

BLUE DOLPHIN ENERGY CO

Form 10-Q

August 14, 2008

**Table of Contents**

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
FORM 10-Q**

(Mark One)

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the quarterly period ended: June 30, 2008**

**Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission File Number: 0-15905  
BLUE DOLPHIN ENERGY COMPANY  
(Exact name of registrant as specified in its charter)**

**Delaware**  
(State or other jurisdiction of  
Incorporation or organization)

**73-1268729**  
(I.R.S. Employer  
Identification No.)

**801 Travis Street, Suite 2100, Houston, Texas 77002**

(Address of principal executive offices)

**(713) 568-4725**

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) 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   
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company   
(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

As of August 14, 2008, there were 11,639,715 shares of the registrant's common stock, par value \$.01 per share, outstanding.

**BLUE DOLPHIN ENERGY COMPANY & SUBSIDIARIES  
INDEX TO QUARTERLY REPORT  
ON FORM 10-Q**

<b><u>PART I. FINANCIAL INFORMATION</u></b>	<b>3</b>
<u>ITEM 1. FINANCIAL STATEMENTS</u>	3
<u>Condensed Consolidated Balance Sheets</u>	3
<u>Condensed Consolidated Statements of Operations (Unaudited)</u>	4
<u>Condensed Consolidated Statements of Cash Flows (Unaudited)</u>	5
<u>Notes to Condensed Consolidated Financial Statements (Unaudited)</u>	6
<u>MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND</u>	
<u>ITEM 2. RESULTS OF OPERATIONS</u>	14
<u>ITEM 4T. CONTROLS AND PROCEDURES</u>	19
<b><u>PART II. OTHER INFORMATION</u></b>	<b>20</b>
<u>ITEM 1. LEGAL PROCEEDINGS</u>	20
<u>ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS</u>	20
<u>ITEM 3. DEFAULTS UPON SENIOR SECURITIES</u>	20
<u>ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS</u>	20
<u>ITEM 5. OTHER INFORMATION</u>	20
<u>ITEM 6. EXHIBITS</u>	20
<b><u>SIGNATURES</u></b>	<b>22</b>
<u>Ivar Siem Certification Pursuant to Section 302</u>	
<u>T. Scott Howard Certification Pursuan to Section 302</u>	
<u>Ivar Siem Certification Pursuant to Section 906</u>	
<u>T. Scott Howard Certification Pursuant to Section 906</u>	

**Table of Contents****PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****BLUE DOLPHIN ENERGY COMPANY & SUBSIDIARIES****Condensed Consolidated Balance Sheets**

	June 30, 2008 (unaudited)	December 31, 2007
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 4,527,433	\$ 5,226,779
Accounts receivable	559,766	693,977
Prepaid expenses and other current assets	723,982	508,517
Total current assets	5,811,181	6,429,273
Property and equipment, at cost:		
Oil and gas properties (full-cost method)	1,108,433	751,175
Pipelines	4,659,686	4,659,686
Onshore separation and handling facilities	1,919,402	1,919,402
Land	860,275	860,275
Other property and equipment	285,916	279,468
	8,833,712	8,470,006
Less:		
Accumulated depletion, depreciation and amortization	4,215,115	3,966,087
	4,618,597	4,503,919
Other assets	9,463	10,640
Total Assets	\$ 10,439,241	\$ 10,943,832
<b>Liabilities and Stockholders Equity</b>		
Current liabilities:		
Accounts payable	\$ 472,561	\$ 432,974
Accrued expenses and other liabilities	26,626	109,628
Asset retirement obligations - current portion	264,538	262,187
Other long-term liabilities - current portion	25,996	25,996
Total current liabilities	789,721	830,785
Long-term liabilities:		
Other long-term liabilities, net of current portion	51,992	51,992
Asset retirement obligations, net of current portion	1,884,478	1,831,520

Edgar Filing: BLUE DOLPHIN ENERGY CO - Form 10-Q

Total long-term liabilities	1,936,470	1,883,512
Total Liabilities	2,726,191	2,714,297
Stockholders' Equity:		
Common stock (\$.01 par value, 25,000,000 shares authorized, 11,639,715 and 11,610,363 shares issued and outstanding at June 30, 2008 and December 31, 2007 respectively)	116,397	116,104
Additional paid-in capital	32,302,025	32,117,950
Accumulated deficit	(24,705,372)	(24,004,519)
Total Stockholders' Equity	7,713,050	8,229,535
Total Liabilities and Stockholders' Equity	\$ 10,439,241	\$ 10,943,832

See accompanying notes to the condensed consolidated financial statements.

**Table of Contents****BLUE DOLPHIN ENERGY COMPANY & SUBSIDIARIES**  
**Condensed Consolidated Statements of Operations (Unaudited)**

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2008	2007	2008	2007
Revenue from operations:				
Pipeline operations	\$ 695,402	\$ 531,762	\$ 1,243,219	\$ 1,091,575
Oil and gas sales	293,553	89,165	424,273	384,348
Total revenue	988,955	620,927	1,667,492	1,475,923
Cost of operations:				
Pipeline operating expenses	402,096	562,692	818,052	1,078,863
Lease operating expenses	83,094	90,464	133,267	157,782
Depletion, depreciation and amortization	117,690	152,203	249,028	289,379
General and administrative	561,548	636,830	1,195,357	1,120,192
Accretion expense	26,733	30,391	55,309	60,782
Total costs and expenses	1,191,161	1,472,580	2,451,013	2,706,998
Loss from operations	(202,206)	(851,653)	(783,521)	(1,231,075)
Other income (expense):				
Interest and other income	26,727	67,168	82,668	127,402
Loss before income taxes	(175,479)	(784,485)	(700,853)	(1,103,673)
Income taxes				
Net loss	\$ (175,479)	\$ (784,485)	\$ (700,853)	\$ (1,103,673)
Loss per common share				
Basic	\$ (0.02)	\$ (0.07)	\$ (0.06)	\$ (0.10)
Diluted	\$ (0.02)	\$ (0.07)	\$ (0.06)	\$ (0.10)
Weighted average number of common shares outstanding				
Basic	11,632,165	11,560,361	11,624,746	11,558,754
Diluted	11,632,165	11,560,361	11,624,746	11,558,754

See accompanying notes to the condensed consolidated financial statements.



**Table of Contents**

**BLUE DOLPHIN ENERGY COMPANY & SUBSIDIARIES**  
**Condensed Consolidated Statements of Cash Flows (Unaudited)**

	Six Months Ended June 30,	
	2008	2007
Operating Activities		
Net loss	\$ (700,853)	\$ (1,103,673)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depletion, depreciation and amortization	249,028	289,379
Accretion of asset retirement obligations	55,309	60,782
Common stock issued for services	40,000	39,160
Compensation from issuance of stock options	144,368	13,440
Changes in operating assets and liabilities:		
Accounts receivable	134,211	736,639
Prepaid expenses and other assets	(214,288)	(334,133)
Abandonment costs incurred		(32,133)
Accounts payable and accrued expenses	(43,415)	184,482
Net cash used in operating activities	(335,640)	(146,057)
Investing Activities		
Exploration and development costs	(357,258)	
Capital expenditures	(6,448)	(22,224)
Net cash used in investing activities	(363,706)	(22,224)
Financing Activities		
Decrease in cash and cash equivalents	(699,346)	(168,281)
Cash and Cash Equivalents at Beginning of Period	5,226,779	5,499,147
Cash and Cash Equivalents at End of Period	\$ 4,527,433	\$ 5,330,866

See accompanying notes to the condensed consolidated financial statements.



**Table of Contents**

**BLUE DOLPHIN ENERGY COMPANY & SUBSIDIARIES**  
**Notes to Condensed Consolidated Financial Statements (Unaudited)**  
**June 30, 2008**

**1. Organization and Significant Accounting Policies**

**Organization**

Blue Dolphin Energy Company was incorporated in Delaware in January 1986 to engage in oil and gas exploration, production and acquisition activities and oil and gas transportation and marketing. We were formed pursuant to a reorganization effective June 9, 1986.

The unaudited condensed consolidated financial statements of Blue Dolphin Energy Company and its subsidiaries (referred to herein, with its predecessors and subsidiaries, as Blue Dolphin, we, us and our ) included herein have been prepared by us, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (the SEC ) and, in the opinion of management, reflect all adjustments necessary to present a fair statement of operations, financial position and cash flows. We follow the full-cost method of accounting for oil and gas properties, wherein costs incurred in the acquisition, exploration and development of oil and gas reserves are capitalized. We believe that the disclosures are adequate and the information presented is not misleading, although certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations.

Our accompanying unaudited condensed consolidated financial statements should be read in conjunction with our audited consolidated financial statements and notes thereto included in our annual report on Form 10-KSB for the year ended December 31, 2007. The results of operations for the three and six months ended June 30, 2008 are not necessarily indicative of the results of operations to be expected for the full year.

**Accounting Estimates**

We have made a number of estimates and assumptions relating to the reporting of consolidated assets and liabilities and to the disclosure of contingent assets and liabilities to prepare these unaudited condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States of America. This includes the estimated useful life of pipeline assets, valuation of stock-based payments and reserve information, which affects the depletion calculation as well as the full cost ceiling limitation. While we believe current estimates are reasonable and appropriate, actual results could differ from those estimated.

**Fair Value Measurements**

On January 1, 2008, we adopted Statement of Financial Accounting Standards ( SFAS ) Statement No. 157, *Fair Value Measurements* ( SFAS 157 ), which clarifies the definition of fair value, establishes a framework for measuring fair value, and expands the disclosures on fair value measurements. In February 2008, the Financial Accounting Standards Board ( FASB ) issued Staff Position 157-2, *Effective Date of FASB Statement No. 157* ( FSP 157-2 ), that deferred the effective date of SFAS 157 for one year for nonfinancial assets and liabilities recorded at fair value on a non-recurring basis. The effect of adoption of SFAS 157 for financial assets and liabilities recognized at fair value on a recurring basis did not have a material impact on our financial position and results of operations. We are assessing the impact of SFAS 157 for nonfinancial assets and liabilities.

On January 1, 2008, we adopted SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities, including an amendment of FASB Statement No. 115* ( SFAS 159 ). SFAS 159 permits companies to choose an irrevocable election to measure certain financial assets and financial liabilities at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings at each subsequent reporting date. We did not elect the fair value option under SFAS 159 for any of our financial assets or liabilities upon adoption.

**Recent Accounting Developments**

In December 2007, the FASB issued SFAS No. 141R, *Business Combinations* ( SFAS 141R ), which replaces SFAS No. 141, *Business Combinations*. SFAS 141R establishes principles and requirements for determining how an enterprise recognizes and measures the fair value of certain assets and liabilities acquired in a business

**Table of Contents**

**BLUE DOLPHIN ENERGY COMPANY & SUBSIDIARIES**  
**Notes to Condensed Consolidated Financial Statements (Unaudited)**  
**June 30, 2008**

**Continued**

combination, including non-controlling interests, contingent consideration, and certain acquired contingencies. SFAS 141R also requires acquisition-related transaction expenses and restructuring costs be expensed as incurred rather than capitalized as a component of the business combination. SFAS 141R will be applicable prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. SFAS 141R would have an impact on accounting for any businesses acquired after the effective date of this pronouncement.

In December 2007, the FASB also issued SFAS No. 160, *Non-controlling Interests in Consolidated Financial Statements - An Amendment of ARB No. 51* ( SFAS 160 ). SFAS 160 establishes accounting and reporting standards for the non-controlling interest in a subsidiary (previously referred to as minority interests). SFAS 160 also requires that a retained non-controlling interest upon the deconsolidation of a subsidiary be initially measured at its fair value. Upon adoption of SFAS 160, we would be required to report any non-controlling interests as a separate component of stockholders' equity. We would also be required to present any net income allocable to non-controlling interests and net income attributable to the stockholders of the company separately in our consolidated statements of income. SFAS 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. SFAS 160 requires retroactive adoption of the presentation and disclosure requirements for existing non-controlling interests. All other requirements of SFAS 160 shall be applied prospectively. SFAS 160 would have an impact on the presentation and disclosure of the non-controlling interests of any non wholly-owned businesses acquired in the future.

**2. Earnings per Share**

We apply the provisions of SFAS No. 128, *Earnings per Share* ( SFAS 128 ). SFAS 128 requires the presentation of basic earnings per share ( EPS ) which excludes the dilutive effect of securities or contracts to issue common stock, and is computed by dividing net income (loss) available to common stockholders by the weighted-average number of shares of common stock outstanding for the period. SFAS 128 requires dual presentation of basic EPS and diluted EPS on the face of the statement of operations and requires a reconciliation of the numerators and denominators of basic EPS and diluted EPS. Diluted EPS is computed by dividing net income (loss) available to common stockholders by the diluted weighted average number of shares of common stock outstanding, which includes the potential dilution that could occur if securities or other contracts to issue common stock were converted to common stock that then shared in the earnings of the entity.

Remainder of Page Intentionally Left Blank

Table of Contents

**BLUE DOLPHIN ENERGY COMPANY & SUBSIDIARIES**  
**Notes to Condensed Consolidated Financial Statements (Unaudited)**  
**June 30, 2008**

**Continued**

Employee stock options and stock warrants outstanding at June 30, 2008 were not included in the computation of diluted earnings per share because their assumed exercise and conversion would have an antidilutive effect on the computation of diluted loss per share.

	Net Loss	Weighted Average Number of Shares of Common Stock Outstanding and Potential Dilutive Shares of Common Stock	Per Share Amount
Three months ended June 30, 2008 Basic and diluted loss per share	\$ (175,479)	11,632,165	\$ (0.02)
Three months ended June 30, 2007 Basic and diluted loss per share	\$ (784,485)	11,560,361	\$ (0.07)
Six months ended June 30, 2008 Basic and diluted loss per share	\$ (700,853)	11,624,746	\$ (0.06)
Six months ended June 30, 2007 Basic and diluted loss per share	\$ (1,103,673)	11,558,754	\$ (0.10)

Remainder of Page Intentionally Left Blank

Table of Contents

**BLUE DOLPHIN ENERGY COMPANY & SUBSIDIARIES**  
**Notes to Condensed Consolidated Financial Statements (Unaudited)**  
**June 30, 2008**  
**Continued**

**3. Business Segment Information**

Our income producing operations are conducted in two principal business segments: pipeline operations and oil and gas exploration and production. There were no intersegment revenues during the periods presented. Information concerning these segments for the three and six months ended June 30, 2008 and June 30, 2007 and at June 30, 2008 is as follows:

	Revenues	Operating Income (Loss) <sup>(*)</sup>	Depletion, Depreciation and Amortization
Three Months ended June 30, 2008:			
Pipeline operations	\$ 695,402	\$ (170,730)	\$ 104,332
Oil and gas exploration and production	293,553	40,999	12,315
Other		(72,475)	1,043
Consolidated	\$ 988,955	(202,206)	\$ 117,690
Other income, net		26,727	
Loss before income taxes		\$ (175,479)	
Three Months ended June 30, 2007:			
Pipeline operations	\$ 531,762	\$ (583,451)	\$ 105,360
Oil and gas exploration and production	89,165	(161,239)	45,484
Other		(106,963)	1,359
Consolidated	\$ 620,927	(851,653)	\$ 152,203
Other income, net		67,168	
Loss before income taxes		\$ (784,485)	
Six Months ended June 30, 2008:			
Pipeline operations	\$ 1,243,219	\$ (578,115)	\$ 208,663
Oil and gas exploration and production	424,273	(4,479)	37,714
Other		(200,927)	2,651
Consolidated	\$ 1,667,492	(783,521)	\$ 249,028
Other income, net		82,668	

Edgar Filing: BLUE DOLPHIN ENERGY CO - Form 10-Q

Loss before income taxes		\$	(700,853)	
Six Months ended June 30, 2007:				
Pipeline operations	\$ 1,091,575	\$	(898,309)	\$ 207,328
Oil and gas exploration and production	384,348		(96,012)	79,373
Other			(236,754)	2,678
Consolidated	\$ 1,475,923		(1,231,075)	\$ 289,379
Other income, net			127,402	
Loss before income taxes		\$	(1,103,673)	

**Table of Contents**

**BLUE DOLPHIN ENERGY COMPANY & SUBSIDIARIES**  
**Notes to Condensed Consolidated Financial Statements (Unaudited)**  
**June 30, 2008**  
**Continued**

	June 30, 2008
Identifiable assets:	
Pipeline operations	\$ 5,286,411
Oil and gas exploration and production	625,439
Other	4,527,391
 Consolidated	 \$ 10,439,241

(\*) Consolidated loss from operations includes \$71,432 and \$105,604 in unallocated general and administrative expenses, and \$1,043 and \$1,359 in unallocated depletion, depreciation and amortization for the three months ended June 30, 2008 and 2007, respectively. All unallocated amounts are included in Other.

Consolidated loss from operations includes \$198,276 and \$234,077 in unallocated general and administrative expenses, and

\$2,651 and \$2,678 in unallocated depletion, depreciation and amortization for the six months ended June 30, 2008 and 2007, respectively. All unallocated amounts are included in Other.

#### 4. Stock-Based Compensation

Effective April 14, 2000, after approval by our stockholders, we adopted the 2000 Stock Incentive Plan (the 2000 Plan ). Under the 2000 Plan, we are able to make awards of stock-based compensation. The number of shares of common stock reserved for grants of incentive stock options ( ISOs ) and other stock-based awards was increased from 650,000 shares to 1,200,000 shares after approval by our stockholders at the 2007 Annual Meeting of Stockholders, which was held on May 30, 2007. As of June 30, 2008, we had 274,040 shares of common stock remaining available for future grants. Options granted under the 2000 Plan have contractual terms from six to ten years. The exercise price of ISOs cannot be less than 100% of the fair market value of a share of our common stock determined on the grant date. The 2000 Plan is administered by the Compensation Committee of our Board of Directors.

Pursuant to SFAS 123R, we estimate the fair value of stock options granted on the date of grant using the Black-Scholes-Merton option-pricing model. The following assumptions were used to determine the fair value of stock options granted during the year ended December 31, 2007. There were no stock options granted for the six months ended June 30, 2008.

	December 31, 2007
Stock options granted	378,500
Risk-free interest rate	4.31 to 4.80%
Expected term, in years	3.75 to 5.97
Expected volatility	81.67 to 92.4%
Dividend yield	0.00%

Expected volatility used in the model is based on the historical volatility of our common stock and is weighted 50% for the historical volatility over a past period equal to the expected term and 50% for the historical volatility over the past two years prior to the grant date. This weighting method was chosen to account for the significant changes in our financial condition beginning approximately two years ago. These changes include the improvement in our working capital, improved pipeline throughput and the reduction and ultimate elimination of our outstanding debt.

Table of Contents

**BLUE DOLPHIN ENERGY COMPANY & SUBSIDIARIES**  
**Notes to Condensed Consolidated Financial Statements (Unaudited)**  
**June 30, 2008**

**Continued**

The expected term of options granted used in the model represents the period of time that options granted are expected to be outstanding. The method used to estimate the expected term is the simplified method as allowed under the provisions of the Securities and Exchange Commission's Staff Accounting Bulletin No. 107. This number is calculated by taking the average of the sum of the vesting period and the original contract term. The risk-free interest rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the date of the grant. As we have not declared dividends on our common stock since we became a public company, no dividend yield was used. No forfeiture rate was assumed due to the forfeiture history for this type of award. Actual value realized, if any, is dependent on the future performance of our common stock and overall stock market conditions. There is no assurance that the value realized by an optionee will be at or near the value estimated by the Black-Scholes-Merton option-pricing model.

At June 30, 2008, there were a total of 491,559 shares of common stock reserved for issuance upon exercise of outstanding options under the 2000 Plan. A summary of the status of our stock options granted to key employees, officers and directors, for the purchase of shares of common stock for the period indicated, is as follows:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value
Options outstanding at December 31, 2006	143,997	\$ 1.56		
Options granted	378,500	\$ 2.93		
Options exercised	(27,938)	\$ 0.80		
Options expired or cancelled	(3,000)	\$ 6.00		
Options outstanding at December 31, 2007	491,559	\$ 2.61		
Options granted		\$		
Options exercised		\$		
Options expired or cancelled		\$		
Options outstanding at June 30, 2008	491,559	\$ 2.61	6.7	\$128,880
Options exercisable at June 30, 2008	207,559	\$ 2.22	6.3	\$128,880

Remainder of Page Intentionally Left Blank



**Table of Contents**

**BLUE DOLPHIN ENERGY COMPANY & SUBSIDIARIES**  
**Notes to Condensed Consolidated Financial Statements (Unaudited)**  
**June 30, 2008**

**Continued**

The following table summarizes additional information about stock options outstanding at June 30, 2008:

Range of Exercise Prices	Number Outstanding	Options Outstanding		Options Exercisable	
		Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
\$0.35 to \$0.80	70,830	4.8	\$ 0.44	70,830	\$ 0.44
\$1.55 to \$1.90	23,429	3.6	\$ 1.71	23,429	\$ 1.71
\$2.81 to \$2.99	378,500	7.5	\$ 2.91	94,500	\$ 2.94
\$6.00	18,800	1.9	\$ 6.00	18,800	\$ 6.00
	491,559			207,559	

The following summarizes the net change in non-vested stock options for the periods shown:

	Shares	Weighted Average Grant Date Fair Value
Non-vested at December 31, 2006		\$
Granted	378,500	\$ 2.06
Canceled or expired		\$
Vested	(28,500)	\$ 1.96
Non-vested at December 31, 2007	350,000	\$ 2.05
Granted		\$
Canceled or expired		\$
Vested	(66,000)	\$ 2.35
Non-vested at June 30, 2008	284,000	\$ 2.01

As of June 30, 2008, there was \$453,593 of unrecognized compensation cost related to 350,000 nonvested stock options granted in 2007 under the 2000 Plan. Unrecognized compensation cost of \$289,225 and \$164,368, respectively, will be recognized on a straight line basis over vesting periods of 22 and 15 months for 200,000 and 150,000 of the stock options granted.

**Table of Contents**

**BLUE DOLPHIN ENERGY COMPANY & SUBSIDIARIES**  
**Notes to Condensed Consolidated Financial Statements (Unaudited)**  
**June 30, 2008**  
**Continued**

**5. Warrants**

A summary of warrant activity for the periods shown is as follows:

	Number of Warrants	Weighted- Average Exercise Price	Warrants Exercisable	Weighted- Average Exercise Price
Outstanding, December 31, 2006	16,440	\$ 5.39	16,440	\$ 5.39
Granted		\$		
Exercised		\$		
Outstanding, December 31, 2007	16,440	\$ 5.88	16,440	\$ 5.88
Granted		\$		
Exercised		\$		
Outstanding, June 30, 2008	16,440	\$ 6.37	16,440	\$ 6.37

At June 30, 2008, the range of warrant prices for shares under warrants and the weighted-average remaining contractual life was as follows:

Exercise Prices	Warrants Outstanding, Fully Vested and Exercisable at June 30, 2008		
	Number Outstanding	Weighted Average Remaining Contractual Life in Years	Weighted Average Exercise Price
\$6.00 to \$6.50	16,440	0.8	\$ 6.37

These securities were issued in reliance upon the exemption from registration pursuant to Section 4(2) under the Securities Act of 1933, as amended.

**6. Contingencies**

From time to time we are involved in various claims and legal actions arising in the ordinary course of business. In our opinion, the ultimate disposition of these matters will not have a material effect on our financial position, results of operations or cash flows.

**Table of Contents**

**BLUE DOLPHIN ENERGY COMPANY & SUBSIDIARIES**

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

**Cautionary Statements**

Certain of the statements included in this quarterly report on Form 10-Q, including those regarding future financial performance or results or that are not historical facts, are forward-looking statements as that term is defined in Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act), and Section 27A of the Securities Act of 1933, as amended. The words expect, plan, believe, anticipate, project, estimate, and similar expressions are intended to identify forward-looking statements. Blue Dolphin Energy Company (referred to herein, with its predecessors and subsidiaries, as Blue Dolphin, we, us and our) cautions readers that these statements are not guarantees of future performance or events and such statements involve risks and uncertainties that may cause actual results and outcomes to differ materially from those indicated in forward-looking statements. Some of the important factors, risks and uncertainties that could cause actual results to vary from forward-looking statements include:

the level of utilization of our pipelines;

availability and cost of capital;

actions or inactions of third party operators for properties where we have an interest;

the risks associated with exploration;

the level of production from our oil and gas properties;

oil and gas price volatility;

uncertainties in the estimation of proved reserves and in the projection of future rates of production and timing of development expenditures;

regulatory developments; and

general economic conditions.

Additional factors that could cause actual results to differ materially from those indicated in the forward-looking statements are discussed under the caption Risk Factors in our annual report on Form 10-KSB for the year ended December 31, 2007. Readers are cautioned not to place undue reliance on these forward-looking statements which speak only as of the date thereof. We undertake no duty to update these forward-looking statements. Readers are urged to carefully review and consider the various disclosures made by us which attempt to advise interested parties of the additional factors which may affect our business, including the disclosures made under the caption Management's Discussion and Analysis of Financial Condition and Results of Operations in this report.

**Executive Summary**

We are engaged in two lines of business: (i) provision of pipeline transportation services to producer/shippers, and (ii) oil and gas exploration and production. Our assets are located offshore and onshore in the Texas Gulf Coast area. Our goal is to create greater long-term value for our stockholders by increasing the utilization of our existing pipeline assets and acquiring additional strategic assets that diversify our asset base, improve our competitive position and are accretive to earnings. Although we are primarily focused on acquisitions of pipeline assets, we also continue to review and evaluate opportunities to further develop our existing oil and gas properties and acquire additional oil and gas properties.

During 2007, we benefited from an increase in revenues from our pipeline operations resulting from the commencement of deliveries of production from shippers on both the Blue Dolphin System and the GA 350 Pipeline. On the Blue Dolphin System, one shipper commenced deliveries in July 2007 from two wells. The Blue Dolphin

System is currently transporting an aggregate of approximately 27 MMcf of gas per day representing production from ten wells from eight shippers.

GA 350 Pipeline throughput has also increased from the addition of two shippers in 2007. The GA 350 Pipeline is currently transporting an aggregate of approximately 23 MMcf of gas per day representing production from six wells from five shippers.

**Table of Contents**

**BLUE DOLPHIN ENERGY COMPANY & SUBSIDIARIES**  
**Management's Discussion and Analysis of Financial Condition and Results of Operations**  
**Continued**

Production and resulting revenues from our interests in wells in the High Island area have declined as reserves are depleting. High Island Block 37 is currently producing approximately 2 MMcf of gas per day from one well. We elected to participate in an exploratory well in High Island Block 37 at our 2.8% working interest. Drilling of the well commenced in mid April 2008. The well was determined to be non-commercial subsequent to the current quarter end and will be plugged and abandoned in the third quarter. We expect the remaining costs, subsequent to the end of the current quarter, to total approximately \$323,000.

The High Island Block A-7 well experienced production difficulties during the second quarter of 2007 and is currently shut in. Production data had previously indicated that the well was nearing the end of its productive life and this point may have been reached. We hold an 8.98% working interest in the block. Activity going forward has not yet been determined by the working interest partners in the block.

During the second quarter of 2007, a well in High Island Block 115 in which we had previously earned a 2.5% working interest was re-entered and successfully sidetracked. Production from this well commenced in late-November 2007. The well is currently producing approximately 9 MMcf of gas per day.

Despite recent throughput gains, our pipeline assets remain significantly underutilized. The Blue Dolphin System is currently operating at approximately 13% of capacity, the GA 350 Pipeline is currently operating at approximately 35% of capacity and the Omega Pipeline is inactive. Production declines, temporary stoppages or cessations of production from wells tied into our pipelines or from our High Island area wells could have a material adverse effect on our cash flows and liquidity if the resulting revenue declines are not offset by increases in revenues from existing sources or revenues from other sources. Due to our geographically concentrated asset base and limited capital resources, any negative event has the potential to have a material adverse impact on our financial condition. We are continuing our efforts to increase the utilization of our existing assets and acquire additional assets that will diversify the risks to our cash flows and be accretive to earnings.

**Liquidity and Capital Resources**

At June 30, 2008, our available working capital was approximately \$5.0 million, a decrease of \$0.6 million from approximately \$5.6 million at both December 31 and June 30, 2007. The decrease in working capital was due primarily to the property insurance renewal in the current quarter and payments for the drilling of an exploratory well in High Island Block 37. Due to the low utilization of our pipeline assets, without the revenues and resulting cash inflows we receive from oil and gas sales, we may be required to use our cash and cash equivalents to cover a portion of our operating and general and administrative expenses.

The following table summarizes our financial position at June 30, 2008 and December 31, 2007 (in thousands):

	June 30, 2008		December 31, 2007	
	Amount	%	Amount	%
Working capital	\$ 5,021	52%	\$ 5,598	55%
Property and equipment, net	4,619	48%	4,504	45%
Other noncurrent assets	9		11	
 Total	 \$ 9,649	 100%	 \$ 10,113	 100%
Long-term liabilities	\$ 1,936	20%	\$ 1,883	19%
Stockholders' equity	7,713	80%	8,230	81%
 Total	 \$ 9,649	 100%	 \$ 10,113	 100%



**Table of Contents**

**BLUE DOLPHIN ENERGY COMPANY & SUBSIDIARIES**  
**Management's Discussion and Analysis of Financial Condition and Results of Operations**  
**Continued**

Our financial condition continues to be adversely affected by the low utilization of our pipeline assets. The Blue Dolphin System is currently transporting approximately 27 MMcf of gas per day. The GA 350 Pipeline is currently transporting approximately 23 MMcf of gas per day. This time last year, the Blue Dolphin System was transporting 28 MMcf of gas per day and the GA 350 Pipeline was transporting 19 MMcf of gas per day.

During the first six months of 2008, revenues from pipeline operations increased to \$1,243,219 as compared to \$1,091,575 in 2007. The increase in revenue was primarily attributable to an increase in throughput on the GA 350 Pipeline. Throughput on the Blue Dolphin System during the first six months of 2008 and 2007 averaged 21.2 MMcf of gas per day. Average throughput on the GA 350 Pipeline was 25.5 MMcf of gas per day during the first six months of 2008 as compared to 18.7 MMcf of gas per day during the first six months of 2007.

We have significant available capacity on the Blue Dolphin System, the GA 350 Pipeline and the inactive Omega Pipeline. We believe that the pipelines are in geographic market areas that are of interest to oil and gas operators. This assessment is based on leasing activity and information obtained directly from the operators of properties near our pipelines.

Ultimately, the future utilization of our pipelines and related facilities will depend upon the success of drilling programs around our pipelines, as well as attraction and retention of producers/shippers to the pipeline systems. If we are successful in our efforts to attract additional shippers to our pipelines, we would gain additional throughput resulting in additional revenues. Additional throughput will be required to offset the natural decline in throughput from existing wells as reserves are depleted.

We recognized gross oil and gas sales revenues of \$424,273 and \$384,348 for the six months ended June 30, 2008 and 2007, respectively.

Revenues from our working interest in High Island Block 37 have declined as the rate of production has declined. High Island Block 37 production averaged approximately 5.4 MMcf of gas per day in 2007. The A-2 well experienced production problems in April 2007 and was shut in for approximately eight months. The well began producing again in December 2007, and is currently producing at a rate of approximately 2 MMcf of gas per day. We believe that the A-2 well could continue to produce until late 2008, however, the well could deplete faster than currently anticipated or could develop production problems resulting in the cessation of production. The B-1 well went off production in January 2008. Production from that well has not yet been re-established. At this time last year the B-1 well was producing approximately 5 MMcf of gas per day. The resulting decline in the aggregate production from High Island Block 37 is approximately 60%. We elected to participate in an exploratory well in High Island Block 37 at our 2.8% working interest. Drilling of the well commenced in mid April 2008. Subsequent to the end of the current quarter, the well was determined to be non-commercial and will be plugged and abandoned in the third quarter.

The High Island Block A-7 well experienced production problems in the second quarter 2007. The well has produced only intermittently since. It is currently shut in and may have reached the end of its productive life. The well averaged approximately 0.7 MMcf of gas per day in 2007. Future plans for the block have not been determined.

During the second quarter of 2007, a well in High Island Block 115 in which we had previously earned a 2.5% working interest was re-entered and successfully sidetracked. The well commenced production in late November 2007 and produced at an average rate of approximately 6.3 MMcf of gas per day during the remainder of 2007. The well is currently producing at a rate of approximately 9 MMcf of gas per day.

Table of Contents

**BLUE DOLPHIN ENERGY COMPANY & SUBSIDIARIES**  
**Management's Discussion and Analysis of Financial Condition and Results of Operations**  
**Continued**

The following table summarizes certain of our contractual obligations and other commercial commitments at June 30, 2008 (in thousands):

	Total	Payments Due by Period			5 Years or More
		1 Year or Less	1-3 Years	3-5 Years	
Operating leases	\$ 331	\$ 103	\$ 228	\$	\$
Employment agreement	321	175	146		
Asset retirement obligations	2,149	265	125		1,759
Other long-term liabilities	78	26	52		
Total contractual obligations and other commercial commitments	\$ 2,879	\$ 569	\$ 551	\$	\$ 1,759

**Results of Operations**

For the three months ended June 30, 2008 (the current quarter), we reported a net loss of \$175,479 compared to a net loss of \$784,485 for the three months ended June 30, 2007 (the previous quarter). For the six months ended June 30, 2008 (the current period), we reported a net loss of \$700,853 compared to a net loss of \$1,103,673 for the six months ended June 30, 2007 (the previous period).

**Three Months Ended June 30, 2008 Compared to Three Months Ended June 30, 2007**

*Revenue from Pipeline Operations.* Revenues from pipeline operations increased by \$163,640, or 31%, in the current quarter to \$695,402. Revenues in the current quarter from the Blue Dolphin System increased to approximately \$583,000 compared to approximately \$447,000 in the previous quarter due to increased throughput from existing shippers. Daily gas volumes transported on the Blue Dolphin System averaged 21.6 MMcf of gas per day in the current quarter, up from 19.7 MMcf of gas per day in the previous quarter. Revenues on the GA 350 Pipeline increased by approximately \$27,000 in the current quarter due to an increase in average daily gas volumes transported to 26.5 MMcf of gas per day in the current quarter from 19.7 MMcf of gas per day in the previous quarter.

*Revenue from Oil and Gas Sales.* Revenues from oil and gas sales increased by \$204,388, or 229%, to \$293,553 in the current quarter primarily due to production from High Island Block 115, which commenced in November 2007.

Revenue breakdown for the current quarter by field was \$133,606 for High Island Block 115 and \$159,947 for High Island Block 37. The sales mix by product was 99% gas and 1% condensate. Our average realized gas price per Mcf in the current quarter was \$10.99 compared to \$6.40 in the previous quarter.

*Pipeline Operating Expenses.* Pipeline operating expenses in the current quarter decreased by \$160,596 to \$402,096 due to decreases in compressor repair costs of approximately \$136,000, legal costs of approximately \$34,000 and plant site maintenance expense of approximately \$42,000. The decrease was partially offset by increases in property insurance of approximately \$33,000 and storage tank repairs of approximately \$25,000.

*General and Administrative Expenses.* General and administrative expenses decreased by \$75,282 to \$561,548 in the current quarter due to decreases in office expense of approximately \$62,000, legal costs of approximately \$15,000 and employee related costs of approximately \$10,000. The decrease was partially offset by an increase in office rent of approximately \$18,000.

*Interest and Other Income.* Interest income decreased by \$40,441 to \$26,727 in the current quarter due to decreases in money market funds and the interest rate earned on those funds.



**Table of Contents**

**BLUE DOLPHIN ENERGY COMPANY & SUBSIDIARIES**  
**Management's Discussion and Analysis of Financial Condition and Results of Operations**  
**Continued**

**Six Months Ended June 30, 2008 Compared to Six Months Ended June 30, 2007**

*Revenue from Pipeline Operations.* Revenues from pipeline operations increased by \$151,644, or 14%, in the current period to \$1,243,219. Revenues in the current period from the Blue Dolphin System increased to approximately \$1,026,000 compared to approximately \$935,000 in the previous period due to increased commodity prices for condensate. Daily gas volumes transported on the Blue Dolphin System averaged 21.2 MMcf of gas per day in both the current period and the previous period. Revenues on the GA 350 Pipeline increased by approximately \$61,000 in the current period due to an increase in average daily gas volumes transported to 25.5 MMcf of gas per day in the current period from 18.7 MMcf of gas per day in the previous period.

*Revenue from Oil and Gas Sales.* Revenues from oil and gas sales increased by \$39,925, or 10%, to \$424,273 in the current period primarily due to production from High Island Block 115, which commenced in November 2007. Revenue breakdown for the current period by field was \$216,604 for High Island Block 115 and \$207,669 for High Island Block 37. The sales mix by product was 98% gas and 2% condensate. Our average realized gas price per Mcf in the current period was \$9.50 compared to \$6.85 in the previous period. Our average realized price per barrel of condensate was \$116.83 in the current period compared to \$55.01 in the previous period.

*Pipeline Operating Expenses.* Pipeline operating expenses in the current period decreased by \$260,811 to \$818,052 due to decreases in pipeline repair costs of approximately \$176,000, compressor repair expense of approximately \$132,000, legal costs of approximately \$81,000 and contract labor of approximately \$26,000. The decrease was partially offset by increases in property insurance of approximately \$105,000 and storage tank repairs of approximately \$49,000.

*General and Administrative Expenses.* General and administrative expenses increased by \$75,165 to \$1,195,357 in the current period due to increases in employee related costs of approximately \$168,000, which includes an increase of approximately \$131,000 of stock option expense, and office rent of approximately \$48,000. The increase was partially offset by decreases in other accounting fees of approximately \$41,000, legal costs of approximately \$28,000 and office expense of approximately \$72,000.

*Interest and Other Income.* Interest income decreased by \$44,734 to \$82,668 in the current period due to a decrease in both money market funds and the interest rate earned on those funds.

**Recent Accounting Developments**

See Note 1 in Item 1.

Remainder of Page Intentionally Left Blank

**Table of Contents**

**BLUE DOLPHIN ENERGY COMPANY & SUBSIDIARIES**

**ITEM 4T. CONTROLS AND PROCEDURES**

**Evaluation of Disclosure Controls and Procedures**

As of the end of the period covered by this report, we carried out an evaluation under the supervision and with the participation of our management, including our Chief Executive Officer and Principal Accounting and Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act. Based upon this evaluation, as of June 30, 2008, the Chief Executive Officer and Principal Accounting and Financial Officer concluded that our disclosure controls and procedures were effective to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act, are recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and that such information is accumulated and communicated to our management, including the Chief Executive Officer and Principal Accounting and Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

**Changes in Internal Controls Over Financial Reporting**

There have been no changes in our internal controls over financial reporting during the period covered by this report that have materially affected, or that are reasonably likely to materially affect, our internal control over financial reporting.

Remainder of Page Intentionally Left Blank

**Table of Contents****BLUE DOLPHIN ENERGY COMPANY & SUBSIDIARIES****PART II. OTHER INFORMATION****ITEM 1. LEGAL PROCEEDINGS**

From time to time we are involved in various claims and legal actions arising in the ordinary course of business. In our opinion, the ultimate disposition of these matters will not have a material effect on our financial position, results of operations or cash flows.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

None.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

We held our 2008 Annual Meeting of Stockholders on May 15, 2008. The only matter that was voted upon at the annual meeting was the election of directors, and the number of votes cast for or against, as well as abstentions as to such matter, where applicable, are set forth below:

	Votes For	Votes Against	Abstentions
Election of Directors			
Laurence N. Benz	7,060,838	22,294	385,306
John N. Goodpasture	7,081,005	2,127	385,306
Harris A. Kaffie	7,079,015	4,117	385,306
Erik Ostbye	6,879,343	203,789	385,306
Ivar Siem	7,038,862	44,270	385,306

All directors standing for election were elected to the Board of Directors.

**ITEM 5. OTHER INFORMATION**

None.

**ITEM 6. EXHIBITS**

(a) Exhibits:

3.1<sup>(1)</sup> Amended and Restated Certificate of Incorporation of the Company.

3.2<sup>(2)</sup> Amended and Restated Bylaws of the Company.

31.1 Ivar Siem Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to section 302 of the Sarbanes-Oxley Act of 2002.

31.2 T. Scott Howard Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to section 302 of the Sarbanes-Oxley Act of 2002.

**Table of Contents**

**BLUE DOLPHIN ENERGY COMPANY & SUBSIDIARIES**

32.1 Ivar Siem Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002.

32.2 T. Scott Howard Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002.

- (1) Incorporated herein by reference to Exhibits filed in connection with the definitive Proxy Statement of Blue Dolphin Energy Company under the Securities and Exchange Act of 1934, dated October 13, 2004 (Commission File No. 000-15905).
- (2) Incorporated herein by reference to Exhibits filed in connection with Form 8-K of Blue Dolphin Energy Company under the Securities and Exchange Act of 1934, dated December 26, 2007 (Commission File No. 000-15905).

**Table of Contents**

**BLUE DOLPHIN ENERGY COMPANY & SUBSIDIARIES  
SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

By: **BLUE DOLPHIN ENERGY  
COMPANY**

August 14, 2008

/s/ IVAR SIEM  
IVAR SIEM  
Chairman and Chief Executive Officer

/s/ T. SCOTT HOWARD  
T. SCOTT HOWARD  
Accounting Manager, Assistant Treasurer  
and Assistant Secretary  
(Principal Accounting and Financial  
Officer)  
22

---

**Table of Contents**

Index to Exhibits

- (a) Exhibits:
- 3.1<sup>(1)</sup> Amended and Restated Certificate of Incorporation of the Company.
  - 3.2<sup>(2)</sup> Amended and Restated Bylaws of the Company.
  - 31.1 Ivar Siem Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to section 302 of the Sarbanes-Oxley Act of 2002.
  - 31.2 T. Scott Howard Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to section 302 of the Sarbanes-Oxley Act of 2002.
  - 32.1 Ivar Siem Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002.
  - 32.2 T. Scott Howard Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002.

(1) Incorporated herein by reference to Exhibits filed in connection with the definitive Proxy Statement of Blue Dolphin Energy Company under the Securities and Exchange Act of 1934, dated October 13, 2004 (Commission File No. 000-15905).

(2) Incorporated herein by reference to Exhibits filed in connection with Form 8-K of Blue Dolphin Energy Company under the Securities and Exchange

Act of 1934,  
dated  
December 26,  
2007  
(Commission  
File  
No. 000-15905).