	0
Development costs	441,508	97,114	333,992
Total property acquisition costs	\$ 2,157,528	\$ 209,194	\$ 2,971,468

##### Results of Operations for Oil and Gas Producing Activities

	Twelve Months Ended June 30, 2005	Six Months Ended Ended June 30, 2004	For the Period From September 23, 2003 (Inception) to December 31, 2003
Oil and gas sales	\$ 1,635,187	\$ 118,158	\$ 24,229
Production costs	(874,876)	(134,420)	(76,303)
Production taxes	(68,386)	(14,581)	(3,002)
Depletion	(257,882)	(41,549)	(13,960)
Results of operations for oil and gas producing activities (excluding corporate overhead and financing costs)	\$ 434,043	(\$ 72,392)	(\$ 69,036)

Proved Developed and Undeveloped Reserves Prepared by W.D. Von Gonten & Co.  
Petroleum Engineers

The following table sets forth the net proved reserves of the Company as of July 1, 2005, and the changes therein for the periods from September 23, 2003 (inception) to July 1, 2005. The reserve information was prepared by W.D. Von Gonten & Co., independent petroleum engineers. All of the Company's oil and gas producing activities are located in the United States.

	Oil (bbls)	Gas (mcf)
	-----	-----
September 23, 2003	--	--
Purchases of minerals in place	241,219	778,700
Extensions and discoveries	--	--
Revisions	--	--
Production	(857)	--
Sales of minerals in place	--	--
December 31, 2003	240,362	778,700
Purchases of minerals in place	--	--
Extensions and discoveries	76,412	293,419
Revisions	(74,060)	(563,440)
Production	(3,180)	(123)
Sales of minerals in place	--	--
July 1, 2004 (1)	239,534	508,556
Purchases of minerals in place (2)	418,217	--
Extensions and discoveries	242,340	330,023
Revisions	(100,978)	(34,290)
Production	(27,230)	(72,166)
Sales of minerals in place	--	--
July 1, 2005 (3)	771,883	732,123
Proved developed reserves:		
December 31, 2003	240,400	778,700
July 1, 2004 (4)	238,900	508,556
July 1, 2005 (5)	540,360	396,600

(1) During fiscal 2004, of the 270,000 MCF downward revision in our proved natural gas reserves, net of extensions and discoveries, a 300,000 MCF downward revision was due to the reclassification of our Delhi 208-1 well from proved to probable reserve status, based on new well information that decreased the probability of recovery below the threshold required for proved reserves. Proved natural gas reserve quantities include 5,000 BBL of NGL's, converted at 6 MCF per BBL at July 1, 2004.

(2) Proved developed reserves acquired in the Tullos Field Area during fiscal 2005.

(3) During fiscal 2005, the preponderance of our proved crude oil and natural gas extensions and discoveries were due to the addition of eight proved undeveloped reserve locations (PUDs), resulting from a six month geological study performed by an outside geologist we engaged to review approximately 20% of our Delhi Field. Proved crude oil additions more than exceeded the downgrade of our acquired Tullos reserves, resulting from poor performance related to bad weather, lack of service equipment and lack of repairs and maintenance by the seller in the months immediately preceding our acquisition. Elimination of our Delhi 210-2 well was primarily offset by a decrease in the estimate of fuel use. Proved natural gas reserve quantities include 7,300 BBL of NGL's, converted at 6 MCF per BBL at July 1, 2005.

(4) At July 1, 2004, our proved developed natural gas reserves include 5,000 BBL of NGL, converted at 6 MCF per BBL.

(5) During fiscal 2005, our proved developed natural gas reserves were revised downward due to the loss of our Delhi 210-2 well due to bad casing. At July 1, 2005, our proved developed natural gas reserves included 3,500 BBL of NGL, converted at 6 MCF per BBL.

Standardized Measure of Discounted Future Net Cash Flows at December 31, 2003,  
June 30, 2004 and June 30, 2005

The information that follows has been developed pursuant to SFAS No. 69 and utilizes reserve and production data prepared by independent petroleum consultants. Reserve estimates are inherently imprecise and estimates of new discoveries are less precise than those of producing oil and natural gas properties. Accordingly, these estimates are expected to change as future information becomes available.

The estimated discounted future net cash flows from estimated proved reserves are based on prices and costs as of the date of the estimate unless such prices or costs are contractually determined at such date. Actual future prices and costs may be materially higher or lower. Actual future net revenues also will be affected by factors such as actual production, supply and demand for oil and natural gas, curtailments or increases in consumption by natural gas purchasers, changes in governmental regulations or taxation and the impact of inflation on costs. Future income tax expense has been reduced for the effect of available net operating loss carryforwards.

	Twelve Months Ended June 30, 2005	Six Months Ended June 30, 2004	For the Period From September 23, 2003 (Inception) to December 31, 2003
Future cash inflows	\$ 46,841,246	\$ 11,549,850	\$ 13,318,169
Future production costs	(20,028,389)	(2,978,139)	(2,895,677)
Future development costs	(1,920,000)	(450,000)	(357,000)
Future income taxes	(6,036,000)	(1,465,000)	(2,412,000)
Future net cash flows	\$ 18,856,857	6,656,711	7,653,492
10% annual discount	(5,615,779)	(1,476,100)	(1,479,544)
Standardized Measure	\$ 13,241,078	\$ 5,180,611	\$ 6,173,948

Changes in Standardized Measure

The following table sets forth the changes in standardized measure of discounted future net cash flows for the period from September 23, 2003 (inception) to December 31, 2003, the six months ended June 30, 2004 and the twelve months ended June 30, 2005:

	Twelve Months Ended June 30, 2005	Six Months Ended June 30, 2004	For the Period From September 23, 2003 (Inception) to December 31, 2003
Standardized Measure, beginning	5,180,611	6,173,948	--
Net change in income taxes	(3,209,706)	737,006	(1,945,722)
Oil and gas sales, net of costs	(691,925)	30,843	51,065
Discoveries and extensions	7,131,907		
Purchase of minerals in place	4,780,920	--	8,068,605
Changes in prices and costs	3,285,724	82,230	--
Change in developments costs	(1,045,275)	(84,042)	--
Accretion of discount	518,061	308,697	--
Revisions of estimates	(2,670,979)	(2,131,318)	--
Other	(38,260)	63,247	--
Standardized Measure, ending	13,241,078	5,180,611	6,173,948

## 11. Restricted Deposits

At June 30, 2005, Restricted deposits includes \$301,835 securing a letter of credit posted with the State of Louisiana for future plugging and abandonment liabilities related to the Delhi Field, and \$560,000 related to the debt service reserve under the Prospect Facility.

Of these amounts, \$201,835 and \$200,000 exceed FDIC insurance limits in depository accounts at Wells Fargo Bank and AmSouth Bank, respectively.

## 12. Income Taxes

The tax effect of significant temporary differences representing deferred tax assets and liabilities at December 31, 2003, June 30, 2004 and June 30, 2005 are as follows:

	June 30, 2005	June 30, 2004	December 31, 2003
	-----	-----	-----
Oil and gas properties	(\$ 178,144)	(\$ 69,389)	(\$ 113,558)
Basis in subsidiary stock	125,800	0	0
Other	(10,159)	0	0
Net operating loss carryforwards	6,324,900	366,425	228,043
Valuation allowance	(6,262,397)	(297,036)	(114,485)
	-----	-----	-----
Net deferred tax asset	\$ 0	\$ 0	\$ 0
	=====	=====	=====

The increase in the valuation allowance during fiscal 2003, 2004 and 2005 of \$114,485, \$182,551 and \$5,965,361 respectively, is the result of net tax losses incurred during the year. The increase in the valuation allowance in fiscal 2005 is mostly attributable to the recognition of Reality's NOL carryforwards from prior years, in addition to current year net tax loss. Reality's NOL carryforwards had not been previously recognized as the tax impact of the transaction described in the Note 1 was not resolved until fiscal year 2005.

As of June 30, 2005, we have net operating loss carryforwards of approximately \$18,603,000 that will expire in 2023, 2024 and 2025. Future utilization of the net operating loss carryforwards and other tax attributes, absent a change in law, will be significantly limited by changes in the ownership of the Company in May 2004 under section 382 of the Internal Revenue Code.

The following is a reconciliation of the Company's expected income tax expense (benefit) based on statutory rates to the actual expense (benefit):

	Twelve Months Ended June 30, 2005	Six Months Ended June 30, 2004	For the Period From September 23, 2003 (Inception) to December 31, 2003
	-----	-----	-----
Income taxes (benefit) at US statutory rate	(\$ 735,954)	(\$ 349,412)	(\$ 114,548)
Non-deductible amortization and expenses	--	165,141	62
Deferred Stock Compensation and non-deductible expenses	240,860	--	--
Deferred tax asset valuation allowance adjustment	495,094	182,551	114,485
Net operating losses	--	--	--
Other	0	1,720	1
	-----	-----	-----

### 13. Leases

The Company is obligated for operating lease payments related to the Company's headquarters in Houston, Texas, and a gas processing plant servicing the Company's Delhi Field. Minimum lease payments are as follows:

Fiscal 2006:	\$42,921
Fiscal 2007:	\$33,980
Total	\$76,901

Lease expense was \$121,799 for the twelve months ended June 30, 2005; \$44,770 for the six months ended June 30, 2004 and \$8,541 for the three months ended December 31, 2003.

### 14. Liquidity

As of June 30, 2005, we had \$2,548,688 of unrestricted cash and positive working capital of \$2,599,232, versus negative working capital of \$383,352 at June 30, 2004, and negative working capital of \$360,749 at December 31, 2003. Also at June 30, 2005, the PV10 value of our proved oil and gas reserves to the face value of our debt was over 4:1.

Nevertheless, our net losses totaling \$2,164,571, \$1,027,682 and \$336,905 for the twelve months ended June 30, 2005, the six months ended June 30, 2004 and the period from September 23 (inception) to December 31, 2003, respectively, and our requirement to maintain an EBITDA to interest payable coverage of 2:1, beginning no later than the three month period ending January 31, 2006 under the Prospect Facility, raises questions about our liquidity. Although our net cash losses have narrowed on an annualized basis, our ability to comply with the EBITDA to interest coverage ratio is dependent on achieving certain operating results, especially with respect to our planned drilling program of proved undeveloped reserves at our Delhi Field beginning in May 2005. At September 27, 2005, our Delhi drilling program had not yet begun, due to delays caused by casualty repairs sustained by the drilling contractor for the account of another customer. Due to these delays, we can give no assurance that the delayed results from this program will provide sufficient EBITDA to meet the required interest coverage ratio. If such a covenant breach occurs and is not waived by Prospect, the debt would become immediately due and payable. Since we do not have sufficient liquid assets to prepay our debt in full, we would be required to refinance all or a portion of our existing debt or obtain additional financing. If we were unable to refinance our debt or obtain additional financing, we would be required to curtail portions of our development program, sell assets, and/or reduce capital expenditures. Had we been subject to this requirement on June 30, 2005, we would not have been in compliance.

We are currently addressing these issues by taking actions to expedite the repair and mobilization of the drilling rig that is causing the delay in our proved undeveloped reserve drilling program, possibly adding to the expense of our contract. Alternatively, it may be necessary for us to seek another rig, although we can give no assurance that one will be available within our timeframe, given tight industry supplies. We have also obtained covenant relief from Prospect as discussed under Note 18, "Subsequent Events."

Based on our current estimates of production and current oil and gas prices, and absent a default causing acceleration of our debt, we currently have sufficient capital reserves to satisfy our short-term obligations and to fund our anticipated development activities through December 31, 2005. We will require more capital or success in our development activities, or both, to execute additional acquisitions, fund our development plan beyond 2005, replace our existing depleting reserves or exploit any technology projects we may develop from time to time.

### 15. Loss per Share

The following table sets forth the computation of basic and diluted loss per share:

	Twelve Months ended June 30, 2005	Six Months ended June 30, 2004	For the Period from September 23, 2003 (Inception) to December 31, 2003
	-----	-----	-----
Numerator:			
Net loss applicable to common stockholders	(\$ 2,164,571)	(\$ 1,027,682)	(\$ 336,905)
Plus income impact of assumed conversions:			
Preferred Stock dividends	N/A	N/A	N/A
Interest on convertible subordinated notes	N/A	N/A	N/A
	-----	-----	-----
Net loss applicable to common stockholders plus assumed conversions	(2,164,571)	(1,027,682)	(336,905)
	=====	=====	=====
Denominator:	23,533,922	22,057,614	20,091,720
Affect of potentially dilutive common shares:			
Warrants	N/A	N/A	N/A
Employee and director stock options	N/A	N/A	N/A
Convertible preferred stock	N/A	N/A	N/A
Convertible subordinated notes	N/A	N/A	N/A
Redeemable preferred stock	N/A	N/A	N/A

Denominator for dilutive earnings per share -  
weighted average shares

23,533,922                      22,057,614                      20,091,720

Loss per common share:  
Basic and diluted

(\$            0.09)            (\$            0.05)            (\$            0.02)  
=====

Shares issuable from securities that could  
potentially dilute earnings per share in the  
future that were not included in the  
computation of loss per share because their  
effect was anti-dilutive:

4,222,468                      919,932                      600,000

## 16. Commodity Hedging

As required under our credit agreement with Prospect Energy, we have placed price risk contracts aggregating more than 50% of the production volumes that our outside petroleum engineers have estimated to occur from our existing proved developed producing reserves over the next two years. The Prospect Facility also requires us to extend such coverage on a rolling two-year basis through the five year term of the Facility.

As a part of this program, we purchased a series of price floors from Wells Fargo Bank, set at a NYMEX WTI price of \$38.00 per barrel of crude oil based upon the arithmetic average of the daily settlement price for the first nearby month of NYMEX WTI futures, for 2,000 barrels of crude oil per month for March 2006 through February 2007. The cost of the hedge was \$3.00 per barrel of oil. In accordance with SFAS No. 133, we have recorded these derivative puts at cost, and have marked them to market at the end of each month. Through June 30, 2005, \$58,534 has been marked to market and expensed, leaving a remaining asset of \$13,466.

These derivatives are in addition to future forward delivery contracts we entered into with Plains Marketing L.P., to complete our requirements under the Prospect Facility.

## 17. Major Customers

All of our crude oil is currently sold to Plains Marketing L.P., all of our natural gas is currently being sold to Texla Energy Management, Inc. and all of our natural gas liquids are currently sold to a subsidiary of Enbridge Energy Partners LP.

## 18. Subsequent Events

Effective September 22, 2005, we entered into an amendment to the Prospect Facility, thereby obtaining covenant relief with respect to our obligation to maintain an EBITDA to interest payable coverage ratio of 2:1. The amendment changes our compliance date to begin not later than the three months ended January 31, 2006, as compared to October 31, 2005 under the original terms of the agreement. This amendment was effected in order to allow us to proceed with the delayed drilling program of proved undeveloped reserve locations in our Delhi Field, the results of which we are relying on to achieve the required EBITDA coverage ratio. As explained earlier, the drilling program has been delayed due to a casualty sustained to the contracted rig, while demobilizing from a previous customer. In exchange for the amendment, we have issued to Prospect revocable warrants to purchase 200,000 shares of our common stock, exercisable at \$1.36 per share over five years. The warrants will be automatically revoked in the event we achieve \$200,000 in EBITDA, as defined, for any one month period through April 30, 2006. We also agreed to limit our acquisitions of additional oil and gas properties to a maximum of \$100,000 plus any new funds raised, until we achieve a trailing three month EBITDA to interest coverage ratio of 2.0. The limitation does not include any evaluation costs, so that we may continue to review new projects. For additional details, the amendment to the Loan Agreement and the Revocable Warrant Agreement are attached to our Form 10-K for the year ended June 30, 2005, as Exhibits 10.30 and 10.31, respectively.

All of our oil and gas assets are located in northern Louisiana. On August 29, 2005, the center of Hurricane Katrina, a Category 5 storm, came onshore just east of New Orleans, Louisiana. None of our oil and gas property suffered casualty loss from this storm, as the area was minimally affected by rains off of the west side of Katrina as she progressed inland veering to the east. It is possible, however, that in the aftermath of the storm we may become subject to supply chain disruptions affecting the availability of fuel, power, supplies and the like at any time, although we have not experienced any of these disruptions to date.

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders  
Natural Gas Systems, Inc.  
Houston, Texas

We have audited the accompanying consolidated balance sheets of Natural Gas Systems, Inc. as of June 30, 2005, June 30, 2004 and December 31, 2003 and the related consolidated statements of operations, stockholders' equity, and cash flows for the twelve months ended June 30, 2005, the six months ended June 30, 2004 and the period from September 23, 2003 (inception) to December 31, 2003. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the 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. The Company has determined that it is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Natural Gas Systems, Inc. and subsidiaries as of June 30, 2005, June 30, 2004 and December 31, 2003, and the consolidated results of their operations and their cash flows for each of the periods then ended, and the period from September 23, 2003 (inception) to December 31, 2003, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 14 to the financial statements, the Company has sustained losses since inception and has a requirement under its debt facility to meet a prescribed interest coverage ratio beginning with the three month period ended January 31, 2006. At the present time, the Company is not generating sufficient cash flow from operations to meet the required interest coverage ratio. If the Company does not meet the interest coverage ratio, the debt holder has the right to cause the outstanding debt of \$4,000,000 to become immediately due and payable. At the present time, the Company does not have the resources to pay off the debt in the event it becomes immediately due and payable.

HEIN & ASSOCIATES LLP

Houston, Texas  
August 27, 2005, except for the first paragraph in Note 18 as to which the date is September 27, 2005.

## PART III.

## ITEM 13. EXHIBITS AND REPORTS

## Index of Exhibits

2.1	Asset Purchase Agreement for Tullos Field dated September 3, 2004.	Previously Filed
2.2	Definitive Asset Purchase Agreement, dated as of February 2, 2005, by and between Chadco, Inc., Alan Chadwick McCartney, Sonya McCartney and NGS Sub. Corp.	Previously Filed
3(i)	Articles of Incorporation. Previously Filed 3(ii) Bylaws.	Previously Filed
10.1	Certificate of Draw Request, dated as of February 16, 2005, between the Company and Prospect Energy Corporation ("Prospect")	Previously Filed
10.2	Loan Agreement, dated as of February 2, 2005, between the Company and Prospect	Previously Filed
10.3	Mortgage, Collateral Assignment, Security Agreement and Financing Statement by NGS Sub. Corp., dated as of February 2, 2005	Previously Filed
10.4	Company Promissory Note in favor of Prospect	Previously Filed
10.5	Security Agreement, dated as of February 2, 2005, between NGS Sub Corp. and Prospect	Previously Filed
10.6	Security Agreement, dated as of February 2, 2005, between Natural Gas Systems, Inc., a Delaware corporation, and Prospect	Previously Filed
10.7	Guaranty Agreement, dated as of February 2, 2005, by Natural Gas Systems, Inc., a Delaware corporation, NGS Sub. Corp., Arkla Petroleum, L.L.C. and Four Star Development Corporation, in favor of Prospect	Previously Filed
10.8	Warrant Agreement, dated as of February 2, 2005, between the Company and Prospect	Previously Filed
10.9	Company Common Stock Purchase Warrant in favor of Prospect, dated as of February 2, 2005	Previously Filed
10.10	Revocable Warrant Agreement, dated as of February 2, 2005, between the Company and Prospect	Previously Filed
10.11	Company Revocable Common Stock Purchase Warrant in favor of Prospect, dated as of February 2, 2005	Previously Filed
10.12	Registration Rights Agreement, dated as of February 2, 2005, between the Company and Prospect	Previously Filed
10.13	Executive Employment Agreement, Robert S. Herlin, dated April 4, 2005	Previously Filed
10.14	Herlin Stock Option Agreement, dated April 4, 2005	Previously Filed
10.15	Herlin Warrant Agreement, dated April 4, 2005	Previously Filed
10.16	Amended and Restated Tatum Resources Agreement, dated April 4, 2005	Previously Filed
10.17	Tatum Warrant Agreement, dated April 4, 2005	Previously Filed
10.18	Executive Employment Agreement, Sterling H. McDonald, dated April 4, 2005	Previously Filed
10.19	McDonald Stock Option Agreement, dated April 4, 2005	Previously Filed
10.20	Secured Promissory Note - Laird Q. Cagan, dated August 10, 2004	Previously Filed
10.21	Amendment to Secured Promissory Note - Laird Q. Cagan, dated September 20, 2004	Previously Filed
10.22	Securities Purchase Agreement dated as of May 6, 2005, by and between Natural Gas Systems, Inc. and Rubicon Master Fund	Previously Filed
10.23	Registration Rights Agreement dated as of May 6, 2005, by and between Natural Gas Systems, Inc. and Rubicon Master Fund	Previously Filed
10.24	Amendment to Consulting Agreement, dated as of May 4, 2005, by and between Natural Gas Systems, Inc., and Liviakis Financial Communications, Inc.	Previously Filed
10.25	Stock Grant Agreement, dated as of May 4, 2005, by and between Natural Gas Systems, Inc. and Liviakis Financial Communications, Inc.	Previously Filed
10.26	Executive Employment Agreement, Daryl V. Mazzanti ("Mazzanti"), dated June 23, 2005	Previously Filed
10.27	Mazzanti Stock Option Agreement, dated June 23, 2005	Previously Filed
10.28	Mazzanti Stock Grant Agreement dated June 23, 2005	Previously Filed
10.29	Mazzanti Revocable Warrant Agreement, dated June 23, 2005	Previously Filed
10.30	Amendment to Prospect Loan Agreement, dated September 27, 2005, between the Company and Prospect	Previously Filed
10.31	Revocable Warrant Agreement, dated as of September 27, 2005, between the Company and Prospect	Previously Filed
21.1	List of all subsidiaries of the Company.	Previously Filed
31.1	Certification of Chief Executive Officer pursuant to Section 302 of Sarbanes-Oxley Act of 2002.	Included
31.2	Certification of Chief Financial Officer pursuant to Section 302 of Sarbanes-Oxley Act of 2002.	Included
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.	Included
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.	Included

SIGNATURES

In accordance with Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

NATURAL GAS SYSTEMS, INC.

By: /s/ ROBERT S. HERLIN

-----  
 Robert S. Herlin  
 Chief Executive Officer  
 (Principal Executive Officer)

By: /s/ STERLING H. MCDONALD

-----  
 Sterling H. McDonald  
 Chief Financial Officer  
 (Principal Financial and  
 Accounting Officer)

Date: October 27, 2005

In accordance with the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Date	Signature	Title
October_27, 2005	/s/ E. J. DIPAOLO ----- E. J. DiPaolo	Director
October_27, 2005	/s/ GENE STOEVER ----- Gene Stoever	Director
October_27, 2005	/s/ JOHN PIMENTEL ----- John Pimentel	Director
October_27, 2005	/s/ LAIRD CAGAN ----- Laird Cagan	Chairman of the Board
October_27, 2005	/s/ ROBERT S. HERLIN ----- Robert S. Herlin	Director

CERTIFICATION PURSUANT TO RULE 15D-14 OF THE SECURITIES EXCHANGE ACT OF 1934,  
AS AMENDED AS ADOPTED PURSUANT TO  
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, Robert S. Herlin, Chief Executive Officer of Natural Gas Systems, Inc.,  
certify that:

1. I have reviewed this annual report on Form 10-KSB of Natural Gas Systems, Inc.;
2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the Registrant as of, and for, the periods presented in this report;
4. The Registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the Registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Evaluated the effectiveness of the Registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - c) Disclosed in this report any change in the Registrant's internal control over financial reporting that occurred during the Registrant's most recent fiscal quarter (the Registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the Registrant's internal control over financial reporting; and
5. The Registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Registrant's auditors and the audit committee of Registrant's Board of Directors:
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the Registrant's internal control over financial reporting.

Date: October\_27, 2005

/s/ ROBERT S. HERLIN

-----  
Robert S. Herlin  
Chief Executive Officer

CERTIFICATION PURSUANT TO RULE 15D-14 OF THE SECURITIES EXCHANGE ACT OF 1934,  
AS AMENDED AS ADOPTED PURSUANT TO SECTION 302  
OF THE SARBANES-OXLEY ACT OF 2002

I, Sterling H. McDonald, Chief Financial Officer of Natural Gas Systems, Inc.,  
certify that:

1. I have reviewed this annual report on Form 10-KSB of Natural Gas Systems, Inc.;
2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the Registrant as of, and for, the periods presented in this report;
4. The Registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the Registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Evaluated the effectiveness of the Registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - c) Disclosed in this report any change in the Registrant's internal control over financial reporting that occurred during the Registrant's most recent fiscal quarter (the Registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the Registrant's internal control over financial reporting; and
5. The Registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Registrant's auditors and the audit committee of Registrant's Board of Directors:
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the Registrant's internal control over financial reporting.

Date: October 27, 2005

/s/ STERLING H. MCDONALD

-----  
Sterling H. McDonald  
Chief Financial Officer

CERTIFICATION OF CHIEF EXECUTIVE OFFICER  
PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002  
(18 U.S.C. 1350)

The undersigned, Robert S. Herlin, President and Chief Executive Officer of Natural Gas Systems, Inc. (the "Company"), certifies in connection with the filing with the Securities and Exchange Commission of the Company's Annual Report on Form 10-KSB for the year ended June 30, 2005 (the "Report") pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes Oxley Act of 2002, to his knowledge, that:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

IN WITNESS WHEREOF, the undersigned has executed this certification as of the 27th day of October, 2005.

/s/ ROBERT S. HERLIN

-----  
Robert S. Herlin  
Chief Executive Officer

CERTIFICATION OF CHIEF FINANCIAL OFFICER  
PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002  
(18 U.S.C. 1350)

The undersigned, Sterling H. McDonald, Chief Financial Officer of Natural Gas Systems, Inc. (the "Company"), certifies in connection with the filing with the Securities and Exchange Commission of the Company's Annual Report on Form 10-KSB for the year ended June 30, 2005 (the "Report") pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes Oxley Act of 2002, to his knowledge, that:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

IN WITNESS WHEREOF, the undersigned has executed this certification as of the 27th day of October, 2005.

/s/ STERLING H. MCDONALD

-----  
Sterling H. McDonald  
Chief Financial Officer