

BLUE DOLPHIN ENERGY CO

Form 10QSB

November 14, 2007

**Table of Contents**

**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: September 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 November 9, 2007, there were 11,573,293 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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**TABLE OF CONTENTS**

**PART I. FINANCIAL INFORMATION**

**ITEM 1. FINANCIAL STATEMENTS**

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION**

**ITEM 3. CONTROLS AND PROCEDURES**

**PART II. OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

**ITEM 6. EXHIBITS**

**SIGNATURES**

**INDEX TO EXHIBITS**

**Certification Pursuant to Section 302**

**Certification Pursuant to Section 302**

**Certification Pursuant to Section 906**

**Certification Pursuant to Section 906**

---

**Table of Contents**

**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 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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**Table of Contents**

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

	September 30, 2007
<b>ASSETS</b>	
Current assets:	
Cash and cash equivalents	\$ 5,066,744
Accounts receivable	695,779
Prepaid expenses and other current assets	507,591
 Total current assets	 6,270,114
Property and equipment, at cost:	
Oil and gas properties (full-cost method)	715,970
Pipelines	4,594,696
Onshore separation and handling facilities	1,919,402
Land	860,275
Other property and equipment	273,902
	8,364,245
Less:	
Accumulated depletion, depreciation, amortization and impairment	3,851,688
	4,512,557
 Other assets	 10,640
 <b>TOTAL ASSETS</b>	 <b>\$ 10,793,311</b>
 <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>	
Current liabilities:	
Accounts payable	\$ 273,668
Accrued expenses and other liabilities	147,507
Current portion of asset retirement obligations	258,402
 Total current liabilities	 679,577
Long-term liabilities:	
Asset retirement obligations	1,770,890
 Total long-term liabilities	 1,770,890
 Common stock, (\$.01 par value, 25,000,000 shares authorized, 11,573,293 shares issued and outstanding)	 115,733

Additional paid-in capital	31,947,879
Accumulated deficit	(23,720,768)
	8,342,844
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>	<b>\$ 10,793,311</b>

See accompanying notes to the condensed consolidated financial statements.

3

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**Table of Contents**

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

	Three Months Ended September 30,	
	2007	2006
Revenue from operations:		
Pipeline operations	\$ 717,118	\$ 623,024
Oil and gas sales	68,470	445,684
 Total revenue	 785,588	 1,068,708
Cost of operations:		
Pipeline operating expenses	349,293	307,516
Lease operating expenses	91,202	113,886
Depletion, depreciation and amortization	134,041	117,569
General and administrative	480,197	389,005
Accretion expense	30,392	26,443
 Total costs and expenses	 1,085,125	 954,419
 Income (loss) from operations	 (299,537)	 114,289
Other income (expense):		
Interest and other expense		(30)
Interest and other income	61,389	45,671
 Income (loss) before income taxes	 (238,148)	 159,930
 Income taxes		
 Net income (loss)	 \$ (238,148)	 \$ 159,930
 Income (loss) per common share		
Basic	\$ (0.02)	\$ 0.01
Diluted	\$ (0.02)	\$ 0.01
 Weighted average number of common shares outstanding		
Basic	11,570,553	11,550,714
Diluted	11,570,553	11,656,302

See accompanying notes to the condensed consolidated financial statements.



**Table of Contents**

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

	Nine Months Ended September 30,	
	2007	2006
Revenue from operations:		
Pipeline operations	\$ 1,808,693	\$ 1,342,699
Oil and gas sales	452,818	1,913,102
 Total revenue	 2,261,511	 3,255,801
Cost of operations:		
Pipeline operating expenses	1,428,156	830,120
Lease operating expenses	248,984	329,710
Depletion, depreciation and amortization	423,420	345,029
General and administrative	1,600,389	1,358,667
Accretion expense	91,174	79,331
 Total costs and expenses	 3,792,123	 2,942,857
 Income (loss) from operations	 (1,530,612)	 312,944
Other income (expense):		
Interest and other expense		(31,805)
Interest and other income	188,791	83,851
 Income (loss) before income taxes	 (1,341,821)	 364,990
 Income taxes		
 Net income (loss)	 \$ (1,341,821)	 \$ 364,990
 Income (loss) per common share		
Basic	\$ (0.12)	\$ 0.03
Diluted	\$ (0.12)	\$ 0.03
 Weighted average number of common shares outstanding		
Basic	11,562,730	11,084,704
Diluted	11,562,730	11,183,317

See accompanying notes to the condensed consolidated financial statements.

**Table of Contents**

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

	Nine Months Ended, September 30,	
	2007	2006
<b>OPERATING ACTIVITIES</b>		
Net income (loss)	\$ (1,341,821)	\$ 364,990
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depletion, depreciation and amortization	423,420	345,029
Accretion of asset retirement obligations	91,174	79,331
Common stock issued for services	59,160	30,000
Compensation from issuance of stock options	53,760	
Changes in operating assets and liabilities:		
Accounts receivable	478,540	585,208
Prepaid expenses and other assets	(159,065)	(139,498)
Abandonment costs incurred	(76,290)	
Accounts payable and accrued expenses	62,830	(232,375)
Net cash provided by (used in) operating activities	(408,292)	1,032,685
<b>INVESTING ACTIVITIES</b>		
Exploration and development costs		(19,695)
Property, equipment and other assets	(24,111)	(266,260)
Investment in unconsolidated affiliates		(1,177)
Net cash used in investing activities	(24,111)	(287,132)
<b>FINANCING ACTIVITIES</b>		
Proceeds from the sale of common stock, net of offering costs		3,848,324
Payments on borrowings		(540,000)
Net cash provided by financing activities		3,308,324
Increase (decrease) in cash and cash equivalents	(432,403)	4,053,877
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	5,499,147	1,297,088
CASH AND CASH EQUIVALENTS AT END OF PERIOD	\$ 5,066,744	\$ 5,350,965

See accompanying notes to the condensed consolidated financial statements.

**Table of Contents**

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

**1. Liquidity**

At September 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. The decrease in working capital at the end of the first three quarters of 2007 reflects the impact of significantly reduced revenues from sales of oil and gas partially offset by increased revenues from our pipeline operations. 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 Blue Dolphin System is currently transporting an aggregate of approximately 27 MMcf of gas per day from ten shippers and the GA 350 Pipeline is currently transporting an aggregate of approximately 35 MMcf of gas per day from six shippers. Throughput on the Blue Dolphin System and the GA 350 Pipeline increased significantly during 2006 and 2007 as a result of the production of seven shippers commencing deliveries from a total of eight wells. Four of these shippers are delivering production into the Blue Dolphin System and three of the shippers are delivering production into the GA 350 Pipeline. In 2006, one shipper began deliveries into the Blue Dolphin System in each of May, June and November, and in 2007, a shipper began deliveries from two wells in July. On the GA 350 Pipeline, shippers began deliveries in December 2006, and in June and September of 2007. Additionally, in July 2006, an existing shipper successfully recompleted a well, resulting in an increase of daily production from that well. In June 2007, another existing shipper drilled a well, also resulting in an increase of daily production. As a result, the Blue Dolphin System transported an average of 22.4 MMcf of gas per day during the first three quarters of 2007 as compared to 15.3 MMcf of gas per day during the first three quarters of 2006. The GA 350 Pipeline transported an average of 20.3 MMcf of gas per day during the first three quarters of 2007 as compared to 8.3 MMcf of gas per day during the first three quarters of 2006.

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. Daily production from High Island Block 37 has declined by approximately 55% since September 30, 2006 to approximately 2.5 MMcf of gas per day currently. 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 of 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 yet know the level of production to expect from this well. We expect production to commence late in the fourth quarter 2007.

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**Table of Contents**

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

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

	Nine Months Ended September 30,	
	2007	2006
	(\$ in thousands)	
Net cash provided by (used in):		
Operating activities	\$ (408)	\$ 1,033
Investing activities	(24)	(287)
Financing activities		3,308
Net increase (decrease) in cash	\$ (432)	\$ 4,054

**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 shares of common stock outstanding, which includes the potential dilution that could occur if securities or other contracts to issue common stock were converted to common stock that then shared in the earnings of the entity.

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

Table of Contents

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

	Net Income (Loss)	Weighted- Average Number of Common Shares Outstanding and Potential Dilutive Common Shares	Per Share Amount
Three months ended September 30, 2007			
Basic and diluted loss per share	\$ (238,148)	11,570,553	\$ (0.02)
Three months ended September 30, 2006			
Basic earnings per share	\$ 159,930	11,550,714	\$ 0.01
Effect of dilutive potential common shares		105,588	
Diluted earnings per share	\$ 159,930	11,656,302	\$ 0.01
Nine months ended September 30, 2007			
Basic and diluted loss per share	\$ (1,341,821)	11,562,730	\$ (0.12)
Nine months ended September 30, 2006			
Basic earnings per share	\$ 364,990	11,084,704	\$ 0.03
Effect of dilutive potential common shares		98,613	
Diluted earnings per share	\$ 364,990	11,183,317	\$ 0.03

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Table of Contents

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

**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 nine months ended September 30, 2007 and 2006 and at September 30, 2007, is as follows:

	Revenues	Operating Income (Loss) <sup>(*)</sup>	Depletion, Depreciation and Amortization
Three months ended September 30, 2007:			
Pipeline operations	\$ 717,118	\$ (124,794)	\$ 102,460
Oil and gas exploration and production	68,470	(84,058)	30,154
Other		(90,685)	1,427
Consolidated	\$ 785,588	(299,537)	\$ 134,041
Other income, net		61,389	
Loss before income taxes		\$ (238,148)	
Three months ended September 30, 2006:			
Pipeline operations	\$ 623,024	\$ 19,404	\$ 91,060
Oil and gas exploration and production	445,684	183,850	24,152
Other		(88,965)	2,357
Consolidated	\$ 1,068,708	114,289	\$ 117,569
Other income, net		45,641	
Income before income taxes		\$ 159,930	
Nine months ended September 30, 2007:			
Pipeline operations	\$ 1,808,693	\$ (1,023,103)	\$ 309,788
Oil and gas exploration and production	452,818	(180,071)	109,528
Other		(327,438)	4,104
Consolidated	\$ 2,261,511	(1,530,612)	\$ 423,420
Other income, net		188,791	
Loss before income taxes		\$ (1,341,821)	

Nine months ended September 30, 2006:

Pipeline operations	\$ 1,342,699	\$ (214,346)	\$ 248,951
Oil and gas exploration and production	1,913,102	900,051	89,268
Other		(372,761)	6,810
Consolidated	\$ 3,255,801	312,944	\$ 345,029
Other income, net		52,046	
Income before income taxes		\$ 364,990	



**Table of Contents**

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

	September 30, 2007
Identifiable assets:	
Pipeline operations	\$        5,495,586
Oil and gas exploration and production	223,845
Other	5,073,880
 Consolidated	 \$        10,793,311

(\*) Consolidated income or loss from operations includes \$89,258 and \$86,608 in unallocated general and administrative expenses, and \$1,427 and \$2,357 in unallocated depletion, depreciation and amortization for the three months ended September 30, 2007 and 2006, respectively. All unallocated amounts are included in Other.

Consolidated income or loss from operations includes \$323,334 and \$365,951 in unallocated general and

administrative expenses, and \$4,104 and \$6,810 in unallocated depletion, depreciation and amortization for the nine months ended September 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. As of September 30, 2007, we had granted 750,460 stock options under the 2000 Plan since its adoption. In October 2007, we granted 178,500 stock options, leaving 271,040 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. All ISO awards granted in previous years vested immediately, however, 200,000 ISOs granted in 2007 have a three year vesting period and 150,000 ISOs also granted in October 2007 have a two year vesting period. 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

Table of Contents

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

compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant 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 nine months ended September 30, 2007. There were no stock options granted during the nine months ended September 30, 2006.

	Nine Months Ended September 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.

Table of Contents

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

At September 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:

	Nine Months Ended September 30, 2007			
	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic 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	7.8	\$318,843
Options exercisable at the end of the period	143,997	\$ 1.56	5.3	\$292,843

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

	Shares	Weighted Average Grant Date Fair Value
Nonvested at January 1, 2007		\$0.00
Granted	200,000	\$2.35
Canceled or expired		\$0.00
Vested		\$0.00
Nonvested at September 30, 2007	200,000	\$2.35

As of September 30, 2007, there was \$416,640 of unrecognized compensation cost related to 200,000 nonvested stock options granted in 2007 under the existing stock incentive plan, the 2000 Plan. This cost is expected to be recognized on a straight line basis over a period of 31 months, which is the remaining vesting period. Stock options granted in October 2007 resulted in additional unrecognized compensation cost of \$310,818 to be recognized beginning in the fourth quarter of 2007. Unrecognized compensation cost of \$254,910 will be recognized on a straight line basis over a vesting period of 24 months for 150,000 of the stock options granted and \$55,908 will be recognized in the fourth

quarter of 2007 due to immediate vesting of 28,500 of the stock options granted.

Table of Contents

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

**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 September 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  
September 30, 2007

Number Outstanding	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life in Years
16,440	\$5.88	1.4

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 or (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.

**Table of Contents**

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

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

**Table of Contents**

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

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 September 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



**Table of Contents**

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

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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**Table of Contents**

**BLUE DOLPHIN ENERGY COMPANY AND SUBSIDIARIES**

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION**

**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 or Plan of Operation 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 and 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 also continue to review and evaluate opportunities to acquire oil and gas properties.

Through the first three quarters of 2007 we have 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 during 2006 and 2007. The level of throughput on the Blue Dolphin System has increased due to the addition of three shippers during 2006 and one shipper in July 2007. The shipper that commenced deliveries in July 2007 represented production from two wells. The GA 350 Pipeline throughput has also increased from the

addition of one shipper in 2006 and two shippers

**Table of Contents**

**BLUE DOLPHIN ENERGY COMPANY AND SUBSIDIARIES**

in 2007. Shippers commenced deliveries on the GA 350 Pipeline in June 2007 and September 2007. The Blue Dolphin System is currently transporting an aggregate of approximately 27 MMcf of gas per day from ten shippers and the GA 350 Pipeline is currently transporting an aggregate of approximately 35 MMcf of gas per day from six shippers. Production and resulting revenues from our interests in wells in the High Island area have declined as reserves have been depleted. In High Island Block 37, 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 approximately 2.5 MMcf of gas 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 yet know the level of production to expect from this well. We expect production to commence late in the fourth quarter 2007.

Despite the recent throughput gains, our pipeline assets remain significantly under-utilized. The Blue Dolphin System is currently operating at approximately 17% of capacity, the GA 350 Pipeline is currently operating at approximately 55% of capacity and the Omega Pipeline is inactive. 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 have a significant 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 the end of the third 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 third quarter of 2006, working capital was approximately \$5.9 million. The increase in working capital during 2006 was primarily the result of net proceeds of \$3.8 million received from two private placements that were completed in March and April of 2006, revenues from oil and gas sales and increased revenues from our pipeline operations. Working capital at the end of the third quarter of 2007 reflects the impact of significantly reduced revenues from sales of oil and gas, partially offset by increased revenues from our pipeline operations.

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

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

	September 30, 2007		December 31, 2006	
	Amount	%	Amount	%
Working capital	\$ 5,591	55	\$ 6,652	57
Property and equipment, net	4,512	45	4,912	43
Other noncurrent assets	11	0	22	
Total	\$ 10,114	100	\$ 11,586	100
Long-term liabilities	\$ 1,771	18	\$ 2,014	17
Stockholders equity	8,343	82	9,572	83
Total	\$ 10,114	100	\$ 11,586	100

Throughput on the Blue Dolphin System and the GA 350 Pipeline increased significantly during 2006 and 2007 as a result of production from seven shippers commencing deliveries from eight wells. Four of these shippers are delivering production into the Blue Dolphin System and three of the shippers are delivering production into the GA 350 Pipeline. In 2006, one shipper began deliveries into the Blue Dolphin System in each of May, June and November, and in 2007, a shipper began deliveries from two wells in July. On the GA 350 Pipeline, shippers began deliveries in December 2006, and in June and September of 2007. Additionally, in July 2006, an existing shipper successfully recompleted an existing well, resulting in an increase of daily production from that well. In June 2007, another existing shipper drilled a new well, also resulting in an increase of daily production.

We have significant available capacity on the Blue Dolphin System and the inactive Omega Pipeline and available capacity on the GA 350 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.

The average rates of throughput on the Blue Dolphin System and the GA 350 Pipeline during the first nine months of 2007 were significantly higher than the first half of 2006, however, the level of utilization of these pipelines is significantly below maximum capacity. The Blue Dolphin System is currently operating at approximately 17% of capacity, the GA 350 Pipeline is currently operating at approximately 55% of capacity and the Omega Pipeline is inactive. The Blue Dolphin System transported an average of 22.4 MMcf of gas per day during the first three quarters of 2007 as compared to 15.3 MMcf of gas per day during the first three quarters of 2006. The GA 350 Pipeline transported an average of 20.3 MMcf of gas per day during the first three quarters of 2007 as compared to 8.3 MMcf of gas per day during the first three quarters of 2006. Year to date revenues from pipeline operations increased to \$1,808,693 in 2007 as compared to \$1,342,699 in 2006, due to the higher volumes.

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, resulting in additional revenues. Additional throughput will be required to offset the natural decline in throughput from existing wells as reserves are depleted.

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

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. Daily production from High Island Block 37 has declined by approximately 55% since September 30, 2006. We believe that production 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 yet know the level of production to expect from this well. We expect production to commence late 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 approximately \$242,000 and \$761,000 for the nine months ended September 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 2.5 MMcf of gas per day and the second well is shut in. We recognized gross oil and gas sales revenues of approximately \$211,000 and \$1,152,000 for the nine months ended September 30, 2007 and 2006, respectively, associated with our approximate 8.9% working interest in the High Island Block A-7 well. The High Island A-7 well has produced only intermittently since April 2007.

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

	Total	Payments Due by Period			5 Years or More
		1 Year or Less	1-3 Years	3-5 Years	
Operating leases	\$ 409	\$ 103	\$ 306	\$	\$
Employment agreement	452	175	277		
Asset retirement obligations	2,029	258	87		1,684
 Total contractual obligations and other commercial commitments	 \$ 2,890	 \$ 536	 \$ 670	 \$	 \$ 1,684

**Results of Operations**

For the three months ended September 30, 2007 (the current quarter), we reported a net loss of \$238,148 compared to net income of \$159,930 for the three months ended September 30, 2006 (the previous quarter). For the nine months ended September 30, 2007 (the current period), we reported a net loss of \$1,341,821 compared to net income of \$364,990 for the nine months ended September 30, 2006 (the previous period).

**Table of Contents****BLUE DOLPHIN ENERGY COMPANY AND SUBSIDIARIES****Three Months Ended September 30, 2007 Compared to Three Months Ended September 30, 2006**

*Revenue from Pipeline Operations.* Revenues from pipeline operations increased by \$94,094, or 15%, in the current quarter to \$717,118. Revenues in the current quarter from the Blue Dolphin System totaled approximately \$612,000 compared to approximately \$583,000 in the previous quarter primarily as a result of throughput from one new shipper who began deliveries in the current quarter. Daily gas volumes transported on the Blue Dolphin System averaged approximately 25 MMcf of gas per day in the current quarter compared to approximately 23 MMcf of gas per day in the previous quarter. Revenues on the GA 350 Pipeline increased by approximately \$65,000 to approximately \$105,000 in the current quarter due to an increase in average daily gas volumes transported to approximately 23 MMcf of gas per day in the current quarter from approximately 8 MMcf of gas per day in the previous quarter.

*Revenue from Oil and Gas Sales.* Revenues from oil and gas sales decreased by \$377,214, or 85%, to \$68,470 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. Revenue breakdown for the current quarter by field was \$67,872 for High Island Block 37 and \$598 for High Island Block A-7. The sales mix by product was 98% gas and 2% condensate and natural gas liquids. Our average realized gas price per Mcf in the current quarter was \$6.32 compared to \$5.52 in the previous quarter. Our average realized price per barrel of condensate was \$70.82 in the current quarter compared to \$68.45 in the previous quarter.

*Pipeline Operating Expenses.* Pipeline operating expenses increased by \$41,777 to \$349,293 in the current quarter. The increase was due primarily to an increase in insurance expense of approximately \$70,000, offset by decreases in consulting fees of approximately \$20,000 and contract labor costs of approximately \$15,000.

*Lease Operating Expenses.* Lease operating expenses decreased \$22,684 in the current quarter to \$91,202 primarily due to the cessation of production at High Island Block A-7.

*Depletion, Depreciation and Amortization.* Depletion, depreciation and amortization expense increased by \$16,472 in the current quarter to \$134,041. 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 \$91,192 in the current quarter to \$480,197 primarily due to an increase in officer and employee salaries of approximately \$67,000 and approximately \$40,000 in non-cash compensation expense associated with 2007 stock option grants. Also, employee insurance costs increased approximately \$24,000 and office rent increased approximately \$13,000. These increases were partially offset by decreases in consulting costs of approximately \$48,000 and legal fees of approximately \$20,000.

*Interest and Other Income.* Interest and other income increased \$15,718 in the current quarter due to an increase in the interest rate earned on money market funds from the prior quarter.

**Nine Months Ended September 30, 2007 Compared to Nine Months Ended September 30, 2006**

*Revenue from Pipeline Operations.* Revenues from pipeline operations increased by \$465,994, or 35%, in the current period to \$1,808,693. Revenues in the current period from the Blue Dolphin System totaled approximately \$1,548,000 compared to approximately \$1,223,000 in the previous period primarily as a result of throughput from three new shippers in 2006, one new shipper in 2007 and a new well drilled by an existing shipper in 2007. Daily gas volumes transported through the Blue Dolphin System averaged approximately 22 MMcf of gas per day in the current period compared to approximately 15 MMcf of gas

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

per day in the previous period. Revenues on the GA 350 Pipeline increased by approximately \$141,000 to approximately \$261,000 in the current period primarily due to an increase in average daily gas volumes transported to approximately 20 MMcf of gas per day in the current period from approximately 8 MMcf of gas per day in the previous period.

*Revenue from Oil and Gas Sales.* Revenues from oil and gas sales decreased by \$1,460,284, or 76%, to \$452,818 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 \$211,000 for High Island Block A-7 and \$242,000 for High Island Block 37. The sales mix by product was 91% gas and 9% condensate and natural gas liquids. Our average realized gas price per Mcf in the current period was \$6.63 compared to \$7.83 in the previous period. Our average realized price per barrel of condensate was \$56.01 in the current period compared to \$64.59 in the previous period.

*Pipeline Operating Expenses.* Pipeline operating expenses increased by \$598,036 to \$1,428,156 in the current period. This increase was due primarily to costs of approximately \$154,000 to repair a pipeline leak in January 2007, 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, increased insurance costs of approximately \$124,000 due to higher renewal rates and increased legal fees of approximately \$45,000. The legal fees are primarily associated with an action filed against us, the outcome of which we do not believe will have a material impact.

*Lease Operating Expenses.* Lease operating expenses decreased \$80,726 in the current period to \$248,984 primarily due to the cessation of production at High Island Block A-7.

*Depletion, Depreciation and Amortization.* Depletion, depreciation and amortization expense increased by \$78,391 in the current period to \$423,420. Depreciation associated with estimated dismantlement costs increased by approximately \$63,000 due to an increase in asset retirement obligations.

*General and Administrative Expenses.* General and administrative expenses increased \$241,722 in the current period to \$1,600,389 primarily due to increased employee-related expenses of approximately \$284,000 associated with a staff addition, salary increases, officer bonuses of \$60,000, 401(K) matching of approximately \$23,000, increased employee health benefits expense of approximately \$58,000 and approximately \$54,000 in non-cash compensation expense associated with 2007 stock option grants. Accounting-related expenses increased approximately \$67,000 primarily due to Sarbanes-Oxley compliance work. These increases were partially offset by decreased legal fees of approximately \$79,000 and consulting fees of approximately \$114,000.

*Interest and Other Expense.* Interest and other expense decreased \$31,805 in the current period to \$0 due to the elimination of our outstanding debt.

*Interest and Other Income.* Interest and other income increased \$104,940 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.



**Table of Contents**

**BLUE DOLPHIN ENERGY COMPANY AND SUBSIDIARIES**

**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 September 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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**Table of Contents**

**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 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.
- 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).

**Table of Contents**

**BLUE DOLPHIN ENERGY COMPANY AND SUBSIDIARIES  
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.

November 13, 2007

By: **BLUE DOLPHIN ENERGY COMPANY**

/s/ IVAR SIEM

Ivar Siem  
Chairman and Chief Executive Officer

/s/ GREGORY W. STARKS

Gregory W. Starks  
Vice President, Treasurer (Principal Accounting and  
Financial Officer)

**Table of Contents**

INDEX TO EXHIBITS

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(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  
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(Commission  
File  
No. 000-15905).