BLUE DOLPHIN ENERGY CO
Form 10KSB
March 31, 2008

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

þ **Annual Report Under Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the fiscal year ended December 31, 2007

o **Transition Report Under 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
(Name of small business issuer in its charter)

Delaware	**73-1268729**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
801 Travis Street, Suite 2100, Houston, Texas	**77002**
(Address of principal executive office)	(Zip Code)

Issuer s telephone number **(713) 227-7660**
Securities registered pursuant to Section 12(b) of the Exchange Act: **common stock, par value $.01 per share**
Securities registered pursuant to Section 12(g) of the Exchange Act: **none**
(Title of Class)

Check whether the issuer is not required to file reports pursuant to Section 13 or 15 (d) of the Exchange Act. o

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 þ No o

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B contained in this form, and no disclosure will be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB. þ

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No þ

The issuer s revenues for the year ended December 31, 2007 were $3,011,817.

The aggregate market value of the common stock, par value $.01 per share, held by non-affiliates of the registrant as of March 26, 2008, based on the last reported trading price of the registrant s common stock on the NASDAQ Capital Market on that date, was approximately $16,025,000.

As of March 26, 2008, there were 11,624,447 shares of common stock, par value $.01 per share, of the issuer outstanding.

Documents Incorporated By Reference

Certain sections of the registrant s definitive proxy statement for the 2008 Annual Meeting of Stockholders of the registrant (sections entitled Ownership of Securities of the Company, Election of Directors, Executive Compensation and Transactions With Related Persons), which is to be filed with the Securities and Exchange Commission pursuant to Regulation 14A, under the Securities and Exchange Act of 1934 within 120 days of the registrant s fiscal year ended December 31, 2007, are incorporated by reference in Part III of this report.

Transitional Small Business Disclosure Format. Yes o No þ

BLUE DOLPHIN ENERGY COMPANY
FORM 10-KSB REPORT INDEX

PART I

Forward Looking Statements. Certain of the statements included in this annual report on Form 10-KSB, 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 oil and gas exploration;*
- *the level of production from oil and gas properties that we have interests in;*
- *gas and oil price volatility;*
- *uncertainties in the estimation of proved reserves, in the projection of future rates of production, the timing of development expenditures and the amount and timing of property abandonment;*
- *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 . Readers are cautioned not to place undue reliance on these forward-looking statements which speak only as of the date hereof. We undertake no duty to update these forward-looking statements. Readers are urged to carefully review and consider the various disclosures made by us which attempt to advise interested parties of the additional factors which may affect our business, including the disclosures made under the caption Management s Discussion and Analysis of Financial Condition and Results of Operations in this report.

Item 1. Description of Business

THE COMPANY

Blue Dolphin Energy Company, a Delaware corporation formed in 1986, is a holding company and conducts substantially all of its operations through its subsidiaries. We conduct our business activities in two primary business segments: (i) pipeline transportation and related services for producer/shippers, and (ii) oil and gas exploration and production. Substantially all of our assets consist of equity interests in our subsidiaries. Our operating subsidiaries are:

- Blue Dolphin Pipe Line Company, a Delaware corporation;
- Blue Dolphin Petroleum Company, a Delaware corporation;
- Blue Dolphin Exploration Company, a Delaware corporation; and
- Blue Dolphin Services Co., a Texas corporation.

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Our principal executive office is located at 801 Travis Street, Suite 2100, Houston, Texas, 77002, and our telephone number is (713) 227-7660. We maintain shore-based facilities in Freeport, Texas, to serve our Gulf of Mexico operations. We have eight employees and two consultants. Our common stock is traded on the NASDAQ Capital Market under the ticker symbol BDCO. Our website address is http://www.blue-dolphin.com.

Certain terms that are commonly used in the oil and gas industry, including terms that define our rights and obligations with respect to our properties, are defined in the Glossary of Certain Oil and Gas Terms of this Form 10-KSB.

Recent Developments

The Blue Dolphin System is currently transporting an aggregate of approximately 26 MMcf of gas per day from ten shippers and the GA 350 Pipeline is currently transporting an aggregate of approximately 29 MMcf of gas per day from six shippers. Annual revenues from pipeline operations were $2,494,406 in 2007. Throughput on the Blue Dolphin System and the GA 350 Pipeline increased significantly during 2007 due to production gains from three shippers delivering production from a total of four wells. Delivery of production from two of the wells commenced on the Blue Dolphin System and two of the wells commenced on the GA 350 Pipeline. Since the beginning of 2006, the Blue Dolphin System and the GA 350 Pipeline have gained production from seven shippers delivering from eight wells. Four of these shippers are delivering production into the Blue Dolphin System, representing five wells, and three of the shippers are delivering production into the GA 350 Pipeline from three wells. In 2007, a shipper began deliveries into the Blue Dolphin System from two wells in July. On the GA 350 Pipeline, one shipper began deliveries in each of June and September of 2007.

In 2007, in addition to the throughput gains received from shippers added to the pipelines, the Blue Dolphin System also benefited from the drilling activities of an existing shipper. In June 2007, an existing shipper drilled a new well, resulting in an increase of daily production.

Production from the High Island Block 37 A-2 well was restarted in December 2007 after experiencing production problems in April 2007. The well was shut in for approximately eight months. High Island Block 37 averaged approximately 5.4 MMcf of gas per day in 2007 as compared to approximately 15.6 MMcf of gas per day in 2006. We recognized gross oil and gas sales revenues of approximately $276,000 in 2007 associated with our approximate 2.8% working interest in High Island Block 37. The High Island Block 37 A-2 well is currently producing at a rate of approximately 3 MMcf of gas per day. The B-1 well experienced production problems in January 2008 and is currently shut-in. We believe that the A-2 well could continue to produce until mid-2008, however, the well could deplete faster than currently anticipated or could develop production problems resulting in the cessation of production. Additional development of reserves in this block is currently being evaluated.

The well in High Island Block 115 commenced production in late November 2007 and produced at an average rate of approximately 6.3 MMcf per day during the remainder of 2007. We had previously earned a 2.5% working interest in this well, which was drilled successfully in the second quarter 2007. We recognized gross oil and gas sales revenues of approximately $30,000 from this well in 2007. The well is currently producing at a rate of approximately 9 MMcf of gas per day.

The High Island Block A-7 well also experienced production problems in the second quarter 2007. The well has produced only intermittently since. It is currently shut in and may have reached the end of its productive life. The well averaged approximately 0.7 MMcf of gas per day in 2007 as compared to approximately 5.6 MMcf of gas per day in 2006. We recognized gross oil and gas sales revenues of approximately $211,000 for the twelve months ended December 31, 2007 associated with our approximate 8.9% working interest in the High Island Block A-7 well.

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Pipeline Operations and Activities

Our pipeline assets are held in, and operations conducted by, Blue Dolphin Pipe Line Company.

The economic return on our pipeline system investments and the fees chargeable for the services provided are dependent upon the amounts of gas and condensate gathered and transported. Currently, the level of throughput on our pipeline systems is significantly below maximum capacity. Competition for provision of gathering and transportation services similar to ours is intense in the market areas we serve. See Competition for additional information. Since contracts for gathering and transportation services with third party producer/shippers may be for specified time periods, there can be no assurance that current or future producer/shippers will not subsequently tie-in to alternative transportation systems or that current rates charged will be maintained in the future. We actively market our gathering and transportation services to producer/shippers operating in the vicinity of our pipeline systems. Future utilization of the pipelines and related facilities will depend upon the success of drilling programs around the pipelines, and the attraction, and retention, of producer/shippers to the systems.

Blue Dolphin Pipeline System. The Blue Dolphin Pipeline System (the Blue Dolphin System) includes the Blue Dolphin Pipeline, an offshore platform, the Buccaneer Pipeline, onshore facilities for condensate and gas separation and dehydration, 85,000 Bbls of above-ground tankage for storage of crude oil and condensate, a barge loading terminal on the Intracoastal Waterway and 360 acres of land in Brazoria County, Texas where the Blue Dolphin Pipeline comes ashore and where the pipeline system shore facilities, pipeline easements and rights-of-way are located. We own an 83% undivided interest in the Blue Dolphin System. The Blue Dolphin System gathers and transports gas and condensate from various offshore fields in the Galveston Area of the Gulf of Mexico to shore facilities located in Freeport, Texas. After processing, the gas is transported to an end user and a major intrastate pipeline system with further downstream tie-ins to other intrastate and interstate pipeline systems and end users.

The Blue Dolphin Pipeline consists of two segments, an offshore segment and an onshore segment. The offshore segment transports both gas and condensate and is comprised of approximately 34 miles of 20-inch pipeline originating at an offshore platform in Galveston Area Block 288 and running to shore. The offshore segment also includes the platform in Galveston Area Block 288 and 5 field gathering lines totaling approximately 27 miles, connected to the main 20-inch line. An additional 2 miles of 20-inch pipeline onshore connects the offshore segment to the onshore facility at Freeport, Texas. The onshore segment also includes approximately 2 miles of 16-inch pipeline for transportation of gas from the shore facility to a sales point at a Freeport, Texas chemical plants complex and intrastate pipeline system tie-in. The Buccaneer Pipeline, an approximate 2 mile, 8-inch liquids pipeline, transports condensate from the onshore facility storage tanks to our barge-loading terminal on the Intracoastal Waterway near Freeport, Texas for sale to third parties.

Various fees are charged to producer/shippers for provision of transportation and shore facility services. The Blue Dolphin System has an aggregate capacity of approximately 160 MMcf of gas per day and 7,000 Bbls of crude oil and condensate per day. Gas throughput for the Blue Dolphin System averaged 22.3 MMcf of gas per day, or approximately 14% of capacity, and 17.3 MMcf of gas per day, or approximately 9% of capacity during 2007 and 2006, respectively. The Blue Dolphin System is currently transporting approximately 26 MMcf of gas per day. All gas and liquids volumes transported in 2007 and 2006 were attributable to production from third party producer/shippers.

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Galveston Area Block 350 Pipeline. We own an 83% undivided interest in the Galveston Area Block 350 Pipeline (the GA 350 Pipeline). The GA 350 Pipeline is an 8-inch, 13 mile offshore pipeline extending from Galveston Area Block 350 to an interconnect with a transmission pipeline in Galveston Area Block 391 located approximately 14 miles south of the Blue Dolphin Pipeline. Current system capacity on the GA 350 Pipeline is 65 MMcf of gas per day. Gas throughput for the GA 350 Pipeline averaged 22.6 MMcf of gas per day, or approximately 35% of capacity, and 9.0 MMcf of gas per day, or approximately 14% of capacity, during 2007 and 2006, respectively. The pipeline is currently transporting approximately 29 MMcf of gas per day. All gas and liquids volumes transported were attributable to production from third party producer/shippers.

Other. We also own an 83% undivided interest in a third offshore pipeline, the Omega Pipeline, which is currently inactive. The Omega Pipeline originates in the High Island Area, East Addition Block A-173 and extends to West Cameron Block 342, where it was previously connected to the High Island Offshore System. Reactivation of the Omega Pipeline will be dependent upon future drilling activity in the vicinity and successfully attracting producer/shippers to the system.

Oil and Gas Exploration and Production Activities

Although we sold substantially all of our producing oil and gas properties in 2002, we continue our oil and gas exploration and production activities, which include the exploration, acquisition, development, operation and, when appropriate, disposition of oil and gas properties. We focus our oil and gas activities in the western Gulf of Mexico, off the coast of Texas. We currently own seismic and other data that may be used to evaluate and develop prospects, including a non-exclusive license to approximately 200 blocks of 3-D seismic data covering 1,152,000 acres in the western Gulf of Mexico and a substantial inventory of close grid 2-D seismic data. Our oil and gas assets are held by Blue Dolphin Petroleum Company.

The leasehold interests we hold in properties are subject to royalty, overriding royalty and interests of others.

The following is a description of our oil and gas exploration and production assets and activities:

High Island Block 37. High Island Block 37 is located approximately 15 miles south of Sabine Pass, offshore Texas, in an average water depth of approximately 36 feet. We own an approximate 2.8% working interest in this lease that covers 5,760 acres. The lease contains two producing wells which are operated by Seneca Resources Corporation. The B-1 well is currently shut-in. The A-2 well is currently producing approximately 3 MMcf of gas per day. We recorded gross revenues from sales of oil and natural gas in High Island Block 37 of approximately $276,000 and $890,000 for the years ended December 31, 2007 and 2006, respectively.

High Island Block A-7. High Island Block A-7 is located approximately 33 miles southeast of Bolivar Peninsula, offshore Texas, in an average water depth of approximately 39 feet. We own an approximate 8.9% working interest in this lease that covers 5,760 acres. The lease is operated by Hydro Gulf of Mexico, LLC (formerly Spinnaker Exploration Company). The single producing well in this block produced an average of 0.7 MMcf of gas per day during 2007 as a result of production problems experienced in the second quarter. The well is currently shut-in and may have reached the end of its productive life. During the years ended December 31, 2007 and 2006, we recorded gross revenues from oil and natural gas sales of approximately $211,000 and $1,469,000, respectively, from this field.

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High Island Block 115. High Island Block 115 is located approximately 30 miles southeast of Bolivar Peninsula in an average water depth of approximately 38 feet. We own a 2.5% working interest in a single production zone in one well in this lease. Production commenced in late November 2007. In 2007, we recognized gross revenues from oil and natural gas sales of approximately $30,000 from this well. The well is currently producing approximately 9 MMcf of gas per day.

See Note (12), Business Segment Information, in Item 7 Notes to Consolidated Financial Statements for additional information on revenues, operating income (loss), assets and depreciation, depletion and amortization on our business segments.

Proved Oil and Gas Reserves. We have prepared estimates of proved reserves, and discounted present value of future net revenues to our net interest as of December 31, 2007.

The quantities of proved oil and gas reserves presented below include only those amounts which we reasonably expect to recover in the future from known oil and gas reservoirs under existing economic and operating conditions. Therefore, proved reserves are limited to those quantities that are believed to be recoverable at prices and costs, and under regulatory practices and technology existing at the time of the estimate. Accordingly, changes in oil and gas prices, operation and development costs, regulations, technology, future production and other factors, many of which are beyond our control, could significantly affect the estimates of proved reserves and the discounted present value of future net revenues attributable thereto.

Estimates of production and future net revenues cannot be expected to represent accurately the actual production or revenues that may be recognized with respect to oil and gas properties or the actual present market value of such properties. See Note (13), Supplemental Oil and Gas Information, in Item 7 Notes to Consolidated Financial Statements for further information concerning our proved reserves, changes in proved reserves, estimated future net revenues and costs incurred in our oil and gas activities and the discounted present value of estimated future net revenues from our proved reserves.

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The following table presents the estimates of proved reserves, proved developed reserves (as hereinafter defined) and the discounted present value of future net revenues or expenses from proved reserves after income taxes (in thousands) to our net interest in oil and gas properties as of December 31, 2007. The discounted present value of future net revenues or expenses is calculated using the SEC Method (defined below) and is not intended to represent the current market value of the oil and gas reserves we own.

PROVED RESERVES
As of December 31, 2007[(1)(2)]

	Net Oil Reserves (Mbbls)	Net Gas Reserves (MMcf)	Present Value of Future Net Cash Inflows (Outflows) After Income Taxes [(1)]
Total Proved Reserves			
High Island Block A-7	0.0	0	$ (166)
High Island Block 37	0.0	18	6
High Island Block 115	0.8	160	629
	0.8	178	$ 469
Total Proved Developed			
High Island Block A-7	0.0	0	$ (166)
High Island Block 37	0.0	18	6
High Island Block 115	0.8	160	629
	0.8	178	$ 469

(1) The estimated present value of future net cash outflows after income taxes from our proved reserves has been determined by using prices of $88.46 per barrel of oil and $7.13 per Mcf of gas, representing the December 31, 2007 prices for oil and gas and discounted at a 10% annual rate

in accordance with requirements for reporting oil and gas reserves pursuant to regulations promulgated by the United States Securities and Exchange Commission (the SEC Method).

(2) As of December 31, 2007, we reported no proved undeveloped reserves.

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Capital Expenditures for Proved Reserves. The following table presents information regarding the costs we expect to incur in activities associated with our proved reserves. These expenditures represent costs associated with the plugging and abandonment of wells. The information regarding proved reserves summarized in the preceding table assumes the following estimated undiscounted capital expenditures in the years indicated (in thousands).

ESTIMATED UNDISCOUNTED CAPITAL EXPENDITURES
ASSOCIATED WITH PLUGGING AND ABANDONMENT OF WELLS

	Years Ending December 31,				
	2008	2009	2010	2011	2012
High Island Block A-7	265				
High Island Block 37		92			
High Island Block 115				39	

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Production, Price and Cost Data. The following table presents information regarding production volumes and revenues, average sales prices and costs (after deduction of royalties and interests of others) with respect to crude oil, condensate, and gas attributable to our interest for each of the periods indicated.

NET PRODUCTION, PRICE AND COST DATA

	Years Ended December 31,		
	2007	2006	2005
Gas:			
Production (Mcf)	72,788	312,146	378,791
Revenue	$ 476,224	$ 2,131,415	$ 3,071,811
Average production per day (Mcf) (*)	199.4	772.3	1,037.8
Average sales price per Mcf	$ 6.54	$ 6.83	$ 8.11
Condensate:			
Production (Bbls)	177	1,823	781
Revenue	$ 10,345	$ 114,114	$ 40,481
Average production per day (Bbls) (*)	0.5	5.0	2.1
Average sales price per Bbl	$ 58.45	$ 62.60	$ 51.83
NGLs:			
Production (gallons)	36,372	137,139	27,935
Revenue	$ 30,842	$ 113,285	$ 23,718
Average production per day (gallons) (*)	99.7	375.7	76.5
Average sales price per gallon	$ 0.85	$ 0.83	$ 0.85
Production costs (**):			
Per Mcfe:	$ 3.04	$ 1.34	$ 0.40

(*) Average production is based on a 365 day year. However, 2005 average production per day contains 549 days of production for High Island Block 37.

(**) Production costs, exclusive of workover costs, are costs incurred to operate and maintain wells and equipment and to pay production taxes.

Drilling Activity. During the third quarter of 2007, a single well in High Island Block 115 was successfully recompleted. After laying flowlines to the well, production commenced in late November 2007. The rate of production from this well averaged 6.3 MMcf of gas per day through the end of 2007. We did not incur any capital expenditures associated with this recompletion since the obligations associated with our working interest did not commence until flow was established.

Employees

We have a total of eight employees and two consultants. Our employees are capable of supervising and coordinating the operation and administration of our oil and gas properties and pipeline and other assets. From time to time, major maintenance, engineering and construction projects are contracted to third-party engineering and service companies.

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Customers

We generated revenues from both of our primary business segments. Apex Oil & Gas, W&T Offshore and Gryphon Exploration Co. accounted for approximately 26.8%, 17.2% and 11.3%, respectively, of our revenues in 2007. Revenues from customers exceeding 10% of revenues were as follows for 2007 and 2006:

	Oil and Gas Sales	Pipeline Operations	Total
Year Ended December 31, 2007:			
Apex Oil & Gas	$	$ 809,420	$ 809,420
W&T Offshore	$	$ 519,866	$ 519,866
Gryphon Exploration Co.	$	$ 341,406	$ 341,406
Year Ended December 31, 2006:			
Hydro Gulf of Mexico, LLC (formerly Spinnaker Exploration Company)	$ 1,469,132	$	$ 1,469,132
Fidelity Exploration and Production Company	$ 889,682	$	$ 889,682

Competition

Both segments of our business are highly competitive. Vigorous competition occurs among oil, gas and other energy sources, and between producers, transporters, and distributors of oil and gas. Our pipeline business faces competition from other pipelines in the markets that we serve. The principal elements of competition among pipelines are rates, terms of service, access to markets, flexibility and reliability of service. Our oil and natural gas business competes for the acquisition of oil and natural gas properties with numerous entities, including major oil companies, independent oil and natural gas concerns and individual producers and operators, primarily on the basis of the price to be paid for such properties. Many of these competitors are large, well-established companies and have financial and other resources substantially greater than ours, which give them an advantage over us in evaluating and obtaining properties and prospects. Our ability to acquire additional pipelines and oil and natural gas properties and to discover reserves in the future will depend upon our ability to evaluate and select suitable properties and consummate transactions in a highly competitive environment. There is also competition for the hiring of experienced personnel to manage and operate our assets. Several highly competitive alternative transportation and delivery options exist for current and potential customers of our traditional gas and oil gathering and transportation business. Competition also exists with other industries in supplying the energy and fuel needs of consumers.

Markets

The availability of a ready market for oil and natural gas, and the prices of oil and natural gas, depends upon a number of factors, which are beyond our control. These include, among other things:

- the level of domestic production;
- actions taken by foreign oil and gas producing nations;
- the availability of pipelines with adequate capacity;
- the availability of vessels for direct shipment;
- lightering, transshipment and other means of transportation;
- the availability and marketing of other competitive fuels;
- fluctuating and seasonal demand for oil, natural gas and refined products; and

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the extent of governmental regulation and taxation (under both present and future legislation) of the production, importation, refining, transportation, pricing, use and allocation of oil, gas, refined products and alternative fuels.

In view of the many uncertainties affecting the supply and demand for crude oil, condensate, natural gas and refined petroleum products, it is not possible to predict accurately the prices or marketability of the oil and natural gas produced for sale or prices chargeable for transportation and storage services, which we provide. Our sale of natural gas is generally made at the market prices at the time of sale. Therefore, even though we sell natural gas to major purchasers, we believe other purchasers would be willing to buy our natural gas at comparable market prices.

Governmental Regulation

The production, processing, marketing, and transportation of oil and gas by us are subject to federal, state and local regulations which can have a significant impact upon our overall operations.

Federal Regulation of Natural Gas Transportation. The transportation and resale of gas in interstate commerce have been regulated by the Natural Gas Act (NGA), the Natural Gas Policy Act (NGPA), and the rules and regulations promulgated by the Federal Energy Regulatory Commission (FERC). In the past, the federal government has regulated the prices at which gas could be sold. In 1989, Congress enacted the Natural Gas Wellhead Decontrol Act, which removed all remaining Natural Gas Act and Natural Gas Policy Act price and non-price controls affecting producer sales of gas, effective January 1, 1993. The Energy Policy Act of 2005 did not alter our non-FERC-jurisdictional status, but has greatly expanded FERC s authority, including enforcement authority against market manipulation in connection with FERC-jurisdictional transactions. FERC has undertaken vigorous enforcement actions against a number of entities, including those not subject to direct FERC regulation. Additionally, energy pricing has attracted renewed political interest. Thus Congress could reenact price controls in the future. The rates, terms and conditions applicable to interstate transportation of gas by pipelines are regulated by the FERC under the NGA, as well as under Section 311 of the NGPA. In February 2007, FERC issued a policy order acknowledging its lack of jurisdiction over offshore gathering, but stating that FERC would intervene in the event that interstate pipelines with affiliated offshore gathering lines engage in anticompetitive behavior, such conditioning access to interstate pipeline service upon use of the affiliated gathering line.

All of our pipelines located offshore in federal waters are subject to the requirements of the Outer Continental Shelf Lands Act (OCSLA). The FERC has stated that non-jurisdictional gathering lines, as well as interstate pipelines, are fully subject to the open access and nondiscrimination requirements of OCSLA s Section 5, which generally authorizes the FERC to insure that gas pipelines on the Outer Continental Shelf (OCS) will transport for non-owner shippers in a nondiscriminatory manner and will be operated in accordance with certain pro-competitive principles. Since all of our offshore pipelines fall within the exemption for feeder facilities and already operate on the basis required under OCSLA, we do not anticipate significant changes directly resulting from requirements concerning nondiscriminatory open access transportation.

Aside from the OCSLA requirements and federal safety and operational regulations, regulation of gas gathering activities is primarily a matter of state oversight. Regulation of gathering activities in Texas includes various transportation, safety, environmental and non-discriminatory purchase/transport requirements.

Federal Regulation of Oil Pipelines. Our operation of the Buccaneer Pipeline has been subject to a variety of regulations promulgated by the FERC and imposed on all oil pipelines pursuant to federal law. Recently, however, oil pipelines have been granted permanent exemptions from certain FERC filing requirements because of rulings that oil pipeline transportation tariff movements of crude petroleum occurring solely on or across the OCS, or across the OCS to onshore points where transportation ends are not subject to FERC jurisdiction under the OCSLA or the Interstate Commerce Act.

Safety and Operational Regulations. Our operations are generally subject to safety and operational regulations administered primarily by the United States Minerals Management Service (MMS), the U.S. Department of Transportation, the U.S. Coast Guard, the FERC and/or various state agencies. In addition, the OCSLA authorizes regulations relating to safety and environmental protection applicable to leases and permittees operating on the OCS. Specific design and operational standards may apply to OCS vessels, rigs, platforms and structures. Violations of lease conditions or regulations issued pursuant to the OCSLA can result in substantial civil and criminal penalties, as well as potential court injunctions curtailing operations and the cancellation of leases. Such enforcement liabilities can result from either governmental or private prosecution. Currently, we believe that we are in material compliance with the various safety and operational regulations that we are subject to. However, as safety and operational regulations are frequently changed, we are unable to predict the future effect changes in these regulations will have on our operations, if any.

Federal Oil and Gas Leases. All of our exploration and production operations are currently located on federal oil and gas leases in the OCS, which are administered by the MMS. Such leases are issued through competitive bidding, contain relatively standardized terms and require compliance with detailed MMS regulations and orders pursuant to the OCSLA that are subject to interpretation and change by the MMS. For offshore operations, lessees must obtain MMS approval for exploration plans and development and production plans prior to the commencement of such operations. In addition to permits required from other agencies such as the Coast Guard, the Army Corps of Engineers and the Environmental Protection Agency, lessees must obtain a permit from the MMS prior to the commencement of drilling. The MMS has promulgated regulations requiring offshore production facilities located on the OCS to meet stringent engineering and construction specifications. To cover the various obligations of lessees on the OCS, the MMS generally requires that lessees have substantial net worth or post bonds or other acceptable assurance that such obligations will be met. The cost of these bonds or other surety can be substantial, and there is no assurance that bonds or other surety can be obtained in all cases. We are currently in compliance with the bonding requirements of the MMS. Under some circumstances, the MMS may require any of our operations on federal leases to be suspended or terminated. Any such suspension or termination could materially adversely affect our financial condition and results of operations.

With respect to our operations conducted on offshore federal leases, liability may generally be imposed under OCSLA for costs of clean-up and damages caused by pollution resulting from such operations, other than damages caused by acts of war or the negligence of third parties. Under certain circumstances, including but not limited to conditions deemed a threat or harm to the environment, the MMS may also require any of our operations on federal leases to be suspended or terminated in the affected area. Furthermore, the MMS generally requires that offshore facilities be dismantled and removed within one year after production ceases or the lease expires.

Environmental Regulation. Our activities with respect to (1) exploration, development and production of oil and natural gas and (2) the operation and construction of pipelines, plants, and other facilities for the transportation and processing, and storage of oil and natural gas are subject to stringent environmental regulation by local, state and federal authorities, including the U.S. Environmental Protection Agency (EPA). Such regulation has increased the cost of planning, designing, drilling, operating and in some instances, abandoning wells and related equipment. Similarly, such regulation has also increased the cost of design, construction, and operation of crude oil and natural gas pipelines and processing facilities. Although we believe that compliance with existing environmental regulations will not have a material adverse effect on operations or earnings, there can be no assurance that significant costs and liabilities, including civil and criminal penalties, will not be incurred. Moreover, future developments, such as stricter environmental laws and regulations or claims for personal injury or property damage resulting from our operations, could result in substantial costs and liabilities. It is not anticipated that, in response to such regulation, we will be required in the near future to expend amounts that are material relative to our total capital structure.

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The Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) imposes liability, without regard to fault or the legality of the original conduct, on responsible parties with respect to the release or threatened release of a hazardous substance into the environment. Responsible parties, which include the present owner or operator of a site where the release occurred, the owner or operator of the site at the time of disposal of the hazardous substance, and persons that disposed or arranged for the disposal of a hazardous substance at the site, are liable for response and remediation costs and for damages to natural resources. Petroleum and natural gas are excluded from the definition of hazardous substances ; however, this exclusion does not apply to all materials used in our operations. At this time, neither we nor any of our predecessors have been designated as a potentially responsible party under CERCLA.

The federal Resource Conservation and Recovery Act (RCRA) and its state counterparts regulate solid and hazardous wastes and impose civil and criminal penalties for improper handling and disposal of such wastes. EPA and various state agencies have promulgated regulations that limit the disposal options for such wastes. Certain wastes generated by our oil and gas operations are currently exempt from regulation as hazardous wastes, but in the future could be designated as hazardous wastes under RCRA or other applicable statutes and therefore may become subject to more rigorous and costly requirements.

We currently own or lease, or have in the past owned or leased, various properties used for the exploration and production of oil and gas or used to store and maintain equipment regularly used in these operations. Although our past operating and disposal practices at these properties were standard for the industry at the time, hydrocarbons or other substances may have been disposed of or released on or under these properties or on or under other locations. In addition, many of these properties have been operated by third parties whose waste handling activities were not under our control. These properties and any waste disposed thereon may be subject to CERCLA, RCRA, and state laws which could require us to remove or remediate wastes and other contamination or to perform remedial plugging operations to prevent future contamination.

The Oil Pollution Act of 1990 (OPA) and regulations promulgated thereunder include a variety of requirements related to the prevention of oil spills and impose liability for damages resulting from such spills. OPA imposes liability on owners and operators of onshore and offshore facilities and pipelines for removal costs and certain public and private damages arising from a spill. OPA establishes a liability limit for onshore facilities of $350 million and for offshore facilities of all removal costs plus $75 million, and lesser liability limits for vessels depending upon their size. A party cannot take advantage of the liability limits if the spill is caused by gross negligence or willful misconduct or resulted from a violation of federal safety, construction, or operating regulations. If a party fails to report a spill or cooperate in the cleanup, liability limits likewise do not apply. OPA imposes ongoing requirements on responsible parties, including proof of financial responsibility for potential spills. The amount of financial responsibility required depends upon a variety of factors including the type of facility or vessel, its size, storage capacity, oil throughput, proximity to sensitive areas, type of oil handled, history of discharges, worst-case spill potential and other factors. We believe we have established adequate financial responsibility. While the financial responsibility requirements under OPA may be amended to impose additional costs on us, the impact of such a change is not expected to be any more burdensome on us than on others similarly situated.

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The Clean Air Act and state air quality laws and regulations contain provisions that impose pollution control requirements on emissions to the air and require permits for construction and operation of certain emissions sources, including sources located offshore. We may be required to incur capital expenditures for air pollution control equipment in connection with maintaining or obtaining operating permits and approvals addressing emission-related issues, although we do not expect to be materially adversely affected by such expenditures.

The Clean Water Act (CWA) regulates the discharge of pollutants to waters of the United States and imposes permit requirements on such discharges, including discharges to wetlands. Federal regulations under the CWA and OPA require certain owners or operators of facilities that store or otherwise handle oil, to prepare and implement spill prevention, control and countermeasure plans and facility response plans relating to the possible discharge of oil into surface waters. With respect to certain of our operations, we are required to prepare and comply with such plans and to obtain and comply with permits. The CWA also prohibits spills of oil and hazardous substances to waters of the United States in excess of levels set by regulations and imposes liability in the event of a spill. State laws further provide varying civil and criminal penalties and liabilities for the spills to both surface and groundwaters. We believe we are in substantial compliance with the requirements of the CWA, OPA, and state laws, and that any non-compliance would not have a material adverse effect on us.

Various federal and state programs regulate the conservation and development of coastal resources. The federal Coastal Zone Management Act was passed to preserve and, where possible, restore the natural resources of the coastal zone of the United States of America and to provide for federal grants for state management programs that regulate land use, water use and coastal development. Under the Louisiana Coastal Zone Management Program, coastal use permits are required for certain activities, even if the activity only partially infringes on the coastal zone. Among other things, projects involving use of state lands and water bottoms, dredge or fill activities that intersect with more than one body of water, mineral activities, including the exploration and production of oil and gas, and pipelines for the gathering, transportation or transmission of oil, gas and other minerals require such permits. General permits, which entail a reduced administrative burden, are available for a number of routine oil and gas activities. The Texas Coastal Coordination Act (CCA) establishes the Texas Coastal Management Program that applies in the nineteen Texas counties that border the Gulf of Mexico and its tidal bays. The CCA provides for the review of state and federal agency rules and agency actions for consistency with the goals and policies of the Coastal Management Plan. These coastal programs may affect agency permitting of our facilities.

Legislation and Rulemaking. In October 1996, the U.S. Congress enacted the Coast Guard Authorization Act of 1996 (P.L. 104-324) which amended the OPA to establish requirements for evidence of financial responsibility for certain offshore facilities. The amount required is $35 million for certain types of offshore facilities located seaward of the seaward boundary of a state, including properties used for oil transportation. We currently maintain this statutory $35 million coverage.

Federal and state legislative rules and regulations are pending that, if enacted, could significantly affect the oil and gas industry. It is impossible to predict which of those federal and state proposals and rules, if any, will be adopted and what effect, if any, they would have on our operations.

In addition, various federal, state and local laws and regulations covering the discharge of materials into the environment, occupational health and safety issues, or otherwise relating to the protection of public health and the environment, may affect our operations, expenses and costs. The trend in such regulation has been to place more restrictions and limitations on activities that may impact the general or work environment, such as emissions of pollutants, generation and disposal of wastes, and use and handling of chemical substances. It is not anticipated that, in response to such regulation, we will be required in the near future to expend amounts that are material relative to our total capital structure. However, it is possible that the costs of compliance with environmental and health and safety laws and regulations will

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continue to increase. Given the frequent changes made to environmental and health and safety regulations and laws, we are unable to predict the ultimate cost of compliance.

RISK FACTORS

We are primarily dependent on revenues from our pipeline systems and our working interests in three oil and gas producing properties.

As a result of our sale of substantially all of our proved oil and gas reserves in 2002 and the limited amount of reserves on properties we currently own interests in, we expect that our future revenues will be primarily dependent on the level of use of our pipeline systems. Revenues from oil and gas sales accounted for approximately 55% of our total revenues in 2006. However, only 17% of our revenues were from oil and gas sales in 2007. Total revenues in 2007 decreased by approximately $1.3 million from 2006. Various factors will influence the level of use of our pipeline systems, including the success of drilling programs in the areas near our pipelines and our ability to attract new producer/shippers. There are various pipelines in and around our pipeline systems that we vigorously compete with to attract new producer/shippers to our pipeline systems. There can be no assurance that we will be successful in attracting new producer/shippers to our pipeline systems.

The rate of production from oil and gas properties generally declines as reserves are depleted. Our working interests are in properties in the Gulf of Mexico where, generally, the rate of production declines more rapidly than in many other producing areas of the world. As the level of production from these properties continues to decline, our revenue from these interests will decrease. The rate of production from High Island Block 37 declined by approximately 78% in 2007. Production from High Island Block A-7 ceased during 2007. Production data from High Island Block A-7 has provided evidence that the well may have reached the end of its production life. We believe that production from the producing High Island Block 37 well could continue until mid 2008. However, the well could deplete faster than anticipated or could develop production problems resulting in the cessation of production. Since the High Island Block 115 well recently commenced production, it is not possible to accurately predict at what rate or for how long this well will continue to produce. Unless we are able to replace this revenue with revenue from interests in other oil and gas properties, increase the level of utilization of our pipelines or acquire other revenue generating assets at an acceptable cost, our revenues and cash flow from operations will decrease and our financial condition will be materially adversely affected.

The geographic concentration of our assets may have a greater effect on us as compared to other companies.

All of our assets are located in the Western Gulf of Mexico and the onshore Gulf Coast of Texas. Because our assets are not as diversified geographically as many of our competitors, our business is subject to local conditions more than other, more geographically diversified companies. Any regional event, including price fluctuations, natural disasters and restrictive regulations that increase costs may adversely impact our business more than if our assets were geographically diversified.

If we are not able to generate sufficient funds from our operations and other financing sources, we may not be able to finance our operations.

We have historically needed substantial amounts of cash to fund our working capital requirements. We have experienced a negative working capital position in past years and have been dependent on debt and equity financing and sales of revenue generating assets to meet our working capital requirements that were not funded from operations. Low commodity prices, production problems, declines in production, disappointing drilling results and other factors beyond our control could further reduce our funds from operations. As a result we may have to seek debt and equity financing to meet our working capital requirements. Furthermore, we incurred a loss of approximately $1.6 million this year and have incurred losses in the past. These losses may affect our ability to obtain financing. In addition, financing may not be available to us in the future on acceptable terms or at all. In the event additional capital is not available, we may be forced to sell some of our assets on unfavorable terms or on an untimely basis.

We face strong competition from larger companies that may negatively affect our ability to carry on operations.

We operate in a highly competitive industry. Our competitors include major integrated oil companies, substantial independent energy companies, affiliates of major interstate and intrastate pipelines and national and local gas gatherers, many of which possess greater financial and other resources than we do. Our ability to successfully compete in the marketplace is affected by many factors including:

- most of our competitors have greater financial resources than we do, which gives them better access to capital to acquire assets; and

- we sometimes establish a higher standard for the minimum projected rate of return on invested capital than some of our competitors since we cannot afford to absorb certain risks. We believe this puts us at a competitive disadvantage in acquiring pipelines and oil and gas properties.

Oil and gas prices are volatile and a substantial and extended decline in the price of oil and gas would have a material adverse effect on us.

The tightening of natural gas supply and demand fundamentals has resulted in higher, but extremely volatile natural gas prices, and this volatility in natural gas prices is expected to continue. Our revenues, profitability, operating cash flow and our potential for growth are largely dependent on prevailing oil and natural gas prices. Prices for oil and natural gas are subject to large fluctuations in response to relatively minor changes in the supply and demand for oil and natural gas, uncertainties within the market and a variety of other factors beyond our control. These factors include:

- weather conditions in the United States;

- the condition of the United States economy;

- the actions of the Organization of Petroleum Exporting Countries;

- governmental regulation;

- political stability in the Middle East, South America and elsewhere;

- the foreign supply of oil and natural gas;

- the price of foreign imports;

- the availability of alternate fuel sources; and

- the value of the U.S. dollar in relation to other currencies.

In addition, low or declining oil and natural gas prices could have collateral effects that could adversely affect us, including the following:

- reducing the exploration for and development of oil and gas reserves held by third party companies around our pipeline systems;

- increasing our dependence on external sources of capital to meet our cash needs; and

- generally impairing our ability to obtain needed capital.

Reserve estimates depend on many assumptions that may prove to be inaccurate. Any material inaccuracies in our reserve estimates or underlying assumptions could cause the quantities and net present value of our reserves to be overstated.

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Estimating reserves of oil and gas is complex. The process relies on interpretations of available geologic, geophysical, engineering and production data. The extent, quality and reliability of this data can vary. The process also requires certain economic assumptions, some of which are mandated by the SEC regarding oil and natural gas prices, drilling and operating expenses, capital expenditures, taxes and availability of funds. The accuracy of a reserve estimate is a function of:

- the quality and quantity of available data;
- the interpretation of that data;
- the accuracy of various mandated economic assumptions; and
- the judgment of the persons preparing the estimate.

The proved reserve information set forth in this report is based on estimates we prepared. Estimates prepared by others might differ materially from our estimates.

Actual quantities of recoverable oil and gas reserves, future production, oil and gas prices, taxes, development expenditures, abandonment costs and operating expenses most likely will vary from our estimates. Any significant variance could materially affect the quantities and net present value of our reserves. In addition, we may adjust estimates of proved reserves to reflect production history, results of exploration and development and prevailing oil and gas prices. Our reserves also may be susceptible to drainage by operators on adjacent properties.

The present value of future net cash flows will most likely not equate to the current market value of our estimated proved oil and gas reserves. In accordance with SEC requirements, we base the estimated discounted future net cash flows from proved reserves on prices and costs in effect at December 31, 2007. Actual future prices and costs may be materially different from the prices and costs we used.

We cannot control the activities on properties we do not operate.

Currently, other companies operate or control the development of the oil and gas properties in which we have an interest. As a result, we depend on the operator of the wells or leases to properly conduct lease acquisition, drilling, completion and production operations. The failure of an operator, or the drilling contractors and other service providers selected by the operator to properly perform services, or an operator s failure to act in ways that are in our best interest, could adversely affect us, including the amount and timing of revenues, if any, we receive from our interests.

We own and generally anticipate that we will continue to own substantially less than a 50% working interest in our oil and gas prospects and properties and will therefore engage in joint operations with other working interest owners. Since we own or control less than a majority of the working interest, decisions affecting our interest could be made by the owners of a majority of the working interest. For instance, if we are unwilling or unable to participate in the costs of operations approved by owners of a majority of the working interests in a well, our working interest in the well (and possibly other wells on the property) will likely be subject to contractual non-consent penalties. These penalties may include, for example, full or partial forfeiture of our interest in the well or a relinquishment of our interest in production from the well in favor of the participating working interest owners until the participating working interest owners have recovered a multiple of the costs which would have been borne by us if we had elected to participate, which often ranges from 400% to 600% of such costs.

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We have pursued, and intend to continue to pursue, acquisitions. Our business may be adversely affected if we cannot effectively integrate acquired operations.

One of our business strategies has been to acquire operations and assets that are complementary to our existing businesses. Acquiring operations and assets involves financial, operational and legal risks. These risks include:

- inadvertently becoming subject to liabilities of the acquired company that were unknown to us at the time of the acquisition, such as later asserted litigation matters or tax liabilities;
- the difficulty of assimilating operations, systems and personnel of the acquired businesses; and
- maintaining uniform standards, controls, procedures and policies.

Competition from other potential buyers could cause us to pay a higher price than we otherwise might have to pay and reduce our acquisition opportunities. We are often out-bid by larger, better capitalized companies for acquisition opportunities we pursue.

Operating hazards, including those specific to the marine environment, may adversely affect our ability to conduct business.

Our operations are subject to inherent risks normally associated with those operations, such as:

- pipeline ruptures;
- sudden violent expulsions of oil, gas and mud while drilling a well, commonly referred to as a blowout;
- a cave in and collapse of the earth s structure surrounding a well, commonly referred to as cratering;
- explosions;
- fires;
- pollution; and
- other environmental risks.

If any of these events were to occur, we could suffer substantial losses from injury and loss of life, damage to and destruction of property and equipment, pollution and other environmental damage and suspension of operations. Our offshore operations are also subject to a variety of operating risks peculiar to the marine environment, such as hurricanes or other adverse weather conditions and more extensive governmental regulation. These regulations may, in certain circumstances, impose strict liability for pollution damage or result in the interruption or termination of operations.

Losses and liabilities from u