

BLUE DOLPHIN ENERGY CO

Form 10QSB

November 14, 2007

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

Quarterly Report Under Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended: 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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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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BLUE DOLPHIN ENERGY COMPANY AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEET
UNAUDITED

	September 30, 2007
ASSETS	
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
 TOTAL ASSETS	 \$ 10,793,311
 LIABILITIES AND STOCKHOLDERS EQUITY	
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
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 10,793,311

See accompanying notes to the condensed consolidated financial statements.

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

	Three Months Ended 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.

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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.

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

	Nine Months Ended, September 30,	
	2007	2006
OPERATING ACTIVITIES		
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
INVESTING ACTIVITIES		
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)
FINANCING ACTIVITIES		
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.

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**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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BLUE DOLPHIN ENERGY COMPANY AND SUBSIDIARIES
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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.

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BLUE DOLPHIN ENERGY COMPANY AND SUBSIDIARIES
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	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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BLUE DOLPHIN ENERGY COMPANY AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS UNAUDITED
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4. Business Segment Information

Our income producing operations are conducted in two principal business segments: pipeline operations and oil and gas exploration and production. There were no intersegment revenues during the periods presented. Information concerning these segments for the three and nine months ended September 30, 2007 and 2006 and at September 30, 2007, is as follows:

	Revenues	Operating Income (Loss) ^(*)	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	

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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

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BLUE DOLPHIN ENERGY COMPANY AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS UNAUDITED
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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.

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**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		
	Weighted	Weighted	Aggregate
&nb	Average	Average	