

BLUE DOLPHIN ENERGY CO

Form 10QSB

August 14, 2006

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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: June 30, 2006

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

(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, Suite 2100, Houston, Texas 77002

(Address of principal executive offices)

(713) 227-7660

(Issuer's telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report.)

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 August 14, 2006, there were 11,550,644 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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Certification Pursuant to 18 U.S.C. Section 302

Certification Pursuant to 18 U.S.C. Section 906

Certification Pursuant to 18 U.S.C. Section 906

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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 subsidiaries (referred to herein, with its predecessors and subsidiaries, as Blue Dolphin , we , us and our) included herein have been prepared by us, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (the SEC) and, in the opinion of management, reflect all adjustments necessary to present a fair statement of operations, financial position and cash flows. We follow the full-cost method of accounting for oil and gas properties, wherein costs incurred in the acquisition, exploration and development of oil and gas reserves are capitalized. We believe that the disclosures are adequate and the information presented is not misleading, although certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations.

Our accompanying 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, 2005.

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CONDENSED CONSOLIDATED BALANCE SHEET**

	UNAUDITED June 30, 2006
ASSETS	
Current assets:	
Cash and cash equivalents	\$ 5,405,283
Accounts receivable	1,208,151
Prepaid expenses and other assets	400,184
TOTAL CURRENT ASSETS	7,013,618
Property and equipment, at cost:	
Oil and gas properties (full-cost method)	564,530
Pipelines	4,543,782
Onshore separation and handling facilities	1,919,402
Land	860,275
Other property and equipment	269,192
	8,157,181
Less: accumulated depletion, depreciation, amortization and impairment	3,153,670
	5,003,511
Other assets	12,256
TOTAL ASSETS	\$ 12,029,385
LIABILITIES AND STOCKHOLDERS EQUITY	
Current liabilities:	
Accounts payable	\$ 766,901
Notes payable	560,000
Accrued expenses and other liabilities	36,887
TOTAL CURRENT LIABILITIES	1,363,788
Long-term liabilities:	
Asset retirement obligations	1,809,157
TOTAL LONG-TERM LIABILITIES	1,809,157
Common stock, (\$.01 par value, 25,000,000 shares authorized, 11,547,849 shares issued and outstanding)	115,478
Additional paid-in capital	31,827,713

Accumulated deficit	(23,086,751)
	8,856,440
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 12,029,385

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 June 30,	
	2006	2005
Revenue from operations:		
Pipeline operations	\$ 400,267	\$ 327,093
Oil and gas sales	685,802	42,336
	1,086,069	369,429
Cost of operations:		
Pipeline operating expenses	295,115	200,189
Lease operating expenses	121,263	41,225
Depletion, depreciation and amortization	112,151	85,056
General and administrative	476,525	648,086
Accretion expense	26,444	24,404
	1,031,498	998,960
INCOME (LOSS) FROM OPERATIONS	54,571	(629,531)
Other income (expense):		
Interest and other expense	(18,365)	(41,184)
Interest and other income	31,889	2,892
INCOME (LOSS) BEFORE INCOME TAXES	68,095	(667,823)
Income taxes		
Net income (loss)	\$ 68,095	\$ (667,823)
Income (loss) per common share		
basic	\$ 0.01	\$ (0.08)
diluted	\$ 0.01	\$ (0.08)
Weighted average number of common shares outstanding		
basic	11,422,625	8,777,142
diluted	11,531,377	8,777,142

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

	Six Months Ended June 30,	
	2006	2005
Revenue from operations:		
Pipeline operations	\$ 719,675	\$ 648,708
Oil and gas sales	1,467,418	79,751
	2,187,093	728,459
Cost of operations:		
Pipeline operating expenses	522,604	488,049
Lease operating expenses	215,824	57,859
Depletion, depreciation and amortization	227,460	170,885
General and administrative	969,662	1,608,826
Accretion expense	52,888	48,809
	1,988,438	2,374,428
INCOME (LOSS) FROM OPERATIONS	198,655	(1,645,969)
Other income (expense):		
Interest and other expense	(31,775)	(80,631)
Interest and other income	38,180	328,340
Equity in loss of affiliate		
INCOME (LOSS) BEFORE INCOME TAXES	205,060	(1,398,260)
Income taxes		
Net income (loss)	\$ 205,060	\$ (1,398,260)
Income (loss) per common share		
basic	\$ 0.02	\$ (0.18)
diluted	\$ 0.02	\$ (0.18)
Weighted average number of common shares outstanding		
basic	10,847,840	7,871,972
diluted	10,943,092	7,871,972

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

	Six Months Ended June 30,	
	2006	2005
OPERATING ACTIVITIES		
Net income (loss)	\$ 205,060	\$ (1,398,260)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depletion, depreciation and amortization	227,460	170,885
Amortization of debt issue costs		27,501
Gain on sale of oil and gas property		(140,409)
Accretion of asset retirement obligations	52,888	48,809
Equity in loss of affiliate		
Common stock issued for services	15,000	
Gain on debt restructuring		(132,368)
Compensation expense for exercise of stock options		686,472
Changes in operating assets and liabilities:		
Accounts receivable	394,145	17,389
Prepaid expenses and other assets	(217,607)	(26,523)
Trade accounts payable and accrued expenses	344,566	(78,950)
NET CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES	1,021,512	(825,454)
INVESTING ACTIVITIES		
Exploration and development costs	(14,810)	(1,584)
Property, equipment and other assets	(235,934)	(5,608)
Proceeds from sale of assets		214,632
Investment in unconsolidated affiliates	(897)	
NET CASH PROVIDED BY (USED IN) INVESTING ACTIVITIES	(251,641)	207,440
FINANCING ACTIVITIES		
Proceeds from the sale of common stock, net of offering costs	3,848,324	
Payments on borrowings	(510,000)	(70,000)
Financing costs		(2,275)
NET CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES	3,338,324	(72,275)
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	4,108,195	(690,289)
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	1,297,088	1,560,549
CASH AND CASH EQUIVALENTS AT END OF PERIOD	\$ 5,405,283	\$ 870,260

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
JUNE 30, 2006

1. Liquidity

At June 30, 2006, our working capital was approximately \$5.6 million, an increase of \$3.5 million over the \$2.1 million of available working capital at December 31, 2005. We believe we have sufficient liquidity to satisfy our working capital requirements for the twelve months ending June 30, 2007.

We are receiving monthly revenues from our interests in wells in High Island Block 37 and High Island Block A-7. The two wells in High Island Block 37 are currently producing approximately 12 MMcf per day, combined. High Island Block A-7 has one well currently producing at approximately 7 MMcf per day.

We have entered into gas and condensate transportation and handling agreements with the operators of four discoveries near the Blue Dolphin System since the end of the second quarter of 2005. Three of the new contracted shippers were delivering production into our pipeline as of the end of the second quarter of 2006, increasing natural gas transportation throughput on our Blue Dolphin System to approximately 24 MMcf per day. We expect that the fourth new contracted shipper will commence deliveries of production into the Blue Dolphin System in the third or fourth quarter of 2006.

On March 8, 2006, we entered into a stock purchase agreement with certain accredited investors for the private placement of 1,171,432 shares of our common stock at a price of \$1.75 per share. The net proceeds from this offering after commissions and expenses were approximately \$2,025,000. We also issued warrants to purchase an aggregate of 8,572 shares of common stock. We are using the proceeds from this offering for general corporate and working capital purposes, however, we may use a portion, or all, of these proceeds for possible acquisitions and expansions of our existing facilities.

On April 28, 2006, we entered into a second stock purchase agreement with an accredited institutional investor for the private placement of 400,000 shares of our common stock. We incurred commissions and expenses of approximately \$160,000 associated with the offering, and issued warrants to purchase an aggregate of 24,000 shares of common stock. The net proceeds from this offering after commissions and expenses were approximately \$1,800,000. We are using the proceeds from this offering for general corporate and working capital purposes, however, we may use a portion, or all, of these proceeds for possible acquisitions and expansions of our existing facilities.

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

	Six Months Ended June 30, (amounts in thousands)	
	2006	2005
Net cash provided by (used in):		
Operating activities	\$ 1,022	\$ (825)
Investing activities	(252)	207
Financing activities	3,338	(72)
Net increase (decrease) in cash	\$ 4,108	\$ (690)

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**BLUE DOLPHIN ENERGY COMPANY AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
UNAUDITED Continued
JUNE 30, 2006**

2. Related Party Transactions

On March 31, 2006, we purchased 334 shares of common stock in Drillmar Energy, Inc. for \$334 in a private placement offering by Drillmar, Inc. to its shareholders on a proportionate basis to their current ownership percentage in Drillmar, Inc. This investment represented 0.07% of the total offering, which is approximately equal to our current ownership in Drillmar, Inc.

On May 25, 2006, we purchased 2 shares of common stock in Drillmar, Inc. (an affiliate of Drillmar Energy, Inc.) for \$563 in a private placement offering by Drillmar, Inc. to its shareholders on a proportionate basis to their current ownership percentage in Drillmar, Inc. This investment represented 0.07% of the total offering.

Our Chairman, Ivar Siem, and one of our Directors, Harris A. Kaffie, beneficially own 30.7%, and 20.9%, respectively, of Drillmar Inc. s common stock and 29.5% and 20.4%, respectively, of Drillmar Energy, Inc. s common stock. Messrs. Siem and Kaffie are both directors, and Mr. Siem is Chairman and President of Drillmar.

3. Contingencies

We are involved in various claims and legal actions arising in the ordinary course of business. In our opinion, the ultimate disposition of these matters will not have a material effect on our financial position, results of operations or cash flows.

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BLUE DOLPHIN ENERGY COMPANY AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
UNAUDITED Continued
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4. 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 dilution 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. Employee stock options and stock warrants at June 30, 2005 were not included in the computation of diluted earnings per share for the six months and three months ended June 30, 2005 because their assumed exercise and conversion would have an antidilutive effect on the computation of diluted loss per share.

	Net Income (loss)	Weighted- Average Number of Common Shares Outstanding and Potential Dilutive Common Shares	Per Share Amount
Six months ended June 30, 2006			
Basic earnings per share	\$ 205,060	10,847,840	\$ 0.02
Effect of dilutive potential common shares		95,252	
Diluted earnings per share	\$ 205,060	10,943,092	\$ 0.02
Six months ended June 30, 2005			
Basic and diluted loss per share	\$ (1,398,260)	7,871,972	\$ (0.18)
Three months ended June 30, 2006			
Basic earnings per share	\$ 68,095	11,422,625	\$ 0.01
Effect of dilutive potential common shares		108,752	
Diluted earnings per share	\$ 68,095	11,531,377	\$ 0.01
Three months ended June 30, 2005			
Basic and diluted loss per share	\$ (667,823)	8,777,142	\$ (0.08)

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BLUE DOLPHIN ENERGY COMPANY AND SUBSIDIARIES
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5. 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 six months and three months ended June 30, 2006 and 2005, and at June 30, 2006 are as follows:

	Revenues	Operating Income (loss)(*)	Depletion, Depreciation and Amortization
Six months ended June 30, 2006:			
Pipeline operations	\$ 719,675	(233,751)	157,891
Oil and gas exploration and production	1,467,418	716,202	65,116
Other		(283,796)	4,453
Consolidated	2,187,093	198,655	227,460
Other income, net		6,405	
Income before income taxes		205,060	
Six months ended June 30, 2005:			
Pipeline operations	\$ 648,708	(613,326)	161,795
Oil and gas exploration and production	79,751	(58,179)	4,305
Other		(974,464)	4,785
Consolidated	728,459	(1,645,969)	170,885
Other income, net		247,709	
Loss before income taxes		(1,398,260)	
Quarter ended June 30, 2006:			
Pipeline operations	\$ 400,267	(115,407)	78,945
Oil and gas exploration and production	685,802	332,376	31,087
Other		(162,398)	2,119
Consolidated	1,086,069	54,571	112,151
Other income, net		13,524	
Income before income taxes		68,095	
Quarter ended June 30, 2005:			
Pipeline operations	\$ 327,093	(263,722)	79,921

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Oil and gas exploration and production	42,336	(42,121)	2,934
Other		(323,688)	2,201
Consolidated	369,429	(629,531)	85,056
Other income, net		(38,292)	
Loss before income taxes		(667,823)	

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BLUE DOLPHIN ENERGY COMPANY AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
UNAUDITED Continued
JUNE 30, 2006

	June 30, 2006
Identifiable assets:	
Pipeline operations	\$ 6,162,636
Oil and gas exploration and production	825,798
Other	5,040,951
 Consolidated	 \$ 12,029,385

(*) Consolidated income or loss from operations includes \$279,343 and \$969,699 in unallocated general and administrative expenses, and unallocated depletion, depreciation and amortization of \$4,453 and \$4,785 for the six months ended June 30, 2006 and 2005, respectively. All unallocated amounts are included in Other .

Consolidated income or loss from operations includes \$160,280 and \$321,488 in unallocated general and administrative expenses, and

unallocated
depletion,
depreciation and
amortization of
\$2,119 and
\$2,201 for the
three months
ended June 30,
2006 and 2005,
respectively. All
unallocated
amounts are
included in
Other .

6. Stock-Based Compensation

Effective April 14, 2000, we adopted, after approval by our stockholders, the 2000 Stock Incentive Plan (the 2000 Plan). Under the 2000 Plan, we can make incentive awards of shares of our common stock. We amended the 2000 Plan effective March 19, 2003, after approval by our stockholders on May 21, 2003, increasing the number of shares of common stock available for incentive stock options (ISOs) and other stock incentive awards from 500,000 to 650,000 shares. The 2000 Plan is administered by the Compensation Committee of our Board of Directors. Options granted must be exercised within 10 years from their grant date. The exercise price of ISOs cannot be less than 100% of the grant date fair market value of a share of our common stock. All ISO awards granted in previous years vested immediately. The 2000 Plan also provides for the granting of other incentive awards, however only ISOs and non-statutory stock options have been issued under the 2000 Plan.

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 grant date fair market value of a share of our common stock.

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 the first quarter and second

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JUNE 30, 2006

quarter of 2006, compensation expense recognized in the periods 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 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.

As a result of adopting SFAS 123(R) on January 1, 2006, our income before taxes, net income and basic and diluted earnings per share for the three months and six months ended June 30, 2006 were unchanged compared to if we had continued to account for stock-based compensation under APB opinion No. 25 for our stock option grants.

Stock-based compensation expense of \$153,027 and \$686,472 were recognized in the three months and six months ended June 30, 2005, respectively. Prior to adoption of SFAS 123(R), recognition of non-cash compensation expense was required by Financial Accounting Standards Board Interpretation No. 44 Accounting for Certain Transactions Involving Stock Compensation An Interpretation of APB Opinion No. 25 (FIN 44). Pursuant to FIN 44, stock options exercised in a cashless manner by surrendering a portion of the option shares issued to pay the option exercise price, trigger variable accounting treatment, requiring the measurement of compensation expense at a period beyond the date of grant.

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 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 have 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.

The fair market value of each option granted, pursuant to SFAS No. 123(R), is estimated on the date of grant using the Black-Scholes-Merton option-pricing model, which uses assumptions noted in the following table.

	Six Months Ended June 30,	
	2006	2005
Stock Options Granted	0	90,376
Risk-free interest rate on date of grant	N/A	3.72%
Expected term, in years	N/A	10.00
Expected volatility	N/A	104.6%
Dividend yield	0.00%	0.00%

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Expected volatility is based on implied volatility of our common stock. Historical data is used to estimate option exercises and employee terminations used in the model. The data shows that of the 117,142 shares exercised in 2004 and 289,321 exercised in 2005, the average length of time between grant date and exercise date was approximately 2.05 years. Also, of the option grants that have been outstanding for two or more years, approximately 24% of the total number of shares granted are forfeited within the first two years after the grant date. The expected term of options granted used in the model represents the period of time that options granted are expected to be outstanding. This 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 vesting period (zero) and the original contract term (10 years). 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. Actual value realized, if any, is dependent on the future performance of our common stock and overall stock market conditions. There is no assurance the value realized by an optionee will be at or near the value estimated by the Black-Scholes-Merton model.

Had compensation cost for our stock options been determined based on the fair market value at the grant dates for awards made in 2005, our net income (loss), and earnings (loss) per share would have been adjusted to the pro forma amounts indicated below. For purposes of this pro forma disclosure, the value of the options is estimated using the Black-Scholes-Merton option-pricing model.

	Three Months Ended June 30, 2005	Six Months Ended June 30, 2005
Net loss as reported	\$ (667,823)	\$ (1,398,260)
Add: total stock-based employee compensation expense included in net income (loss), net of related tax effects	153,027	686,472
Deduct: total stock-based employee compensation expense determined under fair value based method for all awards, net of tax related effects		(66,420)
Pro forma net loss	\$ (514,796)	\$ (778,208)
Basic and diluted loss per share:		
As reported	\$ (0.08)	\$ (0.18)
Pro forma	\$ (0.06)	\$ (0.10)

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At June 30, 2006 we had reserved a total of 143,997 shares of common stock for issuance under the above mentioned stock option plans. A summary of the status of our fixed stock options granted to key employees, officers and directors, for the purchase of shares of common stock, are as follows:

	Six Months Ended June 30,			
	2006	Weighted Average Exercise Price	2005	Weighted Average Exercise Price
	Shares		Shares	
Options outstanding at the beginning of the year	143,997	\$ 1.56	346,942	\$ 1.09
Options granted	0	\$ 0.00	90,376	\$ 0.80
Options exercised	0	\$ 0.00	(236,821)	\$ 0.74
Options expired or cancelled	0	\$ 0.00	(1,000)	\$ 1.55
Options outstanding at the end of the second quarter	143,997		199,497	
Weighted average exercise price of options outstanding	\$ 1.56		\$ 1.37	
Weighted average fair value of options granted during the period	\$ 0.00		\$ 0.73	
Weighted average remaining contractual life of options outstanding	6.5 years		7.7 years	

At June 30, 2006, options for 143,997 shares of common stock were vested and immediately exercisable. There were 90,376 options granted in the first quarter of 2005 and none in the second quarter of 2005. There were no options granted during the first or second quarters of 2006. Pursuant to the requirements of SFAS No. 123(R), the weighted average fair market value of options granted during 2005 was \$0.73 per share. The weighted average exercise price for outstanding options at June 30, 2006 and 2005 per share was \$1.56 and \$1.37, respectively. Outstanding options at June 30, 2006 expire between May 17, 2010 and February 3, 2015.

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BLUE DOLPHIN ENERGY COMPANY AND SUBSIDIARIES
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Exercise Prices	Number Outstanding	Options Outstanding, Fully Vested and Exercisable at June 30, 2006 Weighted Average Remaining Contractual Life	In Years	Weighted Average Exercise Price
\$.35 to \$.80	98,768		7.3	\$ 0.54
\$1.55 to \$1.90	23,429		5.6	\$ 1.71
\$6.00	21,800		3.9	\$ 6.00
	143,997			

7. Warrants

As part of a private placement which closed on March 8, 2006, we issued warrants to purchase 8,572 shares of common stock pursuant to the terms and conditions of a Placement Agency Agreement between us and Starlight Investments, LLC dated May 27, 2005.

The warrants were vested in full and immediately exercisable upon issuance and the exercise price per share varies upon the following conditions:

- (i) until the later of the registration of the warrants or one year from the issue date, 110% of the purchase price of \$1.75 (\$1.925)
- (ii) from the later of (x) the registration of the warrants and (y) one year, until two years from the issue date of the warrants, 120% of the purchase price of \$1.75 (\$2.10)
- (iii) after the expiration of two years from the issue date of the warrants, 130% of the purchase price of \$1.75 (\$2.275)

This issuance was accounted for under SFAS No. 123(R) and Emerging Issues Task Force No. 00-18 Accounting Recognition for Certain Transactions Involving Equity Instruments Granted to Other Than Employees (EITF No. 00-18) using the Black-Scholes-Merton option-pricing model, which resulted in a fair value of approximately \$8,000, which was netted against the gross proceeds of a private placement as a direct offering cost.

As part of a private placement which closed on April 28, 2006, we issued warrants to purchase 24,000 shares of common stock pursuant to the terms and conditions of a Placement Agency Agreement between us and Starlight Investments, LLC dated May 27, 2005.

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JUNE 30, 2006

The warrants vest immediately upon issuance and the exercise price per share varies upon the following conditions:

- (iv) until the later of the registration of the warrants or one year from the issue date, 110% of the purchase price of \$4.90 (\$5.390)

- (v) from the later of (x) the registration of the warrants and (y) one year, until two years from the issue date of the warrants, 120% of the purchase price of \$4.90 (\$5.880)

- (vi) after the expiration of two years from the issue date of the warrants, 130% of the purchase price of \$4.90 (\$6.37)

This issuance was accounted for under SFAS No. 123(R) and EITF No. 00-18 using the Black-Scholes-Merton option-pricing model, which resulted in a fair value of approximately \$61,000, which was netted against the gross proceeds of a private placement as a direct offering cost.

8. Recent Accounting Developments

On July 13, 2006, FASB Interpretation No. 48 Accounting for Uncertainty in Income Taxes-An Interpretation of FASB Statement No. 109 (FIN 48), was issued. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes. FIN 48 also prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The new FASB standard also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition.

The evaluation of a tax position in accordance with FIN 48 is a two-step process. The first step is a recognition process whereby the enterprise determines whether it is more likely than not that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. In evaluating whether a tax position has met the more-likely-than-not recognition threshold, the enterprise should presume that the position will be examined by the appropriate taxing authority that has full knowledge of all relevant information. The second step is a measurement process whereby a tax position that meets the more-likely-than-not recognition threshold is calculated to determine the amount of benefit to recognize in the financial statements. The tax position is measured at the largest amount of benefit that is greater than 50% likely of being realized upon ultimate settlement.

The provisions of FIN 48 are effective for fiscal years beginning after December 15, 2006. Earlier application is permitted as long as the enterprise has not yet issued financial statements, including interim financial statements, in the period of adoption. The provisions of FIN 48 are to be applied to all tax positions upon initial adoption of this standard. Only tax positions that meet the more-likely-than-not recognition threshold at the effective date may be recognized or continue to be recognized upon adoption of FIN 48. The cumulative effect of applying the provisions of FIN 48 should be reported as an

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BLUE DOLPHIN ENERGY COMPANY AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
UNAUDITED Continued
JUNE 30, 2006

adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that fiscal year.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

CAUTIONARY NOTE REGARDING FORWARD LOOKING STATEMENTS

Forward Looking Statements. Certain of the statements included in this quarterly report on Form 10-QSB, including those regarding future financial performance or results or that are not historical facts, are forward-looking statements as that term is defined in Section 21E of the Securities Exchange Act of 1934, as amended, and Section 27A of the Securities Act of 1933, as amended. The words expect, plan, believe, anticipate, project, estimate, and similar expressions are intended to identify forward-looking statements. Blue Dolphin Energy Company (referred to herein, with its predecessors and subsidiaries, as Blue Dolphin, we, us and our) cautions readers that these statements are not guarantees of future performance or events and such statements involve risks and uncertainties that may cause actual results and outcomes to differ materially from those indicated in forward-looking statements. Some of the important factors, risks and uncertainties that could cause actual results to vary from forward-looking statements include:

the level of utilization of our pipelines;

availability and cost of capital;

actions or inactions of third party operators for properties where we have an interest;

the risks associated with exploration;

the level of production from oil and gas properties;

gas and oil price volatility;

uncertainties in the estimation of proved reserves and in the projection of future rates of production and timing of development expenditures;

regulatory developments; and

general economic conditions.

Additional factors that could cause actual results to differ materially from those indicated in the forward-looking statements are discussed under the caption Risk Factors in our annual report on Form 10-KSB for the year ended December 31, 2005. Readers are cautioned not to place undue reliance on these forward-looking statements which speak only as of the date thereof. We undertake no duty to update these forward-looking statements. Readers are urged to carefully review and consider the various disclosures made by us which attempt to advise interested parties of the additional factors which may affect our business, including the disclosures made under the caption Management's Discussion and Analysis of Financial Condition and Results of Operations in this report.

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BLUE DOLPHIN ENERGY COMPANY AND SUBSIDIARIES

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS Continued

EXECUTIVE SUMMARY

We are engaged in two lines of business: (i) provision of pipeline transportation services to producer/shippers, and (ii) oil and gas exploration and production. We conduct our operations through our subsidiaries. Our assets are located offshore and onshore in the Texas Gulf coast area. Our goal is to create greater value for our stockholders by increasing the utilization of our existing pipeline assets, acquiring additional strategic assets to diversify our asset base and improve our competitive position, and continuing strict control over our operating costs and general and administrative costs. Although we are primarily focusing on acquisitions of pipeline assets, we will continue to review and evaluate opportunities to acquire producing oil and gas properties.

At the beginning of 2005, we faced a significant working capital deficiency resulting from the low utilization of our pipeline assets, a lack of other significant sources of revenue and our inability to raise capital. To address this working capital deficiency, during the first and second quarters of 2005 we negotiated with noteholders to restructure the terms of some of our indebtedness. In the third and fourth quarters of 2005 several actions and events contributed to a significant improvement in our financial condition:

We entered into gas and condensate transportation and handling agreements with three new shippers to deliver production into the Blue Dolphin System. One of the new shippers, Manti Operating Company, commenced production in August 2005.

In September 2005, we began receiving payments for our after-payout working interest in two wells in High Island Block 37. The two wells produced at a combined average rate of approximately 19 MMcf per day for the six months ended June 30, 2006. We recorded gross revenues of \$324,443 and \$667,698 from High Island Block 37 for the three months and six months ended June 30, 2006, respectively.

Also in September 2005, two wells in High Island Block A-7 were successfully recompleted. Although one of the wells produced for only a portion of the first quarter of 2006 and is currently not producing, the two wells produced at a combined average rate of approximately 6 MMcf per day for the six months ended June 30, 2006. We recorded gross revenues of \$361,359 and \$799,720 for High Island Block A-7 for the three months and six months ended June 30, 2006, respectively.

In 2006, we have raised additional capital through two private placements of our common stock which provided additional working capital that we may use for possible acquisitions and planned expansions of existing facilities. Also in 2006, as detailed below, we have entered into transportation and handling agreements with another new shipper and two of the new shippers previously contracted with commenced deliveries into the Blue Dolphin System.

In March 2006, we entered into a stock purchase agreement with certain accredited investors for the private placement of 1,171,432 shares of our common stock. Net proceeds from the offering after payment of commissions and expenses were approximately \$2,025,000.

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BLUE DOLPHIN ENERGY COMPANY AND SUBSIDIARIES

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS Continued

In April 2006, we entered into a second stock purchase agreement with an accredited institutional investor for the private placement of 400,000 shares of our common stock. Net proceeds from the offering after payment of commissions and expenses were approximately \$1,800,000.

In May 2006, we entered into gas and condensate transportation and handling agreements with a new shipper to deliver production into the Blue Dolphin System.

Also in May 2006, one of the new shippers contracted with in 2005 began deliveries of production into the Blue Dolphin System.

In June 2006, the new shipper contracted with in May 2006 began deliveries of production into the Blue Dolphin System.

We currently expect our working interests in High Island Block 37 and High Island Block A-7 to continue to generate revenues for the remainder of 2006. However, the rate of production from these wells declines as reserves are depleted and there is the possibility that these wells could experience production problems which could significantly decrease the level of production or cause cessation of production. These production declines could have a material adverse effect on our cash flows and liquidity.

We also expect the throughput from another contracted transportation customer on the Blue Dolphin System to increase utilization of the pipeline during the second half of 2006. However, we cannot predict the impact of these additional throughput volumes on our revenues until the deliveries commence.

Due to our small size, geographically concentrated asset base, and limited capital resources, any negative event has the potential to cause significant harm to our financial condition. For the remainder of 2006, we will continue our efforts to acquire assets that will diversify the risks to our cash flows and be accretive to earnings.

Liquidity And Capital Resources

We ended 2005 with working capital of approximately \$2.1 million. Our working capital at June 30, 2006 was approximately \$5.6 million. The increase in working capital from year end 2005 was primarily the result of the proceeds received from the private placements completed during the first and second quarters of 2006. We also continued to receive significant revenues from our High Island Block 37 and High Island Block A-7 interests during the first half of 2006, however, the revenues are declining as the rate of production declines. The gas transportation rates charged on the Blue Dolphin System negotiated in 2004 also had a positive effect despite the continued low level of utilization of the pipeline.

Table of Contents**BLUE DOLPHIN ENERGY COMPANY AND SUBSIDIARIES****ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS Continued**

On February 28, 2005, we entered into an amendment to our purchase agreement with MCNIC to acquire MCNIC's one-third interest in the Blue Dolphin Pipeline System and the inactive Omega Pipeline. Pursuant to the terms of the amendment, the original promissory note of \$750,000 was exchanged for a new promissory note in the principal amount of \$250,000, and all accrued interest on the original promissory note was forgiven, approximately \$132,000. We agreed to make a principal payment of \$30,000 upon execution of the amendment and to make monthly principal payments of \$10,000 through December 31, 2006. MCNIC may also receive additional payments of up to \$500,000 from 50% of the net profits, if any, realized from the one-third interest through December 31, 2006. The principal amount of the new promissory note may also be increased by up to \$500,000 if 50% or more of our 83% interest in the assets is sold before December 31, 2006. However, in the event that both of these contingencies are triggered, the principal of the promissory note cannot be increased by more than \$500,000 in the aggregate. Any contingent payments must be made by March 31, 2007. We made principal payments of \$130,000 on this promissory note in 2005, have made payments of \$60,000 in 2006, and have \$60,000 remaining to be paid in 2006.

In April 2005, the holders of \$450,000 of the \$750,000 aggregate principal amount of promissory notes sold in September 2004, agreed to extend the maturity date of their promissory notes to June 30, 2006, and to defer the payment of all unpaid and future interest on their promissory notes until maturity. The \$450,000 aggregate principal amount of promissory notes were retired on June 30, 2006 along with interest payments of \$88,123 for a total cash payment of \$538,123. The remaining \$300,000 aggregate principal promissory notes were retired at maturity on September 8, 2005. The promissory notes were originally sold on September 8, 2004 pursuant to the Note and Warrant Purchase Agreement we entered into with certain accredited investors and certain of our directors.

In March 2006, we entered into a stock purchase agreement with certain accredited investors for the private placement of 1,171,432 shares of our common stock. We incurred commissions and expenses of approximately \$25,000 associated with the offering, and issued warrants to purchase an aggregate of 8,572 shares of common stock. The warrants issued in the March private placement vested immediately upon issuance and the exercise price per share varies based on the following conditions: (i) until the later of the registration of the warrants or one year from the issue date, 110% of the purchase price of \$1.75, (ii) from the later of (x) the registration of the warrants and (y) one year, until two years from the issue date, 120% of the purchase price of \$1.75 and (iii) after the expiration of two years from the issue date of the warrants, 130% of the purchase price of \$1.75. The net proceeds of approximately \$2,025,000 are being used for general corporate and working capital purposes, however, we may use the proceeds for possible acquisitions and planned expansions of our existing facilities.

In April 2006, we entered into a second stock purchase agreement with an accredited institutional investor for the private placement of 400,000 shares of our common stock. We incurred commissions and expenses of approximately \$160,000 associated with the offering, and issued warrants to purchase an aggregate of 24,000 shares of common stock. The warrants issued in the April private placement vested immediately upon issuance and the exercise price per share varies based on the following conditions: (i) until the later of the registration of the warrants or one year from the issue date, 110% of the purchase price of \$4.90, (ii) from the later of (x) the registration of the warrants and (y) one year, until two years from the issue date, 120% of the purchase price of \$4.90 and (iii) after the

Table of Contents**BLUE DOLPHIN ENERGY COMPANY AND SUBSIDIARIES****ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS Continued**

expiration of two years from the issue date of the warrants, 130% of the purchase price of \$4.90. The net proceeds of approximately \$1,800,000 are also being used for general corporate and working capital purposes, and may also be used for possible acquisitions and planned expansions of our facilities.

In addition to providing funds immediately available for specific uses, the net proceeds of the private placements also provide additional working capital, which aids our ability to withstand events that could have an adverse effect on our operations.

The following table summarizes certain of our contractual obligations and other commercial commitments at June 30, 2006 (amounts in thousands):

Contractual Obligations and Other	Total	Payments Due by Period			After 5 years
		1 year or less	1-3 years	3-5 years	
Notes Payable and Long-Term Debt	\$ 560	560			
Operating Leases, net of sublease	82	64	12	6	
Abandonment Costs	1,809		244		1,565
Total Contractual Obligations and Other					
Commercial Commitments	\$ 2,451	624	256	6	1,565

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

	June 30, 2006		December 31, 2005	
	Amount	%	Amount	%
Working Capital	\$ 5,649	53	\$ 2,053	29
Property and equipment, net	5,004	47	4,980	71
Other noncurrent assets	12		11	
Total	\$ 10,665	100	\$ 7,044	100
Long-term Liabilities	\$ 1,809	17	\$ 2,256	32
Stockholders' equity	8,856	83	4,788	68
Total	\$ 10,665	100	\$ 7,044	100

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BLUE DOLPHIN ENERGY COMPANY AND SUBSIDIARIES

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS Continued

We expect to continue to receive revenues from the sales of gas and oil from High Island Block 37 during 2006. We have recognized gross gas and oil sales revenues of \$324,443 and \$667,698 associated with High Island 37 for the three months and six months, respectively, ended June 30, 2006. There are two wells in this block currently producing at a combined rate of approximately 12 MMcf per day. We have a working interest of approximately 2.8% in both wells. We also expect to continue to receive revenues for our interests in the two wells in High Island Block A-7 which were successfully recompleted in September 2005. We recognized gross gas and oil sales revenues of \$361,359 and \$799,720 for High Island Block A-7 for the three months and six months, respectively, ended June 30, 2006. Only one of the two wells is currently producing. Production is currently approximately 7 MMcf per day. Our working interest is approximately 8.9 % in both wells.

Despite the significant revenues generated by sales of gas and oil from our working interests in High Island Block 37 and High Island Block A-7, our financial condition continues to be adversely affected by the poor utilization of our pipeline assets. Without the revenues and resulting cash inflows we are receiving from sales of gas and oil, we would not be generating sufficient cash from operations to cover our operating and general and administrative expenses. Effective October 1, 2004, we negotiated an increase in the gas transportation rates on the Blue Dolphin System due to operating losses incurred. As a result, gas transportation and dehydration revenues from the Blue Dolphin System for the first half of 2006 were approximately \$576,000. Without the increased rates, gas transportation and dehydration revenues would have been approximately \$303,000 for this same period.

Natural gas transportation throughput on our Blue Dolphin System is currently approximately 24 MMcf per day, representing approximately 12% of system capacity. Natural gas throughput on the GA 350 Pipeline is currently 8 MMcf per day, which is approximately 13% of pipeline capacity. We have significant available capacity on the Blue Dolphin System, the GA 350 Pipeline and the inactive Omega Pipeline. We believe all of the pipelines are in geographic market areas that are experiencing an increased level of interest by oil and gas operators. This assessment is based on recent leasing and drilling activity in the lease blocks surrounding the pipelines, as well as information obtained directly from the operators of properties near our pipelines. There have been six recent discoveries near the Blue Dolphin System and the GA 350 Pipeline in 2005 and 2006. We have entered into contracts for transportation and handling services with operators of four of the discoveries and are currently in negotiations with the other two operators. One of the new shippers began deliveries into the Blue Dolphin System in August 2005. We began providing transportation services to two of the new contracted shippers in the second quarter of 2006. One of the new shippers began deliveries in May, 2006 and another new shipper began deliveries in June, 2006. The fourth new contracted shipper is expected to commence deliveries in the third or fourth quarter of 2006.

Drilling activity around our pipelines is currently being impeded by a shortage of drilling equipment and service providers in the Gulf of Mexico due to infrastructure repairs following Hurricanes Katrina and Rita, as well as increased demand caused by higher drilling activity levels, resulting from higher commodity prices. Ultimately, the future utilization of our pipelines and related facilities will depend upon the success of drilling programs around our pipelines, and attraction and retention of producer/shippers to the pipeline systems.

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BLUE DOLPHIN ENERGY COMPANY AND SUBSIDIARIES

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS Continued

During the six months ended June 30, 2006, we incurred capital expenditures of \$14,810 for the further development of our proved reserves. In addition, we elected to non-consent on a proposal from the operator of High Island Block A-7 to perform another recompletion on the lesser-producing of the two wells. This well ceased production in February 2006. Our share of the cost would have been approximately \$60,000.

RESULTS OF OPERATIONS

We reported net income for the six months ended June 30, 2006 (current period) of \$205,060 compared to a net loss of \$1,398,260 reported for the six months ended June 30, 2005 (previous period). For the three months ended June 30, 2006 (current quarter), we reported net income of \$68,095 compared to a net loss of \$667,823 for the three months ended June 30, 2005 (previous quarter).

First Half of 2006 Compared to First Half of 2005

Revenue from pipeline operations. Revenues from pipeline operations increased by \$70,967 or 10.9% in the current period to \$719,675. Revenues in the current period from the Blue Dolphin System totaled approximately \$640,000 compared to approximately \$521,000 in the previous period primarily as a result of production from a new shipper who began deliveries in the third quarter of 2005, and two shippers who began deliveries in the second quarter of 2006.

The increased revenues on the Blue Dolphin System were partially offset by decreased revenues on the GA 350 Pipeline of approximately \$79,000, compared to \$128,000 in the previous period, primarily due to a decrease in average daily gas volumes transported to approximately 8 MMcf per day in the current period from approximately 13 MMcf per day in the previous period.

Revenue from oil and gas sales. Revenues from oil and gas sales increased by \$1,387,667 to \$1,467,418. The previous period's oil and gas revenue of \$79,751 was derived solely from production from one well in High Island Block A-7. Two wells in High Island Block A-7 were recompleted in the third quarter of 2005, resulting in significantly more production. However, the lower producing of the two wells ceased production in February 2006. The revenue breakdown by field for the first half of 2006 was \$799,720 for High Island Block A-7 and \$667,698 for High Island Block 37. The sales mix by product was 92% gas and 8% condensate and natural gas liquids. Our average realized gas price per Mcf in the current period was \$8.50, compared to \$6.74 in the previous period. Our average realized price per barrel of condensate was \$62.69 in the current period, compared to \$47.20 in the previous period.

Pipeline operating expenses. Pipeline operating expenses in the current period increased by \$34,555 to \$522,604 primarily due to a decrease in legal costs of approximately \$95,000, offset by an increase of approximately \$102,000 in insurance costs due to a refund received in the previous period for having no claims in the previous policy period and higher property and liability insurance premiums. The higher legal costs in the previous period are associated with an action filed against us, the outcome of which we do not believe will have a material impact. However, as this litigation continues, we will continue to incur legal expenses which could have a material adverse effect on our financial condition. Repairs and maintenance expense increased approximately \$32,000 as compared to the prior year.

Table of Contents**BLUE DOLPHIN ENERGY COMPANY AND SUBSIDIARIES****ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS Continued**

General and administrative. General and administrative expenses decreased by \$639,164 to \$969,662 in the current period. The decrease was due to recognition in the previous period of \$686,472 of non-cash compensation expense associated with cashless exercises of 236,821 stock options by certain of our directors and employees during the period, partially offset by an increase of approximately \$31,000 in consulting and professional fees in the current period.

Depletion, depreciation and amortization. Depletion, depreciation and amortization expense increased by \$56,575 in the current period to \$227,460. In the current period we recorded depletion of \$57,516 associated with our oil and gas properties, while we had \$1,562 in the previous period. The increase in depletion was a result of there being no remaining unamortized oil and gas costs in the previous period.

Interest and other expense. Interest and other expense decreased \$48,856 in the current period to \$31,775. Interest expense in the current period decreased by approximately \$21,000 due to a decrease in the amount of our outstanding debt. Other expense in the previous period included approximately \$28,000 for the amortization of debt issuance costs.

Interest and other income. Interest and other income decreased by \$290,160 in the current period. Other income in the previous period includes a gain from the placement of our interests in the Galveston Block 287/297 leases of approximately \$140,000, a gain on the elimination of accrued interest pursuant to the restructuring of the MCNIC promissory note of approximately \$132,000 and the collection of accounts receivable that were previously written off of approximately \$45,000.

Second Quarter of 2006 Compared to Second Quarter of 2005

Revenue from pipeline operations. Revenues from pipeline operations increased by \$73,174 or 22.4% in the current quarter to \$400,267. Revenues in the current quarter from the Blue Dolphin System totaled approximately \$359,000 compared to approximately \$267,000 in the previous quarter primarily as a result of production from a new shipper who began deliveries in the third quarter of 2005, and the two new shippers who began deliveries in the second quarter of 2006.

The increased revenues on the Blue Dolphin System were partially offset by decreased revenues on the GA 350 Pipeline of approximately \$18,000, due to a decrease in average daily gas volumes transported to approximately 9 MMcf per day in the second quarter of 2006 from approximately 12 MMcf per day in the previous quarter.

Revenue from oil and gas sales. Revenues from oil and gas sales increased by \$643,466 to \$685,802. The previous quarter's oil and gas revenue of \$42,336 was derived solely from production from one well in High Island Block A-7. Two wells in High Island Block A-7 were recompleted in the third quarter of 2005, resulting in significantly more production. However, the lower producing of the two wells ceased production in February 2006. The revenue breakdown by field for the second quarter of 2006 was \$361,359 for High Island Block A-7 and \$324,443 for High Island Block 37. The sales mix by product was 88% gas and 12% condensate and natural gas liquids. Our average realized gas price per Mcf in the current quarter was \$8.43, compared to \$6.76 in the previous quarter. Our average realized price per barrel of condensate was \$71.46 in the current quarter, compared to \$47.28 in the previous quarter.

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BLUE DOLPHIN ENERGY COMPANY AND SUBSIDIARIES

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS Continued

Pipeline operating expenses. Pipeline operating expenses in the current quarter increased by \$94,926 to \$295,115 due primarily to an increase in legal costs of approximately \$37,000, combined with an increase of approximately \$24,000 in insurance costs due to higher property and liability insurance premiums, and an increase of \$34,000 in repairs and maintenance expense.

General and administrative. General and administrative expenses decreased by \$171,561 to \$476,525 in the current quarter. The decrease was due to recognition in the previous quarter of \$153,027 of non-cash compensation expense associated with cashless exercises of 80,571 stock options by certain of our directors and employees during the quarter, combined with a decrease of approximately \$19,000 in consulting and professional fees in the current quarter.

Depletion, depreciation and amortization. Depletion, depreciation and amortization expense increased by \$27,095 in the current quarter to \$112,151. In the current quarter we recorded depletion of \$25,176 associated with our oil and gas properties, while we had \$1,562 in the previous quarter. The increase in depletion was a result of there being no remaining unamortized oil and gas costs in the previous period.

Interest and other expense. Interest and other expense decreased \$22,819 in the current quarter to \$18,365. Interest expense in the current quarter decreased by approximately \$7,000 due to a decrease in the amount of our outstanding debt. Other expense in the previous quarter included approximately \$16,000 for the amortization of debt issuance costs.

Interest and other income. Interest and other income increased \$28,997 in the current quarter to \$31,889 due to interest earned on increased cash balances in the current quarter.

Recent Accounting Developments

See Note 8 in Item 1.

ITEM 3. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

As of the end of the period covered by this report, we carried out an evaluation under the supervision and with the participation of our management, including our Chief Executive Officer and Principal Accounting and Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act. Based upon this evaluation, as of June 30, 2006, the Chief Executive Officer and Principal Accounting and Financial Officer concluded that our disclosure controls and procedures were effective to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act, are recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and that such information is accumulated and communicated to our management, including the CEO and CFO, as appropriate to allow timely decisions regarding required disclosure.

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BLUE DOLPHIN ENERGY COMPANY AND SUBSIDIARIES

ITEM 3. CONTROLS AND PROCEDURES Continued

Changes in Internal Controls Over Financial Reporting

There have been no changes in our internal controls over financial reporting during the period covered by this report that have materially affected, or that are reasonably likely to materially affect, our internal control over financial reporting.

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BLUE DOLPHIN ENERGY COMPANY AND SUBSIDIARIES
PART II. OTHER INFORMATION

ITEM 2. UNREGISTERED SALES OF SECURITIES AND USE OF PROCEEDS

On April 17, 2006, 429 outstanding warrants were exercised by warrant holders. The exercises were accomplished via net exercise, whereby holders surrender their right to receive a portion of the shares of common stock. The rights to receive 134 shares of common stock were surrendered and the Company issued 295 shares of common stock upon exercise.

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

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

The Company's annual meeting of stockholders was held on May 17, 2006. The matters that were voted upon at the meeting, and the number of votes cast for or against, as well as the number of abstentions as to such matter, where applicable, are set forth below.

1) Election of Directors

	Votes For	Votes Against	Abstentions
Ivar Siem	10,680,503	8,472	21,705
Laurence N. Benz	7,275,433	3,413,342	21,705
Michael S. Chadwick	7,273,433	3,415,342	21,705
Harris A. Kaffie	10,686,972	1,803	21,705
Erik Ostbye	10,688,739	36	21,705
F. Gardner Parker	7,277,200	3,411,575	21,705

2) Amendment to the Company's 2000 Stock Incentive Plan to increase the number of shares of common stock that can be issued pursuant to the plan.

	Votes For	Votes Against	Abstentions
	4,536,169	45,726	6,461

This amendment failed to pass as a result of there being an insufficient number of shares voting for the amendment.

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**BLUE DOLPHIN ENERGY COMPANY AND SUBSIDIARIES
PART II. OTHER INFORMATION-Continued**

ITEM 6. EXHIBITS

A) Exhibits

3.1 (1) Amended and Restated Certificate of Incorporation of the Company.

3.2 (2) Amended and Restated Bylaws of the Company.

31.1 Ivar Siem Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Gregory W. Starks Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to section 302 of the Sarbanes-Oxley Act of 2002.

32.1 Ivar Siem Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002.

32.2 Gregory W. Starks Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002.

(1) Incorporated herein by reference to Exhibit A filed in connection with the definitive Proxy Statement of Blue Dolphin Energy Company under the Securities and Exchange Act of 1934, dated October 13, 2004 (Commission File No. 000-15905).

(2) Incorporated herein by reference to Exhibit 3.1 filed in connection with Form 10-QSB of Blue Dolphin Energy Company for the

quarter ended
June 30, 2004
under the
Securities and
Exchange Act of
1934, dated
August 23, 2004
(Commission
File No.
000-15905).

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**BLUE DOLPHIN ENERGY COMPANY AND SUBSIDIARIES
SIGNATURES**

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

By: **BLUE DOLPHIN ENERGY
COMPANY**

Date: August 14, 2006

/s/ Ivar Siem

Ivar Siem
Chairman and Chief Executive Officer

/s/ Gregory W. Starks

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

- A) Exhibits
- 3.1 (1) Amended and Restated Certificate of Incorporation of the Company.
- 3.2 (2) Amended and Restated Bylaws of the Company.
- 31.1 Ivar Siem Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Gregory W. Starks Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Ivar Siem Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Gregory W. Starks Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002.
- (1) Incorporated herein by reference to Exhibit A filed in connection with the definitive Proxy Statement of Blue Dolphin Energy Company under the Securities and Exchange Act of 1934, dated October 13, 2004 (Commission File No. 000-15905).
- (2) Incorporated herein by reference to Exhibit 3.1 filed in connection with Form 10-QSB of Blue Dolphin Energy Company for the quarter ended June 30, 2004

under the
Securities and
Exchange Act of
1934, dated
August 23, 2004
(Commission
File No.
000-15905).