

BLUE DOLPHIN ENERGY CO

Form 10-Q

May 14, 2009

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

(Mark One)

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended: March 31, 2009**

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

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

Delaware
(State or other jurisdiction of
incorporation or organization)

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

801 Travis Street, Suite 2100, Houston, Texas 77002

(Address of principal executive offices)

(713) 568-4725

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). 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 12, 2009, there were 11,745,299 shares of the registrant's common stock, par value \$.01 per share, outstanding.

BLUE DOLPHIN ENERGY COMPANY & SUBSIDIARIES
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| | March 31, 2009 (unaudited) | December 31, 2008 |
|--|----------------------------------|----------------------|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 3,546,118 | \$ 3,864,876 |
| Accounts receivable | 433,745 | 442,715 |
| Prepaid expenses and other current assets | 230,724 | 436,242 |
| Total current assets | 4,210,587 | 4,743,833 |
| Property and equipment, at cost: | | |
| Oil and gas properties (full-cost method) | 1,086,650 | 1,286,700 |
| 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 | 302,813 | 290,313 |
| | 8,828,826 | 9,016,376 |
| Less: Accumulated depletion, depreciation and amortization | (4,622,972) | (4,494,059) |
| Net property and equipment | 4,205,854 | 4,522,317 |
| Other assets | 9,463 | 9,463 |
| Total Assets | \$ 8,425,904 | \$ 9,275,613 |
| Liabilities and Stockholders Equity | | |
| Current liabilities: | | |
| Accounts payable | \$ 418,312 | \$ 389,268 |
| Accrued expenses and other liabilities | 25,130 | 9,593 |
| Asset retirement obligations - current portion | 25,996 | 25,996 |
| Other long-term liabilities - current portion | 25,996 | 25,996 |
| Total current liabilities | 469,438 | 424,857 |
| Long-term liabilities: | | |
| Other long-term liabilities, net of current portion | 25,996 | 25,996 |
| Asset retirement obligations, net of current portion | 2,206,265 | 2,183,190 |
| Total long-term liabilities | 2,232,261 | 2,209,186 |

| | | |
|---|--------------|--------------|
| Total Liabilities | 2,701,699 | 2,634,043 |
| Commitments and contingencies | | |
| Stockholders' Equity: | | |
| Common stock (\$.01 par value, 25,000,000 shares authorized, 11,745,299 and 11,691,243 shares issued and outstanding at March 31, 2009 and December 31, 2008, respectively) | 117,453 | 116,912 |
| Additional paid-in capital | 32,577,520 | 32,495,417 |
| Accumulated deficit | (26,970,768) | (25,970,759) |
| Total Stockholders' Equity | 5,724,205 | 6,641,570 |
| Total Liabilities and Stockholders' Equity | \$ 8,425,904 | \$ 9,275,613 |

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 March 31, | |
|--|---------------------------------|--------------|
| | 2009 | 2008 |
| Revenue from operations: | | |
| Pipeline operations | \$ 514,759 | \$ 547,817 |
| Oil and gas sales | 21,946 | 130,720 |
| Total revenue from operations | 536,705 | 678,537 |
| Cost of operations: | | |
| Pipeline operating expenses | 466,260 | 415,956 |
| Lease operating expenses | 48,031 | 50,173 |
| Depletion, depreciation and amortization | 128,913 | 131,338 |
| Impairment of oil and gas properties | 203,110 | |
| General and administrative | 602,194 | 561,625 |
| Stock-based compensation | 62,644 | 72,184 |
| Accretion expense | 27,918 | 28,576 |
| Total cost of operations | 1,539,070 | 1,259,852 |
| Loss from operations | (1,002,365) | (581,315) |
| Other income (expense): | | |
| Interest and other income | 2,356 | 55,941 |
| Loss before income taxes | (1,000,009) | (525,374) |
| Income taxes | | |
| Net loss | \$ (1,000,009) | \$ (525,374) |
| Loss per common share | | |
| Basic | \$ (0.09) | \$ (0.05) |
| Diluted | \$ (0.09) | \$ (0.05) |
| Weighted average number of common shares outstanding | | |
| Basic | 11,717,670 | 11,617,328 |
| Diluted | 11,717,670 | 11,617,328 |

See accompanying notes to the condensed consolidated financial statements.

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

| | Three Months Ended March 31, | |
|---|---------------------------------|--------------|
| | 2009 | 2008 |
| Operating Activities | | |
| Net loss | \$ (1,000,009) | \$ (525,374) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Depletion, depreciation and amortization | 128,913 | 131,338 |
| Accretion of asset retirement obligations | 27,918 | 28,576 |
| Common stock issued for services | 20,000 | 20,000 |
| Compensation from issuance of stock options | 62,644 | 72,184 |
| Impairment of oil and gas properties | 203,110 | |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | 8,970 | (6,518) |
| Prepaid expenses and other assets | 205,518 | 206,333 |
| Abandonment costs incurred | (4,843) | |
| Accounts payable, accrued expenses, and other liabilities | 44,581 | (96,855) |
| Net cash used in operating activities | (303,198) | (170,316) |
| Investing Activities | | |
| Purchases of property and equipment | (12,500) | |
| Exploration and development costs | (3,060) | |
| Net cash used in investing activities | (15,560) | |
| Financing Activities | | |
| Net decrease in cash and cash equivalents | (318,758) | (170,316) |
| Cash and Cash Equivalents at Beginning of Period | 3,864,876 | 5,226,779 |
| Cash and Cash Equivalents at End of Period | \$ 3,546,118 | \$ 5,056,463 |

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, 2009

1. Organization and Operation of the Company

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 wholly-owned 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 consolidated statements of operations, financial position and cash flows. We believe that the disclosures are adequate and the information presented is not misleading. This report has been prepared in accordance with Form 10-Q instructions and therefore, certain information and footnote disclosures normally included in audited financial statements prepared in accordance with U.S. generally accepted accounting principles (GAAP) have been condensed or omitted pursuant to the SEC s 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-K for the fiscal year ended December 31, 2008. The results of operations for the three months ended March 31, 2009 are not necessarily indicative of the results of operations to be expected for the year ended December 31, 2009.

2. Summary of Significant Accounting Policies

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 GAAP. 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 consolidated 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.

Full-Cost Method of Accounting. 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. Under this method of accounting, we recognized an impairment to our oil and gas properties of \$203,110 for the quarter ended March 31, 2009.

Earnings per Share. We apply the provisions of SFAS No. 128, *Earnings per Share* (SFAS 128). SFAS 128 requires the presentation of basic earnings per share (EPS) which excludes the dilutive effect of securities or

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BLUE DOLPHIN ENERGY COMPANY & SUBSIDIARIES
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March 31, 2009

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 condensed and consolidated statement of operations and requires a reconciliation of the numerators and denominators of basic EPS and diluted EPS. Diluted EPS is computed by dividing net income (loss) available to common stockholders by the diluted weighted average number of shares of common stock outstanding, which includes the potential dilution that could occur if securities or other contracts to issue common stock were converted to common stock that then shared in the earnings of the entity.

Employee stock options and stock warrants outstanding at March 31, 2009 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.

| | Basic and Diluted | Three Months Ended | |
|---|-------------------|--------------------|--------------|
| | | March 31, | |
| | | 2009 | 2008 |
| Net loss | | \$ (1,000,009) | \$ (525,374) |
| Weighted average number of shares of common stock outstanding and potential dilutive shares of common stock | | 11,717,670 | 11,617,328 |
| Per share amount | | \$ (0.09) | \$ (0.05) |

Recent Accounting Developments

Business Combinations. 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 combination, including non-controlling interests, contingent consideration, and certain acquired contingencies. SFAS 141R also requires acquisition-related transaction expenses and restructuring costs to 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.

Non-Controlling Interests in Consolidated Financial Statements. 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 or loss attributable to the stockholders of the company separately in our consolidated statements of operations. SFAS 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. SFAS 160 requires retroactive adoption of the presentation and disclosure requirements for existing non-controlling interests. All other requirements of SFAS 160 shall be applied prospectively. SFAS 160 would have an impact on the presentation and disclosure of the non-controlling interests of any non wholly-owned businesses acquired in the future.

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March 31, 2009

3. Business Segment Information

Our operations are conducted in two principal business segments: (i) pipeline transportation services and (ii) oil and gas exploration and production. Our segments are managed jointly mainly due to our size. Management uses earnings before interest expense and income taxes (EBIT) to assess the operating results and effectiveness of our business segments, which consist of our consolidated businesses and investments. We believe EBIT is useful to our investors because it allows them to evaluate our operating performance using the same performance measure analyzed internally by management. We define EBIT as net income (loss) adjusted for: (i) items that do not impact our income or loss from continuing operations, such as the impact of accounting changes, (ii) income taxes and (iii) interest expense (income). We exclude interest expense (income) and other expense or income not pertaining to the operations of our segments from this measure so that investors may evaluate our current operating results without regard to our financing methods or capital structure. We understand that EBIT may not be comparable to measurements used by other companies. Additionally, EBIT should be considered in conjunction with net income and other performance measures such as operating cash flows.

Following is a reconciliation of our EBIT (by segment) for the three months ended March 31, 2009 and 2008, and at March 31, 2009 and 2008:

| | March 31, 2009 | | | |
|--|----------------------------|---|-------------------------------------|--------------------|
| | Segment | | | |
| | Pipeline Transportation | Oil and Gas Exploration & Production | Corporate & Other ⁽¹⁾ | Total |
| Revenues | \$ 514,759 | \$ 21,946 | \$ | \$ 536,705 |
| Operation cost ⁽²⁾ | 1,032,349 | 71,773 | 102,925 | \$ 1,207,047 |
| Depletion, depreciation and amortization | \$ 105,042 | \$ 225,043 | \$ 1,938 | \$ 332,023 |
| EBIT | \$ (622,632) | \$ (274,870) | \$ (104,863) | \$ (1,002,365) |
| Capital expenditures | \$ 12,500 | \$ 3,060 | \$ | \$ 15,560 |
| Identifiable assets ⁽³⁾ | \$ 4,603,878 | \$ 336,091 | \$ 3,485,935 | \$ 8,425,904 |

(1) Includes unallocated G&A costs associated with corporate maintenance costs and legal expenses. It also includes as identifiable assets corporate

available cash
of 3.4 million.

- (2) Allocable G&A costs are allocated based on revenues.
- (3) Identifiable assets contain related legal obligations of each segment including cash, accounts receivable and payable and recorded net assets.

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BLUE DOLPHIN ENERGY COMPANY & SUBSIDIARIES
Notes to Condensed Consolidated Financial Statements (Unaudited)
March 31, 2009

| | March 31, 2008 | | | |
|--|----------------------------|---|-------------------------------------|-------------------|
| | Segment | | | |
| | Pipeline Transportation | Oil and Gas Exploration & Production | Corporate & Other ⁽¹⁾ | Total |
| Revenues | \$ 547,817 | \$ 130,720 | \$ | \$ 678,537 |
| Operation cost ⁽²⁾ | 850,870 | 150,800 | 126,844 | \$ 1,128,514 |
| Depletion, depreciation and amortization | \$ 104,332 | \$ 25,398 | \$ 1,608 | \$ 131,338 |
| EBIT | \$ (407,385) | \$ (45,478) | \$ (128,452) | \$ (581,315) |
| Capital expenditures | \$ | \$ | \$ | \$ |
| Identifiable assets ⁽³⁾ | \$ 5,580,894 | \$ 326,538 | \$ 4,534,931 | \$ 10,442,363 |

(1) Includes unallocated G&A costs associated with corporate maintenance costs and legal expenses. It also includes as identifiable assets corporate available cash of 4.5 million.

(2) Allocable G&A costs are allocated based on revenues.

(3) Identifiable assets contain related legal obligations of each segment including cash, accounts

receivable and
payable and
recorded net
assets.

4. Asset Retirement Obligations

We recorded the following activity related to its asset retirement obligations liability for the three months ended March 31, 2009:

| | |
|---|------------------|
| Asset retirement obligations as of December 31, 2008 | \$ 2,183,190 |
| Liabilities settled | (4,843) |
| Accretion expense | 27,918 |
| Asset retirement obligations as of March 31, 2009 | \$ 2,206,265 |

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 March 31, 2009, we had 285,040 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 common stock determined on the grant date. The 2000 Plan is administered by the Compensation Committee of our Board of Directors.

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BLUE DOLPHIN ENERGY COMPANY & SUBSIDIARIES
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March 31, 2009

Pursuant to SFAS 123R, we estimate the fair value of stock options granted on the date of grant using the Black-Scholes-Merton option-pricing model. The following assumptions were used to determine the fair value of stock options granted during the year ended December 31, 2008. There were no stock options granted in the quarter ended March 31, 2009.

| | December 31, 2008 |
|-------------------------|----------------------|
| Stock options granted | 75,000 |
| Risk-free interest rate | 3.23% |
| Expected term, in years | 6.00 |
| Expected volatility | 90.7% |
| Dividend yield | 0.00% |

Expected volatility used in the model is based on the historical volatility of the 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 three years ago. These changes include changes in our working capital, changes in 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 SEC'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 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 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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BLUE DOLPHIN ENERGY COMPANY & SUBSIDIARIES
Notes to Condensed Consolidated Financial Statements (Unaudited)
March 31, 2009

At March 31, 2009, there were a total of 480,559 shares of common stock reserved for issuance upon exercise of outstanding options under the 2000 Plan. A summary of the status of stock options granted to key employees, officers and directors, for the purchase of shares of common stock for the periods indicated, is as follows:

| | Shares | Weighted Average Exercise Price | Weighted Average Remaining Contractual Life | Aggregate Intrinsic Value |
|--|----------|--|---|---------------------------------|
| Options outstanding at December 31, 2007 | 491,559 | \$ 2.61 | | |
| Options granted | 75,000 | \$ 1.36 | | |
| Options exercised | | \$ 0.00 | | |
| Options expired or cancelled | (11,000) | \$ 3.10 | | |
| Options outstanding at December 31, 2008 | 555,559 | \$ 2.43 | | |
| Options granted | | \$ | | |
| Options exercised | | \$ | | |
| Options expired or cancelled | (75,000) | \$ 1.36 | | |
| Options outstanding at March 31, 2009 | 480,559 | \$ 2.60 | 5.9 | \$2,857 |
| Options exercisable at March 31, 2009 | 271,559 | \$ 2.35 | 5.2 | \$2,857 |

The following table summarizes additional information about stock options outstanding at March 31, 2009:

| Range of Exercise Prices | Number Outstanding | Options Outstanding | | Options Exercisable | |
|-----------------------------|-----------------------|--|--|-----------------------|--|
| | | Weighted Average Remaining Contractual Life (Years) | Weighted Average Exercise Price | Number Exercisable | Weighted Average Exercise Price |
| \$0.35 to \$0.80 | 70,830 | 4.1 | \$ 0.44 | 70,830 | \$0.44 |
| \$1.55 to \$1.90 | 23,429 | 2.9 | \$ 1.71 | 23,429 | \$1.71 |
| \$2.81 to \$2.99 | 368,500 | 6.7 | \$ 2.91 | 159,500 | \$2.88 |
| \$6.00 | 17,800 | 1.1 | \$ 6.00 | 17,800 | \$6.00 |

480,559

271,559

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BLUE DOLPHIN ENERGY COMPANY & SUBSIDIARIES
Notes to Condensed Consolidated Financial Statements (Unaudited)
March 31, 2009

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

| | Shares | Weighted Average Grant Date Fair Value |
|---------------------------------|-----------|---|
| Non-vested at December 31, 2007 | 350,000 | \$2.05 |
| Granted | 75,000 | \$1.03 |
| Canceled or expired | | \$ |
| Vested | (141,000) | \$2.00 |
| | | |
| Non-vested at December 31, 2008 | 284,000 | \$1.83 |
| Granted | | \$ |
| Canceled or expired | (75,000) | \$1.03 |
| Vested | | \$ |
| | | |
| Non-vested at March 31, 2009 | 209,000 | \$2.12 |

As of March 31, 2009, there was \$241,486 of unrecognized compensation cost related to non-vested stock options granted under the 2000 Plan. The weighted average period over which the unrecognized compensation cost will be recognized is 11 months.

6. Warrants

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

| | Number of Warrants | Weighted- Average Exercise Price | Warrants Exercisable | Weighted- Average Exercise Price |
|--------------------------------|-----------------------|---|-------------------------|---|
| Outstanding, December 31, 2007 | 16,440 | \$5.88 | 16,440 | \$5.88 |
| Granted | | \$ | | |
| Exercised | | \$ | | |
| | | | | |
| Outstanding, December 31, 2008 | 16,440 | \$6.37 | 16,440 | \$6.37 |
| Granted | | \$ | | |
| Exercised | | \$ | | |
| | | | | |
| Outstanding, March 31, 2009 | 16,440 | \$6.37 | 16,440 | \$6.37 |

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BLUE DOLPHIN ENERGY COMPANY & SUBSIDIARIES
Notes to Condensed Consolidated Financial Statements (Unaudited)
March 31, 2009

At March 31, 2009, the range of warrant prices for shares of common stock issuable upon exercise of warrants and the weighted-average remaining contractual life was as follows:

| Warrants Outstanding, Fully Vested and Exercisable at March 31, 2009 | | | |
|---|-----------------------|---|--|
| Exercise Prices | Number Outstanding | Weighted Average Remaining Contractual Life in Years | Weighted Average Exercise Price |
| \$6.00 to \$6.50 | 16,440 | 0.1 | \$ 6.37 |

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

7. 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 consolidated 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, as amended (the Exchange Act), and Section 27A of the Securities Act of 1933, as amended. The words expect, plan, believe, anticipate, project, estimate, and similar expressions are intended to identify forward-looking statements. Blue Dolphin Energy Company (referred to herein, with its predecessors and subsidiaries, as Blue Dolphin, we, us and our) cautions readers that these statements are not guarantees of future performance or events and such statements involve risks and uncertainties that may cause actual results and outcomes to differ materially from those indicated in forward-looking statements. Some of the important factors, risks and uncertainties that could cause actual results to vary from forward-looking statements include:

- § the level of utilization of our pipelines;
- § availability and cost of capital;
- § actions or inactions of third party operators for properties where we have an interest;
- § the risks associated with exploration;
- § the level of production from our oil and gas properties;
- § oil and gas price volatility;
- § uncertainties in the estimation of proved reserves and in the projection of future rates of production and timing of development expenditures;
- § regulatory developments; and
- § general economic conditions.

Additional factors that could cause actual results to differ materially from those indicated in the forward-looking statements are discussed under the caption Risk Factors in our annual report on Form 10-K for the year ended December 31, 2008. 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 quarterly report.

Executive Summary

We are engaged in two lines of business: (i) 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 and maximizing our current facilities, we also continue to review, evaluate opportunities and acquire additional oil and gas properties.

Pipeline Transportation. Although the Blue Dolphin Pipeline System added a new shipper in the three months ended March 31, 2009 (the current quarter), pipeline revenues were down compared to the three months ended March 31, 2008 (the previous quarter). Deliveries from Galveston Area Block 321 into the Blue Dolphin Pipeline System began in mid-March 2009. The Blue Dolphin Pipeline System is currently transporting an aggregate of approximately 19

MMcf of gas per day from nine shippers. The GA 350 Pipeline is currently transporting an aggregate of approximately 23 MMcf of gas per day from six shippers.

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BLUE DOLPHIN ENERGY COMPANY & SUBSIDIARIES

Management's Discussion and Analysis of Financial Condition and Results of Operations

Oil and Gas Exploration and Production.

§ **Galveston Area Block 321** In September 2008, we acquired a 0.5% overriding royalty interest in an exploratory well in Galveston Area Block 321. Drilling of the well commenced in late December 2008 and continued through early January 2009. The well commenced production in mid-March 2009. Production is currently being delivered through the Blue Dolphin Pipeline System.

§ **High Island Block 115** The B-1 well resumed production in February 2009 after being shut-in due to damage to third party onshore facilities resulting from Hurricane Ike in September 2008. We maintain a 2.5% working interest in the well.

§ **High Island Block 37** The A-2 well resumed production in February 2009 after being shut-in due to damage to third party onshore facilities resulting from Hurricane Ike. We maintain a 2.8% working interest in the well. Our pipeline assets remain significantly under-utilized. The Blue Dolphin Pipeline System is currently operating at approximately 12% of capacity, the GA 350 Pipeline is currently operating at approximately 35% of capacity and the Omega Pipeline is inactive. Production declines, temporary stoppages or cessations of production from wells tied into our pipelines or from our working and overriding royalty interests in wells in Galveston Area and High Island blocks 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 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 our asset base, improve our competitive position and be accretive to earnings.

Results of Operations

We reported a net loss of \$1,000,009 in the current quarter compared to a net loss of \$525,374 in the previous quarter.

Three Months Ended March 31, 2009 Compared to Three Months Ended March 31, 2008

Revenue from Pipeline Operations. Revenues from pipeline operations decreased by \$33,058, or 6%, in the current quarter to \$514,759 primarily as a result of decreases in gas volumes transported. Revenues from the Blue Dolphin Pipeline System decreased to approximately \$424,000 in the current quarter compared to approximately \$443,000 in the previous quarter. Daily gas volumes transported on the Blue Dolphin Pipeline System averaged 19 MMcf of gas per day in the current quarter, down from 21 MMcf of gas per day in the previous quarter. Revenues on the GA 350 Pipeline decreased to approximately \$91,000 compared to approximately \$105,000 in the previous quarter due to a decrease in average daily gas volumes transported of 22 MMcf of gas per day in the current quarter from 25 MMcf of gas per day in the previous quarter.

Revenue from Oil and Gas Sales. Revenues from oil and gas sales decreased by \$108,774, or 83%, in the current quarter due to the interruption in production from High Island Block 115 and High Island Block 37 as a result of damage to third party shore facilities caused by Hurricane Ike in September 2008, as well as lower commodity prices. The sales mix by product was 95% gas and 5% condensate. Our average realized gas price per Mcf in the current quarter was \$3.66 compared to \$7.89 in the previous quarter. Our average realized condensate price per barrel was \$42.68 in the current quarter compared to \$115.45 in the previous quarter.

Pipeline Operating Expenses. Pipeline operating expenses in the current quarter increased by \$50,304 to \$466,260 due to increases in storage tank repairs, crane repairs and other repairs related to damage from Hurricane Ike. The increases were partially offset by decreases in salt water disposal and insurance expenses.

Impairment of Oil and Gas Properties. We recorded a full cost ceiling impairment of \$203,110 for the current quarter. Under the full cost method of accounting, we are required on a quarterly basis to determine whether the book value of our oil and natural gas properties (excluding unevaluated properties) is less than or equal to the ceiling, based upon the expected after tax present value (discounted at 10%) of the future net cash flows from our

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

proved reserves, calculated using prevailing oil and natural gas prices on the last day of the period, or a subsequent higher price under certain circumstances. Any excess of the net book value of our oil and natural gas properties over the ceiling must be recognized as a non-cash impairment expense. Our ceiling was calculated using prices of \$47.19 per barrel of oil and \$3.65 per MMBtu. Accordingly, at March 31, 2009, our costs exceeded our ceiling limitation, resulting in a write-down of our oil and natural gas properties.

General and Administrative Expenses and Stock Based Compensation. These expenses increased by \$31,029 to \$664,838 in the current quarter primarily due to increases in compensation expense, consulting fees and contract labor. These increases were partially offset by decreases in audit expense and stock option expense.

Other Income. Other income decreased due to a decrease in interest income of \$53,585 in the current quarter. Interest income decreased because of decreases in both the amount of available funds and the interest rate earned on those funds.

Liquidity and Capital Resources

Sources and Uses of Cash. Our primary source of cash is cash flow from operations. During the three months ended March 31, 2009, we had negative cash flow from operations of \$303,198, excluding working capital changes, mainly due to low utilization of our pipeline systems and loss of oil and gas revenues attributable to Hurricane Ike.

Currently, we do not enter into any hedges or any type of derivatives to offset changes in commodity prices. We also do not have any outstanding debt or a credit facility with a bank or institution that may restrict us from issuing debt or common stock. Available cash at March 31, 2009 was approximately \$3.5 million.

The following table summarizes our change in cash flows at March 31, 2009 and 2008 (in thousands):

| | March 31, 2009 | March 31, 2008 |
|--|-------------------|-------------------|
| Cash flow from operations | | |
| Loss from operations | \$ (557) | \$ (273) |
| Change in current assets and liabilities | 254 | 103 |
| Total cash flow from operations | (303) | (170) |
| Cash outflows | | |
| Capital expenditures | (16) | |
| Total cash outflows | (16) | |
| Total change in cash flows | \$ (319) | \$ (170) |

In the past two years, we have used a portion of our cash reserves to fund our working capital requirements that were not funded from operations.

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BLUE DOLPHIN ENERGY COMPANY & SUBSIDIARIES

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK.

Not Applicable.

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, 2009, 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, is 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.

PART II. OTHER INFORMATION

ITEM 1A. RISK FACTORS

There have been no material changes from the risk factors disclosed in our annual report on Form 10-K for the fiscal year ended December 31, 2008.

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.

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BLUE DOLPHIN ENERGY COMPANY & SUBSIDIARIES

ITEM 6. EXHIBITS

(a) Exhibits:

The following exhibits are filed herewith:

- 3.1⁽¹⁾ Amended and Restated Certificate of Incorporation of Blue Dolphin Energy Company.
- 3.2⁽²⁾ Amended and Restated Bylaws of Blue Dolphin Energy 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**

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

By: **BLUE DOLPHIN ENERGY
COMPANY**

May 14, 2009

/s/ IVAR SIEM

IVAR SIEM
Chairman and Chief Executive Officer

/s/ T. SCOTT HOWARD

T. SCOTT HOWARD
Principal Accounting and Financial Officer
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