

BLUE DOLPHIN ENERGY CO

Form 10-Q

May 14, 2008

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

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the quarterly period ended: March 31, 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) 227-7660**  
(Registrant's telephone number)

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 May 14, 2008, there were 11,624,447 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**

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

|  | March 31,<br>2008<br>(unaudited) | December 31,<br>2007 |
|--|----------------------------------|----------------------|
| <b>Assets</b>  |                                  |                      |
| Current assets:                                      |                                  |                      |
| Cash and cash equivalents                            | \$ 5,056,463                     | \$ 5,226,779         |
| Accounts receivable                                  | 700,495                          | 693,977              |
| Prepaid expenses and other current assets            | 303,361                          | 508,517              |
| Total current assets                                 | 6,060,319                        | 6,429,273            |
| Property and equipment, at cost:                     |                                  |                      |
| Oil and gas properties (full-cost method)            | 751,175                          | 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                         | 279,468                          | 279,468              |
|  | 8,470,006                        | 8,470,006            |
| Less:  |                                  |                      |
| Accumulated depletion, depreciation and amortization | 4,097,425                        | 3,966,087            |
|  | 4,372,581                        | 4,503,919            |
| Other assets   | 9,463                            | 10,640               |
| Total Assets   | \$ 10,442,363                    | \$ 10,943,832        |
| <b>Liabilities and Stockholders Equity</b>           |                                  |                      |
| Current liabilities:                                 |                                  |                      |
| Accounts payable                                     | \$ 326,330                       | \$ 432,974           |
| Accrued expenses and other liabilities               | 119,417                          | 109,628              |
| Asset retirement obligations - current portion       | 264,161                          | 262,187              |
| Other long-term liabilities - current portion        | 25,996                           | 25,996               |
| Total current liabilities                            | 735,904                          | 830,785              |
| Long-term liabilities:                               |                                  |                      |
| Other long-term liabilities, net of current portion  | 51,992                           | 51,992               |
| Asset retirement obligations, net of current portion | 1,858,122                        | 1,831,520            |

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|   |               |               |
|---|---------------|---------------|
| Total long-term liabilities   | 1,910,114     | 1,883,512     |
| Common stock (\$.01 par value, 25,000,000 shares authorized, 11,624,447 and 11,610,363 shares issued and outstanding at March 31, 2008 and December 31, 2007, respectively) | 116,244       | 116,104       |
| Additional paid-in capital  | 32,209,994    | 32,117,950    |
| Accumulated deficit   | (24,529,893)  | (24,004,519)  |
|   | 7,796,345     | 8,229,535     |
| Total Liabilities and Stockholders' Equity  | \$ 10,442,363 | \$ 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<br>March 31, |              |
|--|---------------------------------|--------------|
|  | 2008                            | 2007         |
| Revenue from operations:                             |                                 |              |
| Pipeline operations                                  | \$ 547,817                      | \$ 559,813   |
| Oil and gas sales                                    | 130,720                         | 295,183      |
| Total revenue  | 678,537                         | 854,996      |
| Cost of operations:                                  |                                 |              |
| Pipeline operating expenses                          | 415,956                         | 516,171      |
| Lease operating expenses                             | 50,173                          | 67,318       |
| Depletion, depreciation and amortization             | 131,338                         | 137,176      |
| General and administrative                           | 633,809                         | 483,362      |
| Accretion expense                                    | 28,576                          | 30,391       |
| Total costs and expenses                             | 1,259,852                       | 1,234,418    |
| Loss from operations                                 | (581,315)                       | (379,422)    |
| Other income (expense):                              |                                 |              |
| Interest and other expense                           |                                 |              |
| Interest and other income                            | 55,941                          | 60,234       |
| Loss before income taxes                             | (525,374)                       | (319,188)    |
| Income taxes   |                                 |              |
| Net loss   | \$ (525,374)                    | \$ (319,188) |
| Income per common share                              |                                 |              |
| Basic  | \$ (0.05)                       | \$ (0.03)    |
| Diluted  | \$ (0.05)                       | \$ (0.03)    |
| Weighted average number of common shares outstanding |                                 |              |
| Basic  | 11,617,328                      | 11,557,128   |
| Diluted  | 11,617,328                      | 11,557,128   |

See accompanying notes to the condensed consolidated financial statements.



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

|   | Three Months Ended<br>March 31, |              |
|---|---------------------------------|--------------|
|   | 2008                            | 2007         |
| <b>Operating Activities</b>   |                                 |              |
| Net loss  | \$ (525,374)                    | \$ (319,188) |
| Adjustments to reconcile net loss to net cash provided by operating activities: |                                 |              |
| Depletion, depreciation and amortization  | 131,338                         | 137,176      |
| Accretion of asset retirement obligations                                       | 28,576                          | 30,391       |
| Common stock issued for services  | 20,000                          | 14,160       |
| Compensation from issuance of stock options                                     | 72,184                          |              |
| Changes in operating assets and liabilities:                                    |                                 |              |
| Accounts receivable   | (6,518)                         | 425,138      |
| Prepaid expenses and other assets   | 206,333                         | 39,592       |
| Abandonment costs incurred  |                                 | (815)        |
| Accounts payable and accrued expenses   | (96,855)                        | 88,891       |
| Net cash provided by (used in) operating activities                             | (170,316)                       | 415,345      |
| <b>Investing Activities</b>   |                                 |              |
| <b>Financing Activities</b>   |                                 |              |
| Increase (decrease) in cash and cash equivalents                                | (170,316)                       | 415,345      |
| Cash and Cash Equivalents at Beginning of Period                                | 5,226,779                       | 5,499,147    |
| Cash and Cash Equivalents at End of Period                                      | \$ 5,056,463                    | \$ 5,914,492 |

See accompanying notes to the condensed consolidated financial statements.



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**BLUE DOLPHIN ENERGY COMPANY & SUBSIDIARIES**  
**Notes to Condensed Consolidated Financial Statements (Unaudited)**  
**March 31, 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 months ended March 31, 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

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**BLUE DOLPHIN ENERGY COMPANY & SUBSIDIARIES**  
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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 minority 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 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 at March 31, 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<br>of Common<br>Shares<br>Outstanding and<br>Potential Dilutive<br>Common Shares | Per<br>Share<br>Amount |
|-----------------------------------|--------------|--|------------------------|
| Three months ended March 31, 2008 |              |  |                        |
| Basic and diluted loss per share  | \$ (525,375) | 11,617,328   | \$ (0.05)              |

Three months ended March 31, 2007

|                                  |              |            |           |
|----------------------------------|--------------|------------|-----------|
| Basic and diluted loss per share | \$ (319,188) | 11,557,128 | \$ (0.03) |
|----------------------------------|--------------|------------|-----------|

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**BLUE DOLPHIN ENERGY COMPANY & SUBSIDIARIES**  
**Notes to Condensed Consolidated Financial Statements (Unaudited)**  
**March 31, 2008**  
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**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 months ended March 31, 2008 and 2007, and at March 31, 2008, is as follows:

|  | Revenues   | Operating<br>Income<br>(Loss) <sup>(*)</sup> | Depletion,<br>Depreciation<br>and<br>Amortization |
|--|------------|--|---|
| Three Months ended March 31, 2008:     |            |  |   |
| Pipeline operations                    | \$ 547,817 | \$ (407,385)                                 | \$ 104,332  |
| Oil and gas exploration and production | 130,720    | (45,478)                                     | 25,398  |
| Other                                  |            | (128,452)                                    | 1,608   |
| Consolidated                           | \$ 678,537 | (581,315)                                    | \$ 131,338  |
| Other income, net                      |            | 55,941                                       |   |
| Income before income taxes             |            | \$ (525,374)                                 |   |
| Three Months ended March 31, 2007:     |            |  |   |
| Pipeline operations                    | \$ 559,813 | \$ (314,858)                                 | \$ 101,968  |
| Oil and gas exploration and production | 295,183    | 65,227                                       | 33,890  |
| Other                                  |            | (129,791)                                    | 1,318   |
| Consolidated                           | \$ 854,996 | (379,422)                                    | \$ 137,176  |
| Other income, net                      |            | 60,234                                       |   |
| Loss before income taxes               |            | \$ (319,188)                                 |   |
|  |            |  | March 31, 2008                                    |
| Identifiable assets:                   |            |  |   |
| Pipeline operations                    |            |  | \$ 5,580,894                                      |
| Oil and gas exploration and production |            |  | 326,538   |
| Other                                  |            |  | 4,534,931   |
| Consolidated                           |            |  | \$ 10,442,363                                     |

(\*) Consolidated  
income or loss  
from operations  
includes

\$126,843 and \$128,473 in unallocated general and administrative expenses, and \$1,608 and \$1,318 in unallocated depletion, depreciation and amortization for the three months ended March 31, 2008 and 2007, respectively. All unallocated amounts are included in Other.

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**BLUE DOLPHIN ENERGY COMPANY & SUBSIDIARIES**  
**Notes to Condensed Consolidated Financial Statements (Unaudited)**  
**March 31, 2008**  
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**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 March 31, 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 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 year ended December 31, 2007. There were no stock options granted in the current quarter.

|                         | December 31,<br>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.

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.

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**Notes to Condensed Consolidated Financial Statements (Unaudited)**  
**March 31, 2008**

**Continued**

At March 31, 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<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Life | Aggregate<br>Intrinsic<br>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                          |          | \$ 0.00                                  |   |                                 |
| Options exercised                        |          | \$ 0.00                                  |   |                                 |
| Options expired or cancelled             |          | \$ 0.00                                  |   |                                 |
| Options outstanding at March 31, 2008    | 491,559  | \$ 2.61                                  | 7.0   | \$55,738                        |
| Options exercisable at March 31, 2008    | 141,559  | \$ 1.86                                  | 5.4   | \$55,738                        |

The following table summarizes additional information about stock options outstanding at March 31, 2008:

| Range of Exercise<br>Prices | Options Outstanding   |  |  | Options Exercisable   |  |
|-----------------------------|-----------------------|--|--|-----------------------|--|
|                             | Number<br>Outstanding | Weighted<br>Average<br>Remaining<br>Contractual<br>Life<br>(Years) | Weighted<br>Average<br>Exercise<br>Price | Number<br>Exercisable | Weighted<br>Average<br>Exercise<br>Price |
| \$0.35 to \$0.80            | 70,830                | 5.1  | \$ 0.44                                  | 70,830                | \$0.44                                   |
| \$1.55 to \$1.90            | 23,429                | 3.9  | \$ 1.71                                  | 23,429                | \$1.71                                   |
| \$2.81 to \$2.99            | 378,500               | 7.8  | \$ 2.91                                  | 28,500                | \$2.81                                   |
| \$6.00                      | 18,800                | 2.1  | \$ 6.00                                  | 18,800                | \$6.00                                   |
|                             | 491,559               |  |  | 141,559               |  |

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**Notes to Condensed Consolidated Financial Statements (Unaudited)**  
**March 31, 2008**

**Continued**

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

|                                 | Shares   | Weighted<br>Average<br>Grant Date<br>Fair Value |
|---------------------------------|----------|---|
| Non-vested at December 31, 2006 |          | \$0.00  |
| Granted                         | 378,500  | \$2.06  |
| Canceled or expired             |          | \$0.00  |
| Vested                          | (28,500) | \$1.96  |
| <br>                            |          |   |
| Non-vested at December 31, 2007 | 350,000  | \$2.05  |
| Granted                         |          | \$0.00  |
| Canceled or expired             |          | \$0.00  |
| Vested                          |          | \$0.00  |
| <br>                            |          |   |
| Non-vested at March 31, 2008    | 350,000  | \$2.05  |

As of March 31, 2008, there was \$527,183 of unrecognized compensation cost related to 350,000 nonvested stock options granted in 2007 under the existing stock incentive plan, the 2000 Plan. Unrecognized compensation cost of \$336,000 and \$191,183 will be recognized on a straight line basis over a vesting period of 25 and 18 months for 200,000 and 150,000 of the stock options granted, respectively.

**5. Warrants**

A summary of warrant activity for 2008 and 2007 is as follows:

|                                | Number of<br>Warrants | Weighted-<br>Average<br>Exercise<br>Price | Warrants<br>Exercisable | Weighted-<br>Average<br>Exercise<br>Price |
|--------------------------------|-----------------------|---|-------------------------|---|
| Outstanding, December 31, 2006 | 16,440                | \$5.39                                    | 16,440                  | \$5.39                                    |
| Granted                        |                       | \$0.00                                    |                         |   |
| Exercised                      |                       | \$0.00                                    |                         |   |
| <br>                           |                       |   |                         |   |
| Outstanding, December 31, 2007 | 16,440                | \$5.88                                    | 16,440                  | \$5.88                                    |
| Granted                        |                       | \$0.00                                    |                         |   |
| Exercised                      |                       | \$0.00                                    |                         |   |
| <br>                           |                       |   |                         |   |
| Outstanding, March 31, 2008    | 16,440                | \$5.88                                    | 16,440                  | \$5.88                                    |

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**BLUE DOLPHIN ENERGY COMPANY & SUBSIDIARIES**  
**Notes to Condensed Consolidated Financial Statements (Unaudited)**  
**March 31, 2008**

**Continued**

At March 31, 2008, the range of warrant prices for shares under warrants and the weighted-average remaining contractual life was as follows:

|                  | Warrants Outstanding, Fully Vested and Exercisable at<br>March 31, 2008 |   |  |
|------------------|---|---|--|
|                  | Number<br>Outstanding   | Weighted<br>Average<br>Remaining<br>Contractual<br>Life in<br>Years | Weighted<br>Average<br>Exercise<br>Price |
| Exercise Prices  |   |   |  |
| \$5.50 to \$6.00 | 16,440  | 1.0   | \$ 5.88                                  |

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.

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**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 (the Exchange Act), 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, 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 23 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 29 MMcf of gas per day representing production from six wells from five shippers.

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**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 3 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. Drilling results should be available in the third quarter.

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 now have been reached.

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 11% of capacity, the GA 350 Pipeline is currently operating at approximately 45% 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 small size, 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 March 31, 2008, our available working capital was approximately \$5.3 million, a decrease of \$0.3 million from approximately \$5.6 million of working capital at December 31, 2007 and a decrease of \$1.2 million from approximately \$6.5 million of working capital at March 31, 2007. The decrease in working capital was due primarily to a reduction in oil and gas production and associated revenue from our producing wells. 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 not be able to generate sufficient cash from operations to cover our operating and general and administrative expenses. The following table summarizes our financial position at March 31, 2008 and December 31, 2007 (in thousands):

|                             | March 31,<br>2008 |          | December 31,<br>2007 |          |
|-----------------------------|-------------------|----------|----------------------|----------|
|                             | Amount            | %        | Amount               | %        |
| Working capital             | \$ 5,324          | 55%      | \$ 5,598             | 55%      |
| Property and equipment, net | 4,373             | 45%      | 4,504                | 45%      |
| Other noncurrent assets     | 9                 |          | 11                   |          |
| <br>Total                   | <br>\$ 9,706      | <br>100% | <br>\$ 10,113        | <br>100% |
| <br>Long-term liabilities   | <br>\$ 1,910      | <br>20%  | <br>\$ 1,883         | <br>19%  |
| Stockholders' equity        | 7,796             | 80%      | 8,230                | 81%      |
| <br>Total                   | <br>\$ 9,706      | <br>100% | <br>\$ 10,113        | <br>100% |



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**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 average rates of throughput on the Blue Dolphin System and the GA 350 Pipeline increased during 2007, however, the level of utilization of these pipelines is significantly below available capacity. The Blue Dolphin System is currently transporting approximately 23 MMcf of gas per day and the GA 350 Pipeline is currently transporting approximately 29 MMcf of gas per day. This time last year, the Blue Dolphin System was transporting 20 MMcf of gas per day and the GA 350 Pipeline was transporting 20 MMcf of gas per day.

All five of the shippers we have contracted with since 2005 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. In July 2007, a shipper began deliveries from two wells into the Blue Dolphin System. On the GA 350 Pipeline, shippers began deliveries in June and September of 2007. In addition to the throughput gains from shippers added to the pipelines, the Blue Dolphin System also benefited from the drilling activities of certain existing shippers. In June 2007, an existing shipper drilled a new well, which resulted in an increase in daily production delivered to us. First quarter revenues from pipeline operations decreased slightly to \$547,817 in 2008 as compared to \$559,813 in 2007. Throughput on the Blue Dolphin System during the first quarter of 2008 averaged 20.8 MMcf of gas per day as compared to 22.2 MMcf of gas per day during the first quarter of 2007. Average throughput on the GA 350 Pipeline was 24.5 MMcf of gas per day during the first quarter of 2008 as compared to 17.7 MMcf of gas per day during the first quarter 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. There were nine new discoveries near the Blue Dolphin System and the GA 350 Pipeline during the period from 2005 through early 2007. We have contracted to provide transportation and handling services to operators of five of the nine discoveries.

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 \$130,720 and \$295,183 for the three months ended March 31, 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 3 MMcf of gas per day. We believe that the A-2 well could continue to produce until mid-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 4 MMcf of gas per day. The resulting decline in the aggregate production from High Island Block 37 is approximately 25%. We have 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. Drilling results should be available 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.

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



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

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.

The following table summarizes certain of our contractual obligations and other commercial commitments at March 31, 2008 (in thousands):

|   | Total        | Payments Due by Period |              |              | 5 Years<br>or More |
|---|--------------|------------------------|--------------|--------------|--------------------|
|   |              | 1 Year<br>or Less      | 1-3<br>Years | 3-5<br>Years |                    |
| Operating leases  | \$ 357       | \$ 77                  | \$ 280       | \$           | \$                 |
| Employment agreement  | 365          | 175                    | 190          |              |                    |
| Asset retirement obligations  | 2,122        | 264                    | 89           | 36           | 1,733              |
| Other long-term liabilities   | 78           | 26                     | 52           |              |                    |
| <br>Total contractual obligations and other<br>commercial commitments | <br>\$ 2,922 | <br>\$ 542             | <br>\$ 611   | <br>\$ 36    | <br>\$ 1,733       |

**Results of Operations**

For the three months ended March 31, 2008 (the current quarter), we reported a net loss of \$525,374 compared to a net loss of \$319,188 for the three months ended March 31, 2007 (the previous quarter).

**Three Months Ended March 31, 2008 Compared to Three Months Ended March 31, 2007**

*Revenue from Pipeline Operations.* Revenues from pipeline operations decreased by \$11,996, or 2%, in the current quarter to \$547,817. Revenues in the current quarter from the Blue Dolphin System decreased to approximately \$443,000 compared to approximately \$488,000 in the previous quarter due to normal production declines from existing shippers. Daily gas volumes transported on the Blue Dolphin System averaged 20.8 MMcf of gas per day in the current quarter, down from 22.0 MMcf of gas per day in the previous quarter. Revenues on the GA 350 Pipeline increased by approximately \$33,000 in the current quarter due to an increase in average daily gas volumes transported to 24.5 MMcf of gas per day in the current quarter from 17.7 MMcf of gas per day in the previous quarter.

*Revenue from Oil and Gas Sales.* Revenues from oil and gas sales decreased by \$164,463, or 56%, to \$130,720 in the current quarter due to the natural decline production from the High Island Block 37 wells and the cessation of production from High Island Block A-7. The decrease was partially offset by new production from High Island Block 115, which commenced in November 2007. Revenue breakdown for the current quarter by field was \$82,998 for High Island Block 115 and \$47,722 for High Island Block 37. The sales mix by product was 97% gas and 3% condensate. Our average realized gas price per Mcf in the current quarter was \$7.89 compared to \$7.00 in the previous quarter. Our average realized price per barrel of condensate was \$115.45 in the current quarter compared to \$54.79 in the previous quarter.

*Pipeline Operating Expenses.* Pipeline operating expenses in the current quarter decreased by \$100,215 to \$415,956 due to decreases in pipeline repair costs of approximately \$165,000, legal costs of approximately \$46,000 and contract labor of approximately \$21,000. The decrease was partially offset by increases in property insurance of approximately \$72,000, salt water disposal costs of approximately \$26,000 and storage tank repairs of approximately \$24,000.



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

*General and Administrative Expenses.* General and administrative expenses increased by \$150,447 to \$633,809 in the current quarter due to increases in employee related costs of approximately \$161,000, which includes approximately \$72,000 of stock option expense, and office rent of approximately \$30,000. The increase was partially offset by decreases in other accounting expense of approximately \$39,000 and legal costs of approximately \$13,000.

**Recent Accounting Developments**

See Note 1 in Item 1.

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**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 March 31, 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.

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**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**

None.

**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.

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).

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**BLUE DOLPHIN ENERGY COMPANY & SUBSIDIARIES  
SIGNATURES**

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

By: **BLUE DOLPHIN ENERGY  
COMPANY**

May 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)  
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Exhibit Index

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