

BLUE DOLPHIN ENERGY CO

Form 10QSB

August 13, 2007

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

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

For the quarterly period ended: **June 30, 2007**

☐ Transition Report Under Section 13 or 15(d) of the Exchange Act

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

Commission File Number: **0-15905**

**BLUE DOLPHIN ENERGY COMPANY**

(Exact name of small business issuer 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) 227-7660**

(Issuer's telephone number)

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

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 10, 2007, there were 11,567,813 shares of the registrant's common stock, par value \$.01 per share, outstanding.

Transitional Small Business Disclosure Format (Check one): Yes ☐ No ☒

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**BLUE DOLPHIN ENERGY COMPANY AND SUBSIDIARIES**

**PART I. FINANCIAL INFORMATION**

**ITEM 1. FINANCIAL STATEMENTS**

The 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 condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in our annual report on Form 10-KSB for the year ended December 31, 2006.

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**BLUE DOLPHIN ENERGY COMPANY AND SUBSIDIARIES  
CONDENSED CONSOLIDATED BALANCE SHEET  
UNAUDITED**

|                                                                                                         | June 30,<br>2007     |
|---------------------------------------------------------------------------------------------------------|----------------------|
| <b>ASSETS</b>                                                                                           |                      |
| Current assets:                                                                                         |                      |
| Cash and cash equivalents                                                                               | \$ 5,330,866         |
| Accounts receivable                                                                                     | 437,680              |
| Prepaid expenses and other current assets                                                               | 682,659              |
| Total current assets                                                                                    | 6,451,205            |
| Property and equipment, at cost:                                                                        |                      |
| Oil and gas properties (full-cost method)                                                               | 715,970              |
| Pipelines                                                                                               | 4,595,073            |
| Onshore separation and handling facilities                                                              | 1,919,402            |
| Land                                                                                                    | 860,275              |
| Other property and equipment                                                                            | 271,638              |
|                                                                                                         | 8,362,358            |
| Less:                                                                                                   |                      |
| Accumulated depletion, depreciation, amortization and impairment                                        | 3,717,646            |
|                                                                                                         | 4,644,712            |
| Other assets                                                                                            | 10,640               |
| <b>TOTAL ASSETS</b>                                                                                     | <b>\$ 11,106,557</b> |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                                                             |                      |
| Current liabilities:                                                                                    |                      |
| Accounts payable                                                                                        | \$ 408,236           |
| Accrued expenses and other liabilities                                                                  | 134,592              |
| Current portion of asset retirement obligations                                                         | 297,509              |
| Total current liabilities                                                                               | 840,337              |
| Long-term liabilities:                                                                                  |                      |
| Asset retirement obligations                                                                            | 1,745,549            |
| Total long-term liabilities                                                                             | 1,745,549            |
| Common stock, (\$.01 par value, 25,000,000 shares authorized, 11,567,813 shares issued and outstanding) | 115,678              |
| Additional paid-in capital                                                                              | 31,887,613           |

|                                            |               |
|--------------------------------------------|---------------|
| Accumulated deficit                        | (23,482,620)  |
|                                            | 8,520,671     |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | \$ 11,106,557 |

See accompanying notes to the condensed consolidated financial statements.

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**BLUE DOLPHIN ENERGY COMPANY AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
**UNAUDITED**

|                                                      | Three Months Ended<br>June 30, |            |
|------------------------------------------------------|--------------------------------|------------|
|                                                      | 2007                           | 2006       |
| Revenue from operations:                             |                                |            |
| Pipeline operations                                  | \$ 531,762                     | \$ 400,267 |
| Oil and gas sales                                    | 89,165                         | 685,802    |
| Total revenue                                        | 620,927                        | 1,086,069  |
| Cost of operations:                                  |                                |            |
| Pipeline operating expenses                          | 562,692                        | 295,115    |
| Lease operating expenses                             | 90,464                         | 121,263    |
| Depletion, depreciation and amortization             | 152,203                        | 112,151    |
| General and administrative                           | 636,830                        | 476,525    |
| Accretion expense                                    | 30,391                         | 26,444     |
| Total costs and expenses                             | 1,472,580                      | 1,031,498  |
| Income (loss) from operations                        | (851,653)                      | 54,571     |
| Other income (expense):                              |                                |            |
| Interest and other expense                           |                                | (18,365)   |
| Interest and other income                            | 67,168                         | 31,889     |
| Income (loss) before income taxes                    | (784,485)                      | 68,095     |
| Income taxes                                         |                                |            |
| Net income (loss)                                    | \$ (784,485)                   | \$ 68,095  |
| Income (loss) per common share                       |                                |            |
| Basic                                                | \$ (0.07)                      | \$ 0.01    |
| Diluted                                              | \$ (0.07)                      | \$ 0.01    |
| Weighted average number of common shares outstanding |                                |            |
| Basic                                                | 11,560,361                     | 11,422,625 |
| Diluted                                              | 11,560,361                     | 11,531,377 |

See accompanying notes to the condensed consolidated financial statements.

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**BLUE DOLPHIN ENERGY COMPANY AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
**UNAUDITED**

|                                                      | Six Months Ended<br>June 30, |            |
|------------------------------------------------------|------------------------------|------------|
|                                                      | 2007                         | 2006       |
| Revenue from operations:                             |                              |            |
| Pipeline operations                                  | \$ 1,091,575                 | \$ 719,675 |
| Oil and gas sales                                    | 384,348                      | 1,467,418  |
| Total revenue                                        | 1,475,923                    | 2,187,093  |
| Cost of operations:                                  |                              |            |
| Pipeline operating expenses                          | 1,078,863                    | 522,604    |
| Lease operating expenses                             | 157,782                      | 215,824    |
| Depletion, depreciation and amortization             | 289,379                      | 227,460    |
| General and administrative                           | 1,120,192                    | 969,662    |
| Accretion expense                                    | 60,782                       | 52,888     |
| Total costs and expenses                             | 2,706,998                    | 1,988,438  |
| Income (loss) from operations                        | (1,231,075)                  | 198,655    |
| Other income (expense):                              |                              |            |
| Interest and other expense                           |                              | (31,775)   |
| Interest and other income                            | 127,402                      | 38,180     |
| Income (loss) before income taxes                    | (1,103,673)                  | 205,060    |
| Income taxes                                         |                              |            |
| Net income (loss)                                    | \$ (1,103,673)               | \$ 205,060 |
| Income (loss) per common share                       |                              |            |
| Basic                                                | \$ (0.10)                    | \$ 0.02    |
| Diluted                                              | \$ (0.10)                    | \$ 0.02    |
| Weighted average number of common shares outstanding |                              |            |
| Basic                                                | 11,558,754                   | 10,847,840 |
| Diluted                                              | 11,558,754                   | 10,943,092 |

See accompanying notes to the condensed consolidated financial statements.

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**BLUE DOLPHIN ENERGY COMPANY AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**UNAUDITED**

|                                                                                                    | Six Months Ended,<br>June 30, |              |
|----------------------------------------------------------------------------------------------------|-------------------------------|--------------|
|                                                                                                    | 2007                          | 2006         |
| <b>OPERATING ACTIVITIES</b>                                                                        |                               |              |
| Net income (loss)                                                                                  | \$ (1,103,673)                | \$ 205,060   |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities: |                               |              |
| Depletion, depreciation and amortization                                                           | 289,379                       | 227,460      |
| Accretion of asset retirement obligations                                                          | 60,782                        | 52,888       |
| Common stock issued for services                                                                   | 39,160                        | 15,000       |
| Compensation from issuance of stock options                                                        | 13,440                        |              |
| Changes in operating assets and liabilities:                                                       |                               |              |
| Accounts receivable                                                                                | 736,639                       | 394,145      |
| Prepaid expenses and other assets                                                                  | (334,133)                     | (217,607)    |
| Abandonment costs incurred                                                                         | (32,133)                      |              |
| Accounts payable and accrued expenses                                                              | 184,482                       | 344,566      |
| Net cash provided by (used in) operating activities                                                | (146,057)                     | 1,021,512    |
| <b>INVESTING ACTIVITIES</b>                                                                        |                               |              |
| Exploration and development costs                                                                  |                               | (14,810)     |
| Property, equipment and other assets                                                               | (22,224)                      | (235,934)    |
| Investment in unconsolidated affiliates                                                            |                               | (897)        |
| Net cash used in investing activities                                                              | (22,224)                      | (251,641)    |
| <b>FINANCING ACTIVITIES</b>                                                                        |                               |              |
| Proceeds from the sale of common stock, net of offering costs                                      |                               | 3,848,324    |
| Payments on borrowings                                                                             |                               | (510,000)    |
| Net cash provided by financing activities                                                          |                               | 3,338,324    |
| Increase (decrease) in cash and cash equivalents                                                   | (168,281)                     | 4,108,195    |
| <b>CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD</b>                                            | 5,499,147                     | 1,297,088    |
| <b>CASH AND CASH EQUIVALENTS AT END OF PERIOD</b>                                                  | \$ 5,330,866                  | \$ 5,405,283 |

See accompanying notes to the condensed consolidated financial statements.

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**BLUE DOLPHIN ENERGY COMPANY AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS    UNAUDITED**  
**JUNE 30, 2007**

**1. Liquidity**

At June 30, 2007, our available working capital was approximately \$5.6 million, a decrease of \$1.1 million from approximately \$6.7 million of working capital at December 31, 2006 and equal to working capital at June 30, 2006. Working capital at the end of the first half of 2006 reflects cash inflows from private placements completed in March and April 2006. Working capital at the end of the first half of 2007 reflects the impact of significantly reduced revenues from sales of oil and gas partially offset by increased revenues from our pipeline operations.

The Blue Dolphin System is currently transporting approximately 28 MMcf per day and the GA 350 Pipeline is also currently transporting approximately 19 MMcf per day. All five of the shippers we contracted with during 2005 and 2006 have commenced deliveries. Four of the shippers are delivering production into the Blue Dolphin System and one of the shippers is delivering production into the GA 350 Pipeline. One of the five new shippers began deliveries into the Blue Dolphin System in August 2005. In 2006, one new shipper began deliveries into the Blue Dolphin System in each of May, June and November. Also, in July 2006, a shipper that has delivered production into the Blue Dolphin System for a number of years, successfully recompleted an existing well, resulting in an increase of daily production. One of the new shippers began deliveries into the GA 350 Pipeline in December 2006. As a result of the new volumes, the Blue Dolphin System transported an average of 21.2 MMcf per day during the first half of 2007 as compared to 11.2 MMcf per day during the first half of 2006. The GA 350 Pipeline transported an average of 18.7 MMcf per day during the first half of 2007 as compared to 8.2 MMcf per day during the first half of 2006.

In June 2007, we entered into two agreements for the provision of transportation and handling services representing production from three wells. One of the new shippers commenced deliveries of production into the GA 350 Pipeline in late June 2007. The shipper representing the two wells covered by the second signed agreement commenced deliveries of production into the Blue Dolphin System in July 2007.

The revenues from our working interest in High Island Block 37 are declining as the rate of production declines. One of two producing wells shut in during April 2007 and production from that well has not been re-established. The aggregate rate of production from High Island Block 37 has declined by approximately 55% since the end of the first half of 2006. High Island Block 37 is currently producing approximately 5 MMcf per day from one well. We believe that production from the currently producing High Island Block 37 well could continue to produce into early 2008, however, the well could deplete faster than currently anticipated or could develop production problems resulting in the cessation of production. The High Island Block A-7 well is currently shut-in and may have reached the end of its productive life. During the second quarter 2007, a well in which we had previously earned a 2.5% working interest was drilled successfully in the High Island area. We do not know the level of production to expect from this well. We expect production to commence in the fourth quarter 2007. Without the revenues and resulting cash inflows we receive from oil and gas sales, we may not be able to generate sufficient cash from operations to cover our operating and general and administrative expenses.

In March and April 2006, we entered into stock purchase agreements with accredited investors for the private placement of 1,571,432 shares of our common stock. Net proceeds from these offerings after commissions and expenses were approximately \$3.8 million. The net proceeds are being used for general corporate and working capital purposes, but may be used for possible acquisitions and expansions of our facilities. Despite the decline in revenues from sales of oil and gas we believe we have sufficient liquidity to satisfy our working capital requirements through June 30, 2008.

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**CONTINUED**

The net cash provided by or used in operating, investing and financing activities is summarized below:

|                                 | Six Months Ended<br>June 30, |          |
|---------------------------------|------------------------------|----------|
|                                 | 2007                         | 2006     |
|                                 | (\$ in thousands)            |          |
| Net cash provided by (used in): |                              |          |
| Operating activities            | \$ (146)                     | \$ 1,022 |
| Investing activities            | (22)                         | (252)    |
| Financing activities            |                              | 3,338    |
| Net increase (decrease) in cash | \$ (168)                     | \$ 4,108 |

**2. Commitments and Contingencies**

Pursuant to the terms of an employment agreement effective May 1, 2007, we are obligated to pay a base salary of \$175,000 per year for the three-year term of the agreement.

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 adverse effect on our financial position, results of operations or cash flows.

**3. Earnings per Share**

We apply the provisions of Statement of Financial Accounting Standards 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 income statement 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 common shares 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.

Employee stock options and stock warrants outstanding were not included in the computation of diluted earnings per share for the three and six months ended June 30, 2007 because their assumed exercise and conversion would have an antidilutive effect on the computation of diluted loss per share.

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**BLUE DOLPHIN ENERGY COMPANY AND SUBSIDIARIES**  
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|                                            | Net<br>Income<br>(Loss) | Weighted-<br>Average Number<br>of Common<br>Shares<br>Outstanding and<br>Potential Dilutive<br>Common Shares | Per<br>Share<br>Amount |
|--------------------------------------------|-------------------------|--------------------------------------------------------------------------------------------------------------|------------------------|
| Three months ended June 30, 2007           |                         |                                                                                                              |                        |
| Basic and diluted loss per share           | \$ (784,485)            | 11,560,361                                                                                                   | \$ (0.07)              |
| Three months ended June 30, 2006           |                         |                                                                                                              |                        |
| Basic earnings per share                   | \$ 68,095               | 11,422,625                                                                                                   | \$ 0.01                |
| Effect of dilutive potential common shares |                         | 108,752                                                                                                      |                        |
| Diluted earnings per share                 | \$ 68,095               | 11,531,377                                                                                                   | \$ 0.01                |
| Six months ended June 30, 2007             |                         |                                                                                                              |                        |
| Basic and diluted loss per share           | \$ (1,103,673)          | 11,558,754                                                                                                   | \$ (0.10)              |
| Six months ended June 30, 2006             |                         |                                                                                                              |                        |
| Basic earnings per share                   | \$ 205,060              | 10,847,840                                                                                                   | \$ 0.02                |
| Effect of dilutive potential common shares |                         | 95,252                                                                                                       |                        |
| Diluted earnings per share                 | \$ 205,060              | 10,943,092                                                                                                   | \$ 0.02                |

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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS    UNAUDITED**  
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**4. 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, 2007 and 2006 and at June 30, 2007, is as follows:

|                                        | Revenues     | Operating<br>Income<br>(Loss) <sup>(*)</sup> | Depletion,<br>Depreciation<br>and<br>Amortization |
|----------------------------------------|--------------|----------------------------------------------|---------------------------------------------------|
| 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)                                    |                                                   |
| Three months ended June 30, 2006:      |              |                                              |                                                   |
| Pipeline operations                    | \$ 400,267   | (115,407)                                    | 78,945                                            |
| Oil and gas exploration and production | 685,802      | 332,376                                      | 31,087                                            |
| Other                                  |              | (162,398)                                    | 2,119                                             |
| Consolidated                           | \$ 1,086,069 | 54,571                                       | 112,151                                           |
| Other income, net                      |              | 13,524                                       |                                                   |
| Income before income taxes             |              | 68,095                                       |                                                   |
| 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)                                  |                                                   |
| Six months ended June 30, 2006:        |              |                                              |                                                   |

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|                                        |              |           |         |
|----------------------------------------|--------------|-----------|---------|
| Pipeline operations                    | \$ 719,675   | (233,751) | 157,891 |
| Oil and gas exploration and production | 1,467,418    | 716,202   | 65,116  |
| Other                                  |              | (283,796) | 4,453   |
| Consolidated                           | \$ 2,187,093 | 198,655   | 227,460 |
| Other income, net                      |              | 6,405     |         |
| Income before income taxes             |              | 205,060   |         |

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**BLUE DOLPHIN ENERGY COMPANY AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS    UNAUDITED**  
**JUNE 30, 2007**  
**CONTINUED**

|                                        | June 30, 2007   |
|----------------------------------------|-----------------|
| Identifiable assets:                   |                 |
| Pipeline operations                    | \$    5,605,922 |
| Oil and gas exploration and production | 267,393         |
| Other                                  | 5,233,242       |
| Consolidated                           | \$ 11,106,557   |

(\*) Consolidated income or loss from operations includes \$105,604 and \$160,280 in unallocated general and administrative expenses, and \$1,359 and \$2,119 in unallocated depletion, depreciation and amortization for the three months ended June 30, 2007 and 2006, respectively. All unallocated amounts are included in Other.

Consolidated income or loss from operations includes \$234,077 and \$279,343 in unallocated general and administrative expenses, and \$2,678 and

\$4,453 in unallocated depletion, depreciation and amortization for the six months ended June 30, 2007 and 2006, respectively. All unallocated amounts are included in Other.

## 5. 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. Prior to the increase in the number of shares reserved for incentive stock awards, we had granted 550,460 stock options under the 2000 Plan. After the increase in the shares reserved for grants, 649,540 shares were available for future grants. Options granted under the 2000 Plan must be exercised within 10 years from the date of grant. The exercise price of ISOs cannot be less than 100% of the fair market value of a share of our common stock on the grant date. All ISO awards granted in previous years vested immediately. Although the 2000 Plan provides for the granting of other incentive awards, only ISOs and non-statutory stock options have been issued under the 2000 Plan. The 2000 Plan is administered by the Compensation Committee of our Board of Directors. Effective January 1, 2006, we adopted Statement of Financial Accounting Standards No. 123 (Revised), *Share-Based Payments* ("SFAS 123(R)") utilizing the modified prospective approach. Prior to the adoption of SFAS 123(R) we accounted for stock option grants in accordance with APB Opinion No. 25, *Accounting for Stock Issued to Employees* (the intrinsic value method), and accordingly, recognized no compensation expense when stock options were granted with an exercise price equal to the fair market value of a share of our common stock on the grant date. Under the modified prospective approach, SFAS 123(R) applies to new awards and to awards that were outstanding on January 1, 2006 that are subsequently modified, repurchased, or cancelled. Under the modified prospective approach, had there been any awards granted during 2006, and had there been awards granted prior to January 1, 2006 which were not yet fully vested, compensation expense recognized in 2006 would have included compensation cost for all share-based payments granted prior to, but not yet vested, based on the grant date fair value estimated in accordance with the original provisions of Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation*, and compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant

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**BLUE DOLPHIN ENERGY COMPANY AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS    UNAUDITED**  
**JUNE 30, 2007**  
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date fair value estimated in accordance with the provisions of SFAS 123(R). Prior periods were not restated to reflect the impact of adopting the new standard.

SFAS 123(R) states that a tax deduction is permitted for stock options exercised during the period, generally for the excess of the price at which stock issued from exercise of the options are sold over the exercise price of the options. Tax benefits are to be shown on the Statement of Cash Flows as financing cash inflows. Any tax deductions we receive from the exercise of stock options for the foreseeable future will be applied to the valuation allowance in determining our net operating loss carryforward.

Additionally, we utilized the alternate transition method (simplified method) for calculating the beginning balance in the pool of excess tax benefits in accordance with FASB Staff Position FAS123(R)-3, *Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards*.

Pursuant to SFAS 123(R), 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 six months ended June 30, 2007. There were no stock options granted during the six months ended June 30, 2006.

|                         | Six Months Ended June 30, |       |
|-------------------------|---------------------------|-------|
|                         | 2007                      | 2006  |
| Stock options granted   | 200,000                   | 0     |
| Risk-free interest rate | 4.80%                     | N/A   |
| Expected term, in years | 5.97                      | N/A   |
| Expected volatility     | 92.4%                     | N/A   |
| Dividend yield          | 0.00%                     | 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 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.

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 entity, 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.

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At June 30, 2007, there were a total of 343,997 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, is as follows:

|                                                    |         | Six Months Ended June 30, 2007           |                                                         |                                 |
|----------------------------------------------------|---------|------------------------------------------|---------------------------------------------------------|---------------------------------|
|                                                    |         | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Life | Aggregate<br>Intrinsic<br>Value |
| Options outstanding at the beginning of the period | 143,997 | \$ 1.56                                  |                                                         |                                 |
| Options granted                                    | 200,000 | \$ 3.03                                  |                                                         |                                 |
| Options exercised                                  |         | \$ 0.00                                  |                                                         |                                 |
| Options expired or cancelled                       |         | \$ 0.00                                  |                                                         |                                 |
| Options outstanding at the end of the period       | 343,997 | \$ 2.41                                  | 8.1                                                     | \$ 273,291                      |
| Options exercisable at the end of the period       | 143,997 | \$ 1.56                                  | 5.5                                                     | \$ 273,291                      |

The following summarizes the net change in non-vested stock options for the six months ended June 30, 2007:

|                              | Shares  | Weighted<br>Average<br>Grant Date<br>Fair Value |
|------------------------------|---------|-------------------------------------------------|
| Nonvested at January 1, 2007 |         | \$ 0.00                                         |
| Granted                      | 200,000 | \$ 2.35                                         |
| Canceled or expired          |         | \$ 0.00                                         |
| Vested                       |         | \$ 0.00                                         |
| Nonvested at June 30, 2007   | 200,000 | \$ 2.35                                         |

As of June 30, 2007, there was \$456,960 of unrecognized compensation cost related to nonvested share-based compensation arrangements granted under existing stock option plans. This cost is expected to be recognized on a straight line basis over a period of 34 months, which is the remaining vesting period.

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**6. Warrants**

In March and April 2006, we completed private placements for shares of our common stock and we issued warrants to purchase an aggregate of 32,572 shares of common stock. These warrants were immediately exercisable upon issuance.

These issuances were accounted for pursuant to SFAS 123(R) and Emerging Issues Task Force No. 00-18, *Accounting Recognition for Certain Transactions Involving Equity Instruments Granted to Other Than Employees* using the Black-Scholes-Merton option-pricing model. A fair value of approximately \$69,000 was netted against the gross proceeds of the private placements as a direct offering cost.

At June 30, 2007, the range of warrant prices for shares of common stock underlying the warrants and the weighted-average remaining contractual life was as follows:

Warrants Outstanding, Fully Vested and Exercisable at June  
30, 2007

| Number<br>Outstanding | Weighted<br>Average<br>Exercise Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Life in Years |
|-----------------------|---------------------------------------|------------------------------------------------------------------|
| 16,440                | \$ 5.88                               | 1.8                                                              |

The 8,572 warrants issued in March 2006 with the first private placement were exercised in 2006 at a price of \$1.93 per share. The warrants outstanding represent the unexercised portion of 24,000 warrants issued in the second private placement in April 2006, of which 7,560 of the warrants were exercised in 2006 at an exercise price of \$5.39 per share. The exercise price varies based on the following conditions: (i) until the later of the registration of the warrants or one year from the issue date, 110% of the purchase price of \$4.90 per share; (ii) from the later of (x) the registration of the warrants and (y) one year, until two years from the issue date, 120% of the purchase price of \$4.90 per share; and (iii) after the expiration of two years from the issue date of the warrants, 130% of the purchase price of \$4.90 per share.

**7. Recent Accounting Developments**

In February 2007, the Financial Accounting Standards Board (the FASB) issued FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115* (SFAS 159). This standard permits an entity to choose to measure many financial instruments and certain other items at fair value. Most of the provisions in SFAS 159 are elective; however, the amendment to FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, applies to all entities with available-for-sale and trading securities. The FASB's stated objective in issuing this standard is as follows: to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions.

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The fair value option established by SFAS 159 permits all entities to choose to measure eligible items at fair value at specified election dates. A business entity will report unrealized gains and losses on items for which the fair value option has been elected in earnings (or another performance indicator if the business entity does not report earnings) at each subsequent reporting date. The fair value option: (i) may be applied instrument by instrument, with a few exceptions, such as investments otherwise accounted for by the equity method; (ii) is irrevocable (unless a new election date occurs); and (iii) is applied only to instruments and not to portions of instruments.

SFAS 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. Early adoption is permitted as of the beginning of the previous fiscal year provided that the entity makes that choice in the first 120 days of that fiscal year and also elects to apply the provisions of FASB Statement No. 157, *Fair Value Measurements* ( SFAS 157 ). We are currently assessing the impact of SFAS 159 on our consolidated financial statements.

In September 2006, SFAS 157 was issued by the FASB. This new standard provides guidance for using fair value to measure assets and liabilities. The FASB believes the standard also responds to investors' requests for expanded information about the extent to which companies measure assets and liabilities at fair value, the information used to measure fair value and the effect of fair value measurements on earnings. SFAS 157 applies whenever other standards require (or permit) assets or liabilities to be measured at fair value but does not expand the use of fair value in any new circumstances.

Currently, over 40 accounting standards within GAAP require (or permit) entities to measure assets and liabilities at fair value. Prior to SFAS 157, the methods for measuring fair value were diverse and inconsistent, especially for items that are not actively traded. The standard clarifies that for items that are not actively traded, such as certain kinds of derivatives, fair value should reflect the price in a transaction with a market participant, including an adjustment for risk, not just the company's mark-to-model value. SFAS 157 also requires expanded disclosure of the effect on earnings for items measured using unobservable data.

Under SFAS 157, fair value refers to the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the market in which the reporting entity transacts. In this standard, FASB clarifies the principle that fair value should be based on the assumptions market participants would use when pricing the asset or liability. In support of this principle, SFAS 157 establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. The fair value hierarchy gives the highest priority to quoted prices in active markets and the lowest priority to unobservable data, for example, the reporting entity's own data. Under the standard, fair value measurements would be separately disclosed by level within the fair value hierarchy.

The provisions of SFAS 157 are effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year, including any financial statements for an interim period within that fiscal year. We are currently assessing the impact of SFAS 157 on our financial statements.

In July 2006, FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes-An Interpretation of FASB Statement No. 109* ( FIN 48 ), was issued. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes* ( SFAS 109 ). FIN 48 also prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or

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expected to be taken in a tax return. The new FASB standard also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition.

The evaluation of a tax position in accordance with FIN 48 is a two-step process. The first step is a recognition process whereby the enterprise determines whether it is more likely than not that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. In evaluating whether a tax position has met the more-likely-than-not recognition threshold, the enterprise should presume that the position will be examined by the appropriate taxing authority that has full knowledge of all relevant information. The second step is a measurement process whereby a tax position that meets the more-likely-than-not recognition threshold is calculated to determine the amount of benefit to recognize in the financial statements. The tax position is measured at the largest amount of benefit that is greater than 50% likely of being realized upon ultimate settlement.

The provisions of FIN 48 are effective for fiscal years beginning after December 15, 2006. Earlier application is permitted as long as the enterprise has not yet issued financial statements, including interim financial statements, in the period of adoption. The provisions of FIN 48 are to be applied to all tax positions upon initial adoption of this standard. Only tax positions that meet the more-likely-than-not recognition threshold at the effective date may be recognized or continue to be recognized upon adoption of FIN 48. The cumulative effect of applying the provisions of FIN 48 should be reported as an adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that fiscal year.

The provisions of FIN 48 have been applied to all of our material tax positions taken through the date of adoption and during the interim quarterly period ended June 30, 2007. We have determined that all of our material tax positions taken in our income tax returns and the positions we expect to take in our future income tax filings meet the more likely-than-not recognition threshold prescribed by FIN 48. In addition, we have determined that, based on our judgment, none of these tax positions meet the definition of uncertain tax positions that are subject to the non-recognition criteria set forth in the new pronouncement.

In May 2006, the State of Texas enacted a new business tax that is imposed on gross revenues to replace the State's current franchise tax regime. The new legislation's effective date is January 1, 2008, which means that our first Texas margins tax ( TMT ) return will not become due until May 15, 2008 and will be based on our 2007 operations. Although the TMT is imposed on an entity's gross revenues rather than on its net income, certain aspects of the tax make it similar to an income tax. In accordance with the guidance provided in SFAS 109, we have properly determined the impact of the newly-enacted legislation in the determination of our reported state current and deferred income tax liability.

On September 13, 2006, the SEC staff issued Staff Accounting Bulletin No. 108, which adds Section N to Topic 1, Financial Statements *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* ( SAB 108 ). The SEC staff provides guidance on how prior year misstatements should be taken into consideration when quantifying misstatements in current year financial statements for the purposes of determining whether the current year's financial statements are materially misstated. In providing this guidance, the SEC staff references both the iron curtain and rollover approaches to quantifying a current year misstatement for purposes of determining its materiality. The iron curtain approach focuses on how the current year's balance sheet would be affected in correcting a misstatement without considering the year(s) in which the misstatement originated. The rollover approach focuses on the amount of the misstatement that originated in the

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current year's income statement. The SEC staff indicates in SAB 108 that registrants must quantify the impact of correcting all misstatements, including both the carryover and reversing effects of prior year misstatements, on the current year financial statements. In other words, both the iron curtain approach and rollover approach should be used in assessing the materiality of a current year misstatement. SAB 108 provides that once a current year misstatement has been quantified, the guidance in Staff Accounting Bulletin No. 99, Section M, Topic 1, Financial Statements Materiality (SAB 99), should be applied to determine whether the misstatement is material and should result in an adjustment to the financial statements.

If correcting a misstatement in the current year would materially misstate the current year's income statement, the SEC staff indicates that the prior year financial statements should be adjusted. In addition, adjusting for one misstatement in the current year may alter the amount of the misstatement attributable to prior years that exists in the current year's financial statements. If adjusting for the resultant misstatement is material to the current year's financial statements, the SEC staff again indicates that the prior year financial statements should be adjusted. These adjustments to prior year financial statements are necessary even though such adjustments were appropriately viewed as immaterial in the prior year. In making these adjustments, previously filed reports do not need to be amended. Instead, the adjustments should be reflected the next time the registrant would otherwise be filing those prior year financial statements. It should be noted that if, in the current year, a registrant identifies a misstatement in the prior year financial statements and determines that the misstatement is material to those prior year financial statements, the registrant would be required to restate for the material misstatement in accordance with FASB Statement No. 154, *Accounting Changes and Error Corrections* (SFAS 154).

If a registrant has historically been using either the iron curtain approach or the rollover approach and, upon application of the guidance of SAB 108, determines that there is a material misstatement in its financial statements, the SEC staff will not require the registrant to restate its prior year financial statements provided that: (a) management properly applied the approach it previously used as its accounting policy and (b) management considered all relevant qualitative factors in its materiality assessment. If the registrant does not elect to restate its financial statements for the material misstatements that arise in connection with application of the guidance in SAB 108, then for fiscal years ending after November 15, 2006, it must recognize the cumulative effect of applying SAB 108 in the current year beginning balances of the affected assets and liabilities with a corresponding adjustment to the current year opening balance in retained earnings. Certain disclosures are required in this situation. SAB 108 provides additional transition guidance if it is adopted early in an interim period. The adoption of SAB 108 did not have a material effect on our consolidated financial statements.

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**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-QSB, 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, 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 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, 2006. 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 producers/shippers, and (ii) oil and gas exploration and production. We conduct our operations through our subsidiaries. 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, acquiring additional strategic assets to diversify our asset base and improve our competitive position. Although we are primarily focused on acquisitions of pipeline assets, we will continue to review and evaluate opportunities to acquire oil and gas properties.

During the first half of 2007, we benefited from an increase in revenues from our pipeline operations resulting from the commencement of deliveries of production from new shippers on both the Blue Dolphin System and the GA 350 Pipeline during 2006. The level of throughput increased on the Blue Dolphin System from the addition of three shippers in 2006 and on the GA 350 Pipeline from the addition of one shipper in 2006. Additionally, in June 2007, we

entered into agreements for the provision of

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transportation and handling services with two new shippers representing production from three wells. One of the shippers commenced deliveries of production into the GA 350 Pipeline in late June 2007. The shipper representing the two wells covered by the second agreement commenced deliveries of production into the Blue Dolphin System in July 2007. The Blue Dolphin System is currently transporting approximately 28 MMcf per day and the GA 350 Pipeline is currently transporting approximately 19 MMcf per day.

Our working interest in High Island Block 37 continues to generate revenues for us, however, one of the two wells shut in during April 2007 and production from that well has not been re-established. High Island Block 37 is currently producing an aggregate of approximately 5 MMcf per day from one well. The High Island Block A-7 well experienced production difficulties during the second quarter of 2007. It has produced only intermittently since late-April 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 now have been reached. During the second quarter, a well in which we had previously earned a 2.5% working interest was drilled successfully in the High Island area. We do not know the level of production to expect from this well. We expect production to commence in the fourth quarter 2007.

Despite the recent throughput gains and expected future throughput from recently acquired customers, our pipeline assets remain significantly under-utilized. The Blue Dolphin System is currently operating at approximately 14% of capacity and the GA 350 Pipeline is currently operating at approximately 29% of capacity. Production declines, temporary stoppages or cessations of production from wells tied into our pipelines or from the High Island Block 37 well could have a material adverse effect on our cash flows and liquidity if the resulting revenue declines are not offset by revenues from other sources. Due to our small size, geographically concentrated asset base and limited capital resources, any negative event has the potential to significantly impact our financial condition. We are continuing our efforts to increase the utilization of our existing assets and acquire additional assets that will alleviate and diversify the risks to our cash flows and be accretive to earnings.

**Liquidity and Capital Resources**

At the end of the second quarter 2007, we had working capital of approximately \$5.6 million compared to approximately \$6.7 million at the end of 2006. At the end of the second quarter of 2006, working capital was approximately \$5.6 million. All outstanding notes payable were retired by the end of 2006. The increase in working capital during 2006 was primarily the result of proceeds received from two private placements that were completed in the first half of 2006, revenues from oil and gas sales and increased revenues from our pipeline operations.

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The following table summarizes our financial position for the periods indicated (in thousands):

|                             | June 30,<br>2007 |            | December 31,<br>2006 |            |
|-----------------------------|------------------|------------|----------------------|------------|
|                             | Amount           | %          | Amount               | %          |
| Working capital             | \$ 5,610         | 55         | \$ 6,652             | 57         |
| Property and equipment, net | 4,645            | 45         | 4,912                | 43         |
| Other noncurrent assets     | 11               | 0          | 22                   |            |
| <b>Total</b>                | <b>\$ 10,266</b> | <b>100</b> | <b>\$ 11,586</b>     | <b>100</b> |
| Long-term liabilities       | \$ 1,745         | 17         | \$ 2,014             | 17         |
| Stockholders' equity        | 8,521            | 83         | 9,572                | 83         |
| <b>Total</b>                | <b>\$ 10,266</b> | <b>100</b> | <b>\$ 11,586</b>     | <b>100</b> |

Throughput on the Blue Dolphin System and the GA 350 Pipeline increased significantly during 2006. All five of the shippers we contracted with during 2005 and 2006 have commenced deliveries into our pipelines. Four of these shippers are delivering production into the Blue Dolphin System and one of the shippers is delivering production into the GA 350 Pipeline. One of the shippers began deliveries into the Blue Dolphin System in August 2005. In 2006, one shipper began deliveries into the Blue Dolphin System in each of May, June and November. A shipper began deliveries into the GA 350 Pipeline in December 2006. Additionally, in July 2006, a shipper that has delivered production into the Blue Dolphin System for a number of years, successfully recompleted an existing well, resulting in an increase of daily production from that well.

In June 2007, we entered into two agreements for the provision of transportation and handling services representing production from three wells. One of the new shippers commenced deliveries of production into the GA 350 Pipeline in late June 2007. The shipper representing the two wells covered by the second signed agreement commenced deliveries of production into the Blue Dolphin System in July 2007.

The average rates of throughput on the Blue Dolphin System and the GA 350 Pipeline during the first half of 2007 were significantly higher than the first half of 2006. The Blue Dolphin System transported an average of 21.2 MMcf per day during the first half of 2007 as compared to 11.2 MMcf per day during the first half of 2006. Average throughput on the GA 350 Pipeline was 18.7 MMcf per day during the first half of 2007 as compared to 8.2 MMcf per day during the first half of 2006. First half revenues from pipeline operations increased to \$1,091,575 in 2007 as compared to \$719,675 in 2006, due to the higher volumes.

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 experiencing an increased level of interest by oil and gas operators. This assessment is based on leasing, drilling activity and discoveries in the lease blocks near the pipelines, as well as information obtained directly from the operators of properties near our pipelines. There have been nine discoveries near the Blue Dolphin System and the GA 350 Pipeline during the period from 2005 through early 2007. We have entered into contracts for transportation and handling services with operators of eight of the nine discoveries, and are in negotiations with the operator of the other discovery.

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Our financial condition continues to be adversely affected by the low utilization of our pipeline assets. 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 reserves to our pipelines, we would gain additional throughput on the pipelines, resulting in additional revenues. Additional throughput will be required to offset the natural decline in throughput from existing wells as reserves are depleted.

The revenues from our working interest in High Island Block 37 are declining as the rate of production declines as expected from the remaining producing well. Production from High Island Block 37 has declined by approximately 55% since the end of the first half of 2006. We believe that production from the remaining High Island Block 37 well could continue into early 2008, however, the well could deplete faster than currently anticipated or could develop production problems resulting in the cessation of production. The High Island Block A-7 well is currently shut in and may have reached the end of its productive life. During the second quarter, a well in which we had previously earned a 2.5% working interest was drilled successfully in the High Island area. We do not know the level of production to expect from this well. We expect production to commence in the fourth quarter 2007. Without the revenues and resulting cash inflows we receive from oil and gas sales, we may not be able to generate sufficient cash from operations to cover our operating and general and administrative expenses.

We recognized gross oil and gas sales revenues of \$174,287 and \$667,698 for the six months ended June 30, 2007 and 2006, respectively, associated with our 2.8% contractual working interest in two wells in High Island Block 37. One High Island Block 37 well is currently producing at a rate of approximately 5 MMcf per day and the second well is shut in. We recognized gross oil and gas sales revenues of \$210,061 and \$799,720 for the six months ended June 30, 2007 and 2006, respectively, associated with our approximate 8.9% working interest in the High Island Block A-7 well.

In early-2005, we entered into an amendment to our purchase agreement with MCNIC to acquire MCNIC's one-third interest in the Blue Dolphin System and the inactive Omega Pipeline. Pursuant to the terms of the amendment, we issued a new promissory note in the principal amount of \$250,000 and either (i) MCNIC could have received a contingent payment of up to \$500,000 from 50% of the net profits, if any, realized from the one-third interest through December 31, 2006, or (ii) the principal amount of the new promissory note could have been increased by up to \$500,000 if 50% or more of our 83% interest in the assets was sold before December 31, 2006. A contingent payment from 50% of the net profits was not triggered nor did we sell the assets. As a result, the \$500,000 contingent portion of the promissory note was extinguished effective December 31, 2006.

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**Table of Contents****BLUE DOLPHIN ENERGY COMPANY AND SUBSIDIARIES**

The following table summarizes certain of our contractual obligations and other commercial commitments at June 30, 2007 (in thousands):

|                                                                | Total    | Payments Due by Period |        |        |          |
|----------------------------------------------------------------|----------|------------------------|--------|--------|----------|
|                                                                |          | 1 Year                 | 1-3    | 3-5    | 5 Years  |
|                                                                |          | or Less                | Years  | Years  | or More  |
| Operating leases                                               | \$ 411   | \$ 103                 | \$ 188 | \$ 120 | \$       |
| Employment agreement                                           | 495      | 87                     | 408    |        |          |
| Asset retirement obligations                                   | 2,043    | 298                    | 86     |        | 1,659    |
| Total contractual obligations and other commercial commitments | \$ 2,949 | \$ 488                 | \$ 682 | \$ 120 | \$ 1,659 |

In March and April 2006, we entered into stock purchase agreements with accredited investors for the private placement of 1,571,432 shares of our common stock. Net proceeds from these offerings after commissions and expenses were approximately \$3.8 million. The net proceeds are being used for general corporate and working capital purposes, but may be used for possible acquisitions and expansions of our facilities.

**Results of Operations**

For the three months ended June 30, 2007 (the current quarter), we reported a net loss of \$784,485 compared to net income of \$68,095 for the three months ended June 30, 2006 (the previous quarter). For the six months ended June 30, 2007 (the current period), we reported a net loss of \$1,103,673 compared to net income of \$205,060 for the six months ended June 30, 2006 (the previous period).

**Three Months Ended June 30, 2007 Compared to Three Months Ended June 30, 2006**

*Revenue from Pipeline Operations.* Revenues from pipeline operations increased by \$131,495, or 33%, in the current quarter to \$531,762. Revenues in the current quarter from the Blue Dolphin System totaled approximately \$447,000 compared to approximately \$359,000 in the previous quarter primarily as a result of throughput from three new shippers who began deliveries in the second half of 2006. Daily gas volumes transported on the Blue Dolphin System averaged approximately 20 MMcf per day in the current quarter compared to approximately 13 MMcf per day in the previous quarter. Revenues on the GA 350 Pipeline increased by approximately \$43,000 in the current quarter due to an increase in average daily gas volumes transported to approximately 20 MMcf per day in the current quarter from approximately 9 MMcf per day in the previous quarter.

*Revenue from Oil and Gas Sales.* Revenues from oil and gas sales decreased by \$596,637, or 87%, to \$89,165 in the current quarter due to the natural decline in the rate of production from High Island Block 37 and the cessation of production from High Island Block A-7 combined with a decline in the realized price of natural gas. Revenue breakdown for the current quarter by field was \$20,001 for High Island Block A-7 and \$69,164 for High Island Block 37. The sales mix by product was 85% gas and 15% condensate and natural gas liquids. Our average realized gas price per Mcf in the current quarter was \$6.40 compared to \$8.43 in the previous quarter. Our average realized price per barrel of condensate was \$67.08 in the current quarter compared to \$71.46 in the previous quarter.

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*Pipeline Operating Expenses.* Pipeline operating expenses increased by \$267,577 to \$562,692 in the current quarter. The increase was due primarily to costs of approximately \$153,000 to repair the compressor at Platform C in Galveston Area Block 288, approximately \$55,000 for painting and repairs to the office, buildings and barge dock at the Freeport facility and increased insurance costs of approximately \$45,000 due to higher renewal rates.

*Lease Operating Expenses.* Lease operating expenses decreased \$30,799 in the current quarter to \$90,464 primarily due to the cessation of production at High Island Block A-7.

*Depletion, Depreciation and Amortization.* Depletion, depreciation and amortization expense increased by \$40,052 in the current quarter to \$152,203. Depreciation associated with estimated dismantlement costs increased by approximately \$21,000 due to an increase in asset retirement obligations.

*General and Administrative Expenses.* General and administrative expenses increased \$160,305 in the current quarter to \$636,830 due to officer bonuses of \$60,000, 401(k) matching of approximately \$23,000 and costs associated with a staff addition. Also, approximately \$67,000 of expense was recognized related to our previous lease agreements for the 801 Travis location.

*Interest and Other Expense.* Interest and other expense decreased \$18,365 in the current quarter to \$0 due to the elimination of our outstanding debt.

*Interest and Other Income.* Interest and other income increased \$35,279 in the current quarter due to an increase in money market funds and an increase in the interest rate earned on those funds.

**Six Months Ended June 30, 2007 Compared to Six Months Ended June 30, 2006**

*Revenue from Pipeline Operations.* Revenues from pipeline operations increased by \$371,900, or 52%, in the current period to \$1,091,575. Revenues in the current period from the Blue Dolphin System totaled approximately \$935,000 compared to approximately \$640,000 in the previous period primarily as a result of throughput from three new shippers who began deliveries during 2006. Daily gas volumes transported through the Blue Dolphin System averaged approximately 21 MMcf per day in the current period compared to approximately 11 MMcf per day in the previous period. Revenues on the GA 350 Pipeline increased by approximately \$77,000 in the current period primarily due to an increase in average daily gas volumes transported to approximately 19 MMcf per day in the current period from approximately 8 MMcf per day in the previous period.

*Revenue from Oil and Gas Sales.* Revenues from oil and gas sales decreased by \$1,083,070 to \$384,348 in the current period. High Island Block A-7 ceased production in the current period and one well at High Island Block 37 ceased production in the current period, leaving one producing well. Revenues were also negatively affected by a decrease in the realized price of natural gas. Revenue breakdown for the current period by field was approximately \$210,061 for High Island Block A-7 and \$174,287 for High Island Block 37. The sales mix by product was 90% gas and 10% condensate and natural gas liquids. Our average realized gas price per Mcf in the current period was \$6.85 compared to \$8.50 in the previous period. Our average realized price per barrel of condensate was \$55.01 in the current period compared to \$62.69 in the previous period.

*Pipeline Operating Expenses.* Pipeline operating expenses increased by \$556,259 to \$1,078,863 in the current period. This increase was due primarily to costs of approximately \$154,000 to repair a pipeline leak in January 2007 and approximately \$159,000 to repair the compressor at Platform C in Galveston Area Block 288, approximately \$55,000 for painting and repairs to the office, buildings and barge dock at the Freeport facility and increased insurance costs of approximately \$55,000 due to higher renewal rates.

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**BLUE DOLPHIN ENERGY COMPANY AND SUBSIDIARIES**

*Lease Operating Expenses.* Lease operating expenses decreased \$58,042 in the current period to \$157,782 primarily due to the cessation of production at High Island Block A-7.

*Depletion, Depreciation and Amortization.* Depletion, depreciation and amortization expense increased by \$61,919 in the current period to \$289,379. Depreciation associated with estimated dismantlement costs increased by approximately \$42,000 due to an increase in asset retirement obligations.

*General and Administrative Expenses.* General and administrative expenses increased \$150,530 in the current period to \$1,120,192 due to officer bonuses of \$60,000, 401(k) matching of approximately \$23,000 and costs associated with a staff addition. Also, approximately \$65,000 of expense was recognized related to our previous lease agreements for the 801 Travis location.

*Interest and Other Expense.* Interest and other expense decreased \$31,775 in the current period to \$0 due to the elimination of our outstanding debt.

*Interest and Other Income.* Interest and other income increased \$89,222 in the current period due to an increase in money market funds and an increase in the interest rate earned on those funds.

**Recent Accounting Developments**

See Note 7 in Item 1.

**ITEM 3. 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, 2007, 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.

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**BLUE DOLPHIN ENERGY COMPANY AND 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 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

We held our 2007 Annual Meeting of Stockholders on May 30, 2007. The matters that were voted upon at the annual meeting, and the number of votes cast for or against, as well as abstentions as to such matter, where applicable, are set forth below:

|                          | Votes<br>For | Votes<br>Against | Abstentions |
|--------------------------|--------------|------------------|-------------|
| 1) Election of Directors |              |                  |             |
| Laurence N. Benz         | 9,531,206    | 14,560           | 65,049      |
| John N. Goodpasture      | 9,545,312    | 454              | 65,049      |
| Harris A. Kaffie         | 9,484,696    | 61,070           | 65,049      |
| Erik Ostbye              | 9,545,312    | 454              | 65,049      |
| Ivar Siem                | 9,521,407    | 24,359           | 65,049      |

2) Amendment to the Company's 2000 Stock Incentive Plan to increase the number of shares of common stock that can be issued pursuant to the plan.

|  | Votes<br>For | Votes<br>Against | Abstentions |
|--|--------------|------------------|-------------|
|  | 3,951,498    | 121,910          | 45,157      |

All directors standing for election were elected to the Board of Directors and the amendment to the Company's 2000 Stock Incentive Plan passed.

**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 Gregory W. Starks Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to section 302 of the Sarbanes-Oxley Act of 2002.

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**BLUE DOLPHIN ENERGY COMPANY AND 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 Gregory W. Starks 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 Exhibit A filed in connection with the definitive Proxy Statement of Blue Dolphin Energy Company under the Securities and Exchange Act of 1934, as filed on October 13, 2004 (Commission File No. 000-15905).
- (2) Incorporated herein by reference to Exhibit 3.1 filed in connection with Form 10-QSB of Blue Dolphin Energy Company for the quarter ended June 30, 2004 under the Securities and Exchange Act of 1934, as filed on August 23, 2004 (Commission File No. 000-15905).

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**SIGNATURES**

In accordance with the requirements of the Securities Exchange Act of 1934, as amended, the Registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**BLUE DOLPHIN ENERGY COMPANY**

August 10, 2007

By: /s/ IVAR SIEM  
Ivar Siem  
Chairman and Chief Executive Officer

By: /s/ GREGORY W. STARKS  
Gregory W. Starks  
Vice President, Treasurer  
(Principal Accounting and Financial  
Officer)

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**Exhibit Index**

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Company for the  
quarter ended  
June 30, 2004  
under the  
Securities and  
Exchange Act of  
1934, as filed on  
August 23, 2004  
(Commission  
File  
No. 000-15905).