

BLUE DOLPHIN ENERGY CO

Form 10-Q

August 15, 2016

BLUE DOLPHIN ENERGY COMPANY FORM 10-Q 6/30/16

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended: June 30, 2016

Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from _____ to _____

Commission File Number: 0-15905

BLUE DOLPHIN ENERGY COMPANY

(Exact name of registrant as specified in its charter)

Delaware 73-1268729
(State or other jurisdiction of (I.R.S. Employer
incorporation or organization) Identification No.)

801 Travis Street, Suite 2100, Houston, Texas 77002
(Address of principal executive offices)

(713) 568-4725
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer

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Non-accelerated filer Smaller reporting company
(Do not check if a
smaller reporting
company)

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

Number of shares of common stock, par value \$0.01 per share outstanding as of August 15, 2016: 10,464,715

BLUE DOLPHIN ENERGY COMPANY FORM 10-Q 6/30/16

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GLOSSARY OF SELECTED OIL AND GAS TERMS

The following are abbreviations and definitions of certain commonly used oil and gas industry terms that are used in this Form 10-Q for the quarterly period ended June 30, 2016 (this “Quarterly Report”):

Atmospheric gas oil (“AGO”). The heaviest product boiled by a crude distillation unit operating at atmospheric pressure. This fraction ordinarily sells as distillate fuel oil, either in pure form or blended with cracked stocks. Blended AGO usually serves as the premium quality component used to lift lesser streams to the standards of saleable furnace oil or diesel engine fuel. Certain ethylene plants, called heavy oil crackers, can take AGO as feedstock.

Barrel (“bbl”). One stock tank bbl, or 42 U.S. gallons of liquid volume, used in reference to oil or other liquid hydrocarbons.

Blending. The physical mixture of a number of different liquid hydrocarbons to produce a finished product with certain desired characteristics. Products can be blended in-line through a manifold system, or batch blended in tanks and vessels. In-line blending of gasoline, distillates, jet fuel and kerosene is accomplished by injecting proportionate amounts of each component into the main stream where turbulence promotes thorough mixing. Additives, including octane enhancers, metal deactivators, anti-oxidants, anti-knock agents, gum and rust inhibitors, and detergents, are added during and/or after blending to result in specifically desired properties not inherent in hydrocarbons.

Barrels per Day (“bpd”). A measure of the bbls of daily output produced in a refinery or transported through a pipeline.

Complexity. A numerical score that denotes, for a given refinery, the extent, capability, and capital intensity of the refining processes downstream of the crude oil distillation unit. The higher a refinery’s complexity, the greater the refinery’s capital investment and number of operating units used to separate feedstock into fractions, improve their quality, and increase the production of higher-valued products. Refinery complexities range from the relatively simple crude oil distillation unit (“topping unit”), which has a complexity of 1.0, to the more complex deep conversion (“coking”) refineries, which have a complexity of 12.0.

Condensate. Liquid hydrocarbons that are produced in conjunction with natural gas. Condensate is chemically more complex than LPG. Although condensate is sometimes similar to crude oil, it is usually lighter.

Crude oil. A mixture of thousands of chemicals and compounds, primarily hydrocarbons. Crude oil quality is measured in terms of density (light to heavy) and sulfur content (sweet to sour). Crude oil must be broken down into its various components by distillation before these chemicals and compounds can be used as fuels or converted to more valuable products.

Depropanizer unit. A distillation column that is used to isolate propane from a mixture containing butane and other heavy components.

Distillates. The result of crude distillation and therefore any refined oil product. Distillate is more commonly used as an abbreviated form of middle distillate. There are mainly four (4) types of distillates: (i) very light oils or light distillates (such as our LPG mix and naphtha), (ii) light oils or middle distillates (such as our jet fuel), (iii) medium oils, and (iv) heavy oils (such as diesel and our heavy oil-based mud blendstock (“HOBM”), reduced crude, and AGO).

Distillation. The first step in the refining process whereby crude oil and condensate is heated at atmospheric pressure in the base of a distillation tower. As the temperature increases, the various compounds vaporize in succession at their

various boiling points and then rise to prescribed levels within the tower according to their densities, from lightest to heaviest. They then condense in distillation trays and are drawn off individually for further refining. Distillation is also used at other points in the refining process to remove impurities. Lighter products produced in this process can be further refined in a catalytic cracking unit or reforming unit. Heavier products, which cannot be vaporized and separated in this process, can be further distilled in a vacuum distillation unit or coker.

Distillation tower. A tall column-like vessel in which crude oil and condensate is heated and its vaporized components distilled by means of distillation trays.

Feedstocks. Crude oil and other hydrocarbons, such as condensate and/or intermediate products, that are used as basic input materials in a refining process. Feedstocks are transformed into one or more finished products.

Finished petroleum products. Materials or products which have received the final increments of value through processing operations, and which are being held in inventory for delivery, sale, or use.

Intermediate petroleum products. A petroleum product that might require further processing before it is saleable to the ultimate consumer. This further processing might be done by the producer or by another processor. Thus, an intermediate petroleum product might be a final product for one company and an input for another company that will process it further.

Jet fuel. A high-quality kerosene product primarily used in aviation. Kerosene-type jet fuel (including Jet A and Jet A-1) has a carbon number distribution between about 8 and 16 carbon atoms per molecule; wide-cut or naphtha-type jet fuel (including Jet B) has between about 5 and 15 carbon atoms per molecule.

Kerosene. A middle distillate fraction of crude oil that is produced at higher temperatures than naphtha and lower temperatures than gas oil. It is usually used as jet turbine fuel and sometimes for domestic cooking, heating, and lighting.

Leasehold interest. The interest of a lessee under an oil and gas lease.

Light crude. A liquid petroleum that has a low density and flows freely at room temperature. It has a low viscosity, low specific gravity, and a high American Petroleum Institute gravity due to the presence of a high proportion of light hydrocarbon fractions.

Liquefied petroleum gas (“LPG”). Manufactured during the refining of crude oil and condensate; burns relatively cleanly with no soot and very few sulfur emissions.

MMcf. One million cubic feet; a measurement of gas volume only.

Naphtha. A refined or partly refined light distillate fraction of crude oil. Blended further or mixed with other materials it can make high-grade motor gasoline or jet fuel. It is also a generic term applied to the lightest and most volatile petroleum fractions.

Petroleum. A naturally occurring flammable liquid consisting of a complex mixture of hydrocarbons of various molecular weights and other liquid organic compounds. The name petroleum covers both the naturally occurring unprocessed crude oils and petroleum products that are made up of refined crude oil.

Propane. A by-product of natural gas processing and petroleum refining. Propane is one of a group of LPGs. The others include butane, propylene, butadiene, butylene, isobutylene and mixtures thereof. (See also definition of LPG.)

Refined petroleum products. Refined petroleum products are derived from crude oil and condensate that have been processed through various refining methods. The resulting products include gasoline, home heating oil, jet fuel, diesel, lubricants and the raw materials for fertilizer, chemicals, and pharmaceuticals.

Refinery. Within the oil and gas industry, a refinery is an industrial processing plant where crude oil and condensate is separated and transformed into petroleum products.

Sour crude. Crude oil containing sulfur content of more than 0.5%.

Stabilizer unit. A distillation column intended to remove the lighter boiling compounds, such as butane or propane, from a product.

Sweet crude. Crude oil containing sulfur content of less than 0.5%.

Sulfur. Present at various levels of concentration in many hydrocarbon deposits, such as petroleum, coal, or natural gas. Also produced as a by-product of removing sulfur-containing contaminants from natural gas and petroleum. Some of the most commonly used hydrocarbon deposits are categorized according to their sulfur content, with lower sulfur fuels usually selling at a higher, premium price and higher sulfur fuels selling at a lower, or discounted, price.

Topping unit. A type of petroleum refinery that engages in only the first step of the refining process -- crude distillation. A topping unit uses atmospheric distillation to separate crude oil and condensate into constituent petroleum products. A topping unit has a refinery complexity range of 1.0 to 2.0.

Throughput. The volume processed through a unit or a refinery or transported through a pipeline.

Turnaround. Scheduled large-scale maintenance activity wherein an entire process unit is taken offline for a week or more for comprehensive revamp and renewal.

Yield. The percentage of refined petroleum products that is produced from crude oil and other feedstocks.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

Consolidated Balance Sheets (Unaudited)

	June 30,	December 31,
	2016	2015
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	\$2,183,562	\$1,853,875
Restricted cash	4,186,150	3,175,299
Accounts receivable, net	9,132,900	5,457,245
Prepaid expenses and other current assets	843,639	939,690
Deposits	260,965	395,414
Inventory	9,684,121	7,808,318
Total current assets	26,291,337	19,629,841
Total property and equipment, net	57,597,369	48,841,812
Restricted cash, noncurrent	7,953,623	15,616,478
Surety bonds	710,000	1,022,000
Trade name	303,346	303,346
Deferred tax assets, net	6,307,479	3,607,237
Total long-term assets	72,871,817	69,390,873
TOTAL ASSETS	\$99,163,154	\$89,020,714
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES		
Accounts payable	\$32,433,145	\$14,882,714
Accounts payable, related party	861,963	300,000
Asset retirement obligations, current portion	26,399	38,644
Accrued expenses and other current liabilities	1,087,654	2,990,891
Interest payable, current portion	77,193	81,467
Long-term debt less unamortized debt issue costs, current portion	32,551,240	1,934,932
Total current liabilities	67,037,594	20,228,648
Long-term liabilities:		
Asset retirement obligations, net of current portion	1,956,590	1,947,220
Deferred revenues and expenses	104,237	125,085
Long-term debt less unamortized debt issue costs, net of current portion	1,349,324	32,846,254

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Long-term interest payable, net of current portion	1,586,522	1,482,801
Total long-term liabilities	4,996,673	36,401,360
TOTAL LIABILITIES	72,034,267	56,630,008
Commitments and contingencies (Note 19)		
STOCKHOLDERS' EQUITY		
Common stock (\$0.01 par value, 20,000,000 shares authorized; 10,614,715 and 10,603,802 shares issued at June 30, 2016 and December 31, 2015, respectively)	106,148	106,038
Additional paid-in capital	36,788,628	36,738,737
Accumulated deficit	(8,965,889)	(3,654,069)
Treasury stock, 150,000 shares at cost	(800,000)	(800,000)
Total stockholders' equity	27,128,887	32,390,706
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$99,163,154	\$89,020,714
See accompanying notes to consolidated financial statements.		

BLUE DOLPHIN ENERGY COMPANY FORM 10-Q 6/30/16
Consolidated Statements of Operations (Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
REVENUE FROM OPERATIONS				
Refined petroleum product sales	\$41,402,286	\$58,839,160	\$72,595,423	\$119,906,222
Tank rental revenue	615,487	286,892	906,974	573,784
Pipeline operations	24,687	35,562	52,339	73,957
Total revenue from operations	42,042,460	59,161,614	73,554,736	120,553,963
COST OF OPERATIONS				
Cost of refined products sold	42,633,298	53,801,698	73,626,775	103,189,147
Refinery operating expenses	2,877,748	2,586,151	6,314,763	5,467,122
Joint Marketing Agreement profit share	97,527	938,661	(573,565)	3,377,298
Pipeline operating expenses	95,195	60,887	174,485	107,483
Lease operating expenses	8,455	14,098	23,107	21,414
General and administrative expenses	255,319	400,018	612,323	745,902
Depletion, depreciation and amortization	470,347	402,937	910,800	802,168
Recovery of bad debt	-	-	(139,868)	-
Accretion expense	28,186	52,720	56,372	105,935
Total cost of operations	46,466,075	58,257,170	81,005,192	113,816,469
Income (loss) from operations	(4,423,615)	904,444	(7,450,456)	6,737,494
OTHER INCOME (EXPENSE)				
Easement, interest and other income	126,097	66,460	257,860	132,467
Interest and other expense	(399,559)	(732,296)	(819,466)	(940,371)
Total other expense	(273,462)	(665,836)	(561,606)	(807,904)
Income (loss) before income taxes	(4,697,077)	238,608	(8,012,062)	5,929,590
Income tax benefit (expense)	1,534,341	(100,729)	2,700,242	(2,090,347)
Net income (loss)	\$(3,162,736)	\$137,879	\$(5,311,820)	\$3,839,243
Income (loss) per common share:				
Basic	\$(0.30)	\$0.01	\$(0.51)	\$0.37
Diluted	\$(0.30)	\$0.01	\$(0.51)	\$0.37

Weighted average number of common shares
outstanding:

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Basic	10,459,996	10,450,210	10,458,895	10,449,829
Diluted	10,459,996	10,450,210	10,458,895	10,449,829

See accompanying notes to consolidated financial statements.

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Consolidated Statements of Cash Flows (Unaudited)

	Six Months Ended June 30,	
	2016	2015
OPERATING ACTIVITIES		
Net income (loss)	\$(5,311,820)	\$3,839,243
Loss from discontinued operations		
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depletion, depreciation and amortization	910,800	802,168
Unrealized loss (gain) on derivatives	(385,350)	467,000
Deferred tax expense (benefit)	(2,700,242)	1,892,551
Amortization of debt issue costs	64,243	500,566
Accretion expense	56,372	105,935
Common stock issued for services	50,000	19,999
Recovery of bad debt	(139,868)	-
Changes in operating assets and liabilities		
Restricted cash		
Accounts receivable	(3,535,787)	1,195,096
Prepaid expenses and other current assets	298,001	349,015
Deposits and other assets	446,449	(1,385,751)
Inventory	(1,875,803)	(643,882)
Accounts payable, accrued expenses and other liabilities	13,256,568	(1,093,032)
Accounts payable, related party	561,963	(1,174,168)
Net cash provided by operating activities	1,695,526	4,874,740
INVESTING ACTIVITIES		
Capital expenditures	(7,072,978)	(5,800,487)
Change in restricted cash for investing activities	7,662,855	(13,500,000)
Net cash provide by (used in) investing activities	589,877	(19,300,487)
FINANCING ACTIVITIES		
Proceeds from issuance of debt	-	28,000,000
Payments on long-term debt	(944,865)	(9,071,159)
Change in restricted cash for financing activities	(1,010,851)	(3,287,813)
Net cash (used in) provided by financing activities	(1,955,716)	15,641,028
Net increase in cash and cash equivalents	329,687	1,215,281
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	1,853,875	1,293,233
CASH AND CASH EQUIVALENTS AT END OF PERIOD	\$2,183,562	\$2,508,514
Supplemental Information:		
Non-cash investing and financing activities		
Financing of capital expenditures via accounts payable	\$2,593,379	\$459,007

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Interest paid	\$988,979	\$353,833
Income taxes paid	\$-	\$95,000
See accompanying notes to consolidated financial statements.		

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BLUE DOLPHIN ENERGY COMPANY FORM 10-Q 6/30/16
Notes to Consolidated Financial Statements (Continued)

Notes to
Consolidated
Financial
Statements

(1) Organization

Nature of Operations. Blue Dolphin Energy Company (“Blue Dolphin,”) is primarily an independent refiner and marketer of petroleum products. Our primary asset is a 15,000 bpd crude oil and condensate processing facility that is located in Nixon, Texas (the “Nixon Facility”). As part of our refinery business segment, we conduct petroleum storage and terminaling operations under third-party lease agreements at the Nixon Facility. We also own and operate pipeline assets and have leasehold interests in oil and gas properties. (See “Note (4) Business Segment Information” for further discussion of our business segments.)

Structure and Management. Blue Dolphin was formed as a Delaware corporation in 1986. We are currently controlled by Lazarus Energy Holdings, LLC (“LEH”), which owns approximately 81% of our common stock, par value \$0.01 per share (the “Common Stock”). LEH manages and operates all of our properties pursuant to an Operating Agreement (the “Operating Agreement”). Jonathan Carroll is Chairman of the Board of Directors (the “Board”), Chief Executive Officer, and President of Blue Dolphin, as well as a majority owner of LEH. (See “Note (8) Accounts Payable, Related Party,” “Note (9) Long-Term Debt, Net,” and “Note (19) Commitments and Contingencies – Financing Agreements” for additional disclosures related to LEH, the Operating Agreement, and Jonathan Carroll.)

Our operations are conducted through the following active subsidiaries:

Lazarus Energy, LLC, a Delaware limited liability company (“LE”).

Lazarus Refining & Marketing, LLC, a Delaware limited liability company (“LRM”).

Blue Dolphin Pipe Line Company (“BDPL”), a Delaware corporation.

Blue Dolphin Petroleum Company, a Delaware corporation.

Blue Dolphin Services Co., a Texas corporation.

See “Part II, Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations – Owned and Leased Assets” in our Form 10-K for the fiscal year ended December 31, 2015 (the “Annual Report”) as filed with the Securities and Exchange Commission (the “SEC”) for additional information regarding our operating subsidiaries.

References in this Quarterly Report to “we,” “us,” and “our” are to Blue Dolphin and its subsidiaries unless otherwise indicated or the context otherwise requires.

Operating Risks. We had cash and cash equivalents of \$2,183,562 and \$1,853,875 as of June 30, 2016 and December 31, 2015, respectively, and restricted cash (current portion) of \$4,186,150 and \$3,175,299 as of June 30, 2016 and

December 31, 2015, respectively. As of June 30, 2016, we had current assets of \$26,291,337 and current liabilities (including the current portion of long-term debt) of \$67,037,594, resulting in a working capital deficit of \$40,746,257. Excluding the current portion of long-term debt, as of June 30, 2016, we had a working capital deficit of \$8,195,017. Non-payment of Operations Payments by GEL TEX Marketing, LLC (“GEL”) under a Joint Marketing Agreement (the “Joint Marketing Agreement”) also contributed to the working capital deficit as of June 30, 2016. We currently rely on Operations Payments and our profit share under the Joint Marketing Agreement and advances from LEH to fund our working capital requirements. If GEL does not advance Operations Payments and the profit share is insufficient to fund our working capital requirements, LEH may, but is not required to, fund our working capital requirements. There can be no assurances that LEH will continue to fund our working capital requirements. (See “Note (8) Accounts Payable, Related Party” and Note (19) Commitments and Contingencies – Genesis Agreements and Legal Matters” for a discussion related to Operations Payments and the Joint Marketing Agreement.)

As of June 30, 2016, we were in violation of certain financial covenants in secured loan agreements with Sovereign Bank (“Sovereign”). As a result of these covenant defaults, Sovereign could elect to declare the amounts owed under these loan agreements to be immediately due and payable, exercise its rights with respect to collateral securing our obligations under these loan agreements, or exercise any other rights and remedies available. Accordingly, \$31,824,613 of debt under these loan agreements was classified within the current portion of long-term debt on our consolidated balance sheet as of June 30, 2016. (See “Note (9) Long-Term Debt, Net” and “Note (20) Subsequent Events” for additional disclosures related to our long-term debt and financial covenant violations.)

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Notes to Consolidated Financial Statements (Continued)

In addition to the Joint Marketing Agreement, we are party to a variety of contracts and agreements with Genesis and its affiliates that enable the purchase of crude oil and condensate, transportation of crude oil and condensate, and other services. Certain of these agreements with Genesis and its affiliates have successive one-year renewals until August 2019 unless sooner terminated by Genesis or its affiliates with 180 days prior written notice. An adverse change in our relationship with Genesis could have a material adverse effect on our operations, liquidity, and financial condition. We are currently involved in a dispute with Genesis over certain contractual matters. (See “Note (19) Commitments and Contingencies – Genesis Agreements” and “Legal Matters” for a summary of the Joint Marketing Agreement and Crude Supply Agreement and information regarding the current contractual dispute with Genesis.)

Execution of our business strategy depends on several factors, including adequate crude oil and condensate sourcing, levels of accounts receivable, refined petroleum product inventories, accounts payable, capital expenditures, and adequate access to credit on satisfactory terms. These factors may be impacted by general economic, political, financial, competitive, and other factors that are beyond our control. There can be no assurance that our business and operational strategy will achieve anticipated outcomes. If our strategy is not successful, our working capital requirements are not funded through Operations Payments or our profit share under the Joint Marketing Agreement or certain advances from LEH, or Sovereign exercises remedies available under the loan agreements for covenant violations, we may experience a significant and material adverse effect on our operations, liquidity, and financial condition.

(2)Basis of Presentation

The accompanying unaudited consolidated financial statements, which include Blue Dolphin and subsidiaries, have been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) for interim consolidated financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, certain information and footnote disclosures normally included in our audited financial statements have been condensed or omitted pursuant to the SEC’s rules and regulations. Significant intercompany transactions have been eliminated in the consolidation. In management’s opinion, all adjustments considered necessary for a fair presentation have been included, disclosures are adequate, and the presented information is not misleading.

The consolidated balance sheet as of December 31, 2015 has been derived from the audited financial statements at that date. The accompanying consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in our Annual Report. Operating results for the three and six months ended June 30, 2016 are not necessarily indicative of the results that may be expected for the fiscal year ending December 31, 2016, or for any other period.

(3)Significant Accounting Policies

The summary of significant accounting policies of Blue Dolphin is presented to assist in understanding our consolidated financial statements. Our consolidated financial statements and accompanying notes are representations of management who is responsible for their integrity and objectivity. These accounting policies conform to GAAP and have been consistently applied in the preparation of our consolidated financial statements.

Use of Estimates. We have made a number of estimates and assumptions related to the reporting of our consolidated assets and liabilities and to the disclosure of contingent assets and liabilities to prepare these consolidated financial statements in conformity with GAAP. While we believe our current estimates are reasonable and appropriate, actual results could differ from those estimated.

Cash and Cash Equivalents. Cash and cash equivalents represent liquid investments with an original maturity of three months or less. Cash balances are maintained in depository and overnight investment accounts with financial institutions that, at times, may exceed insured deposit limits. We monitor the financial condition of the financial institutions and have experienced no losses associated with these accounts. Cash and cash equivalents totaled \$2,183,562 and \$1,853,875 as of June 30, 2016 and December 31, 2015, respectively.

BLUE DOLPHIN ENERGY COMPANY FORM 10-Q 6/30/16
Notes to Consolidated Financial Statements (Continued)

Restricted Cash. Total restricted cash was \$12,139,773 and \$18,791,777 as of June 30, 2016 and December 31, 2015, respectively. Total restricted cash was comprised of restricted cash (current portion), which totaled \$4,186,150 and \$3,175,299 as of June 30, 2016 and December 31, 2015, respectively and restricted cash, noncurrent, which totaled \$7,953,623 and \$15,616,478 as of June 30, 2016 and December 31, 2015, respectively. Restricted cash (current portion) primarily represents: (i) amounts held in our disbursement account with Sovereign attributable to construction invoices awaiting payment from that account, (ii) a payment reserve account held by Sovereign as security for payments under a loan agreement, and (iii) a construction contingency account under which Sovereign will fund contingencies. Restricted cash, noncurrent represents funds held in the Sovereign disbursement account for payment of future construction related expenses to build new petroleum storage tanks. (See “Note (9) Long-Term Debt, Net” for additional disclosures related to our loan agreements with Sovereign.)

Accounts Receivable and Allowance for Doubtful Accounts. Accounts receivable are customer obligations due under normal trade terms. The allowance for doubtful accounts represents our estimate of the amount of probable credit losses existing in our accounts receivable. We have a limited number of customers with individually large amounts due on any given date. Any unanticipated change in any one of these customers’ credit worthiness or other matters affecting the collectability of amounts due from such customers could have a material adverse effect on our results of operations in the period in which such changes or events occur. We regularly review all of our aged accounts receivable for collectability and establish an allowance for individual customer balances as necessary. Allowance for doubtful accounts totaled \$0 and \$139,868 as of June 30, 2016 and December 31, 2015, respectively.

Inventory. The nature of our business requires us to maintain inventory, which primarily consists of refined petroleum products and chemicals. Our overall inventory is valued at lower of cost or market with costs being determined by the average cost method. If the market value of our refined petroleum product inventories declines to an amount less than our average cost, we record a write-down of inventory and an associated adjustment to cost of refined products sold. (See “Note (6) Inventory” for additional disclosures related to our inventory.)

Derivatives. We are exposed to commodity prices and other market risks including gains and losses on certain financial assets as a result of our inventory risk management policy. Under our inventory risk management policy, commodity futures contracts may be used to mitigate the change in value for certain of our refined petroleum product inventories subject to market price fluctuations. The physical inventory volumes are not exchanged and these contracts are net settled with cash.

Although these commodity futures contracts are not subject to hedge accounting treatment under Financial Accounting Standards Board (the “FASB”) Accounting Standards Codification (“ASC”) guidance, we record the fair value of these hedges in our consolidated balance sheet each financial reporting period because of contractual arrangements under which we are effectively exposed to the potential gains or losses. We recognize all commodity hedge positions as either current assets or current liabilities in our consolidated balance sheets, and those instruments are measured at fair value. Changes in the fair value from financial reporting period to financial reporting period are recognized in our consolidated statements of operations. Net gains or losses associated with these transactions are recognized within cost of refined products sold in our consolidated statements of operations using mark-to-market accounting.

(See “Note (17) Fair Value Measurement” and “Note (18) Inventory Risk Management” for additional disclosures related to derivatives.)

Property and Equipment.

Refinery and Facilities. Additions to refinery and facilities assets are capitalized. Expenditures for repairs and maintenance are expensed as incurred and are included as operating expenses under the Operating Agreement. Management expects to continue making improvements to the Nixon Facility based on technological advances.

We record refinery and facilities at cost less any adjustments for depreciation or impairment. Adjustment of the asset and the related accumulated depreciation accounts are made for the refinery and facilities asset's retirement and disposal, with the resulting gain or loss included in the consolidated statements of operations. For financial reporting purposes, depreciation of refinery and facilities assets is computed using the straight-line method using an estimated useful life of 25 years beginning when the refinery and facilities assets are placed in service. We did not record any impairment of our refinery and facilities assets for any period presented.

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Notes to Consolidated Financial Statements (Continued)

Pipelines and Facilities. We record pipelines and facilities at cost less any adjustments for depreciation or impairment. Depreciation is computed using the straight-line method over estimated useful lives ranging from 10 to 22 years. In accordance with FASB ASC guidance on accounting for the impairment or disposal of long-lived assets, we periodically evaluate our long-lived assets for impairment. Additionally, we evaluate our long-lived assets when events or circumstances indicate that the carrying value of these assets may not be recoverable.

Oil and Gas Properties. We account for our oil and gas properties using the full-cost method of accounting, whereby all costs associated with acquisition, exploration and development of oil and gas properties, including directly related internal costs, are capitalized on a cost center basis. Amortization of such costs and estimated future development costs are determined using the unit-of-production method. Our oil and gas properties had no production during the three and six months ended June 30, 2016 and 2015. All leases associated with our oil and gas properties have expired, and our oil and gas properties were fully impaired as of December 31, 2012.

Construction in Progress. Construction in progress expenditures, which relate to construction and refurbishment activities at the Nixon Facility, are capitalized as incurred. Depreciation begins once the asset is placed in service.

(See “Note (7) Property, Plant and Equipment, Net” for additional disclosures related to our refinery and facilities assets, oil and gas properties, pipelines and facilities assets, and construction in progress.)

Intangibles – Other. We have an intangible asset consisting of the Blue Dolphin Energy Company trade name in the amount of \$303,346 on our consolidated balance sheets as of June 30, 2016 and December 31, 2015. We have determined the trade name to have an indefinite useful life. We account for other intangible assets under FASB ASC guidance related to intangibles, goodwill, and other. Under the guidance, we test intangible assets with indefinite lives annually for impairment. Management performed its regular annual impairment testing of trade name in the fourth quarter of 2015. Upon completion of that testing, we determined that no impairment was necessary as of December 31, 2015.

Revenue Recognition.

Refined Petroleum Products Revenue. Jet fuel, our only finished product, is sold in nearby markets to wholesalers. Our intermediate products, including LPG, naphtha, HOBM, and AGO, are primarily sold in nearby markets to wholesalers and refiners for further blending and processing. Revenue from refined petroleum products sales is recognized when sales prices are fixed or determinable, collectability is reasonably assured, and title passes. Title passage occurs when refined petroleum products are delivered in accordance with the terms of the respective sales agreements, and customers assume the risk of loss when title is transferred. Transportation, shipping, and handling costs incurred are included in cost of refined products sold. Excise and other taxes that are collected from customers and remitted to governmental authorities are not included in revenue.

Tank Rental Revenue. Tank rental fees are invoiced monthly in accordance with the terms of the related lease agreement and recognized in revenue as earned.

Easement Revenue. Land easement revenue is recognized monthly as earned and is included in other income.

Pipeline Transportation Revenue. Revenue from our pipeline operations is derived from fee-based contracts and is typically based on transportation fees per unit of volume transported multiplied by the volume delivered. Revenue is recognized when volumes have been physically delivered for the customer through the pipeline.

Deferred Revenue. In 2014, we increased the ownership interest in our pipeline assets from approximately 83% to 100% pursuant to an Asset Sale Agreement (the “Purchase Agreement”) with a former partner. Pursuant to the Purchase Agreement, the former partner paid us \$100,000 in cash, and a surety company \$850,000 in cash as collateral for supplemental pipeline bonds for our benefit in exchange for the payment and discharge of any and all payables, claims, and obligations related to the pipeline assets. We recorded the amount received for our benefit related to the supplemental pipeline bonds as deferred revenue. We recognized the deferred revenue on a straight-line basis through December 31, 2018, the expected retirement date of the associated assets. In 2015, a significant portion of the remaining deferred revenue was recognized as a result of abandoning a segment of the pipeline assets. (See “Part I, Business – Governmental Regulation – Offshore Safety and Environmental Oversight – Decommissioning Requirements” in our Annual Report for a discussion related to supplemental pipeline bonds.)

BLUE DOLPHIN ENERGY COMPANY FORM 10-Q 6/30/16
Notes to Consolidated Financial Statements (Continued)

Income Taxes. We account for income taxes under FASB ASC guidance related to income taxes, which requires recognition of income taxes based on amounts payable with respect to the current three and six month periods and the effects of deferred taxes for the expected future tax consequences of events that have been included in our financial statements or tax returns. Under this method, deferred tax assets and liabilities are determined based on the differences between the financial accounting and tax basis of assets and liabilities, as well as for operating losses and tax credit carryforwards using enacted tax rates in effect for the year in which the differences are expected to reverse.

As of each reporting date, management considers new evidence, both positive and negative, to determine the realizability of deferred tax assets. Management considers whether it is more likely than not that a portion or all of the deferred tax assets will be realized, which is dependent upon the generation of future taxable income prior to the expiration of any net operating loss (“NOL”) carryforwards. When management determines that it is more likely than not that a tax benefit will not be realized, a valuation allowance is recorded to reduce deferred tax assets.

The guidance 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, as well as guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosures, and transition.

(See “Note (15) Income Taxes” for further information related to income taxes.)

Impairment or Disposal of Long-Lived Assets. In accordance with FASB ASC guidance on accounting for the impairment or disposal of long-lived assets, we periodically evaluate our long-lived assets for impairment. Additionally, we evaluate our long-lived assets when events or circumstances indicate that the carrying value of these assets may not be recoverable. The carrying value is not recoverable if it exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset or group of assets. If the carrying value exceeds the sum of the undiscounted cash flows, an impairment loss equal to the amount by which the carrying value exceeds the fair value of the asset or group of assets is recognized. Significant management judgment is required in the forecasting of future operating results that are used in the preparation of projected cash flows and, should different conditions prevail or judgments be made, material impairment charges could be necessary.

Asset Retirement Obligations. FASB ASC guidance related to asset retirement obligations (“AROs”) requires that a liability for the discounted fair value of an ARO be recorded in the period in which it is incurred and the corresponding cost capitalized by increasing the carrying amount of the related long-lived asset. The liability is accreted towards its future value each period, and the capitalized cost is depreciated over the useful life of the related asset. If the liability is settled for an amount other than the recorded amount, a gain or loss is recognized.

Management has concluded that there is no legal or contractual obligation to dismantle or remove the refinery and facilities assets. Further, management believes that these assets have indeterminate lives under FASB ASC guidance for estimating AROs because dates or ranges of dates upon which we would retire these assets cannot reasonably be estimated at this time. When a legal or contractual obligation to dismantle or remove the refinery and facilities assets arises and a date or range of dates can reasonably be estimated for the retirement of these assets, we will estimate the cost of performing the retirement activities and record a liability for the fair value of that cost using present value techniques.

We recorded an ARO liability related to future asset retirement costs associated with dismantling, relocating, or disposing of our offshore platform, pipeline systems, and related onshore facilities, as well as for plugging and abandoning wells and restoring land and sea beds. We developed these cost estimates for each of our assets based upon regulatory requirements, structural makeup, water depth, reservoir characteristics, reservoir depth, equipment demand, current retirement procedures, and construction and engineering consultations. Because these costs typically

extend many years into the future, estimating future costs are difficult and require management to make judgments that are subject to future revisions based upon numerous factors, including changing technology, political, and regulatory environments. We review our assumptions and estimates of future abandonment costs on an annual basis.

(See “Note (11) Asset Retirement Obligations” for additional information related to our AROs.)

BLUE DOLPHIN ENERGY COMPANY FORM 10-Q 6/30/16
Notes to Consolidated Financial Statements (Continued)

Computation of Earnings Per Share. We apply the provisions of FASB ASC guidance for computing earnings per share (“EPS”). The guidance requires the presentation of basic EPS, which excludes dilution and is computed by dividing net income available to common stockholders by the weighted-average number of shares of common stock outstanding for the period. The guidance requires dual presentation of basic EPS and diluted EPS on the face of our consolidated statements of operations and requires a reconciliation of the numerators and denominators of basic EPS and diluted EPS. Diluted EPS is computed by dividing net income available to common stockholders by the diluted weighted average number of common shares outstanding, which includes the potential dilution that could occur if securities or other contracts to issue shares of common stock were converted to common stock that then shared in the earnings of the entity.

The number of shares related to options, warrants, restricted stock, and similar instruments included in diluted EPS is based on the “Treasury Stock Method” prescribed in FASB ASC guidance for computation of EPS. This method assumes theoretical repurchase of shares using proceeds of the respective stock option or warrant exercised, and, for restricted stock, the amount of compensation cost attributed to future services that has not yet been recognized and the amount of any current and deferred tax benefit that would be credited to additional paid-in-capital upon the vesting of the restricted stock, at a price equal to the issuer’s average stock price during the related earnings period. Accordingly, the number of shares includable in the calculation of EPS in respect of the stock options, warrants, restricted stock, and similar instruments is dependent on this average stock price and will increase as the average stock price increases. (See “Note (16) Earnings Per Share” for additional information related to EPS.)

Stock-Based Compensation. In accordance with FASB ASC guidance for stock-based compensation, share-based payments to directors, including the issuance of restricted common stock, are measured at fair value as of the date of grant and are expensed in our consolidated statements of operations over the service period (generally the vesting period).

Treasury Stock. We account for treasury stock under the cost method. When treasury stock is re-issued, the net change in share price subsequent to acquisition of the treasury stock is recognized as a component of additional paid-in-capital in our consolidated balance sheets. (See “Note (12) Treasury Stock” for additional disclosures related to treasury stock.)

New Pronouncements Adopted. The FASB issues an Accounting Standards Update (“ASU”) to communicate changes to the FASB ASC, including changes to non-authoritative SEC content. For the three and six months ended June 30, 2016, we adopted the following recently issued ASU’s:

ASU 2015-17, Income Taxes (Topic 740). In November 2015, FASB issued ASU 2015-17. This guidance simplifies the presentation of deferred income taxes by requiring that deferred tax liabilities and assets be classified as noncurrent instead of separated into current and noncurrent. We adopted this accounting pronouncement effective April 1, 2016. Accordingly, our consolidated balance sheet as of December 31, 2015 has been changed to reclassify approximately \$3.5 million previously reported as deferred tax assets, current portion, net to deferred tax assets, net. The adoption of ASU 2015-17 had no impact on our results of operations or cash flows.

ASU 2015-03, Imputation of Interest (Topic 835): Simplifying the Presentation of Debt Issuance Costs. In April 2015, FASB issued ASU 2015-03. This guidance requires debt issue costs to be presented as an offset to their related debt. We adopted this accounting pronouncement effective January 1, 2016. Accordingly, our consolidated balance sheet as of December 31, 2015 has been changed to reclassify approximately \$2.4 million previously reported as debt issue costs as a direct deduction of long-term debt. The adoption of ASU 2015-03 had no impact on our results of operations or cash flows.

New Pronouncements Issued But Not Yet Effective. The following are recently issued, but not yet effective, ASU's that may have an effect on our consolidated financial position, results of operations, or cash flows:

ASU 2016-13, Financial Instruments — Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments). In June 2016, FASB issued ASU 2016-13. This guidance updates the current impairment model to incorporate both expected and incurred credit losses, eliminating potential overstatements of assets and resulting in more timely recognition of losses. For a public business entity, the amendments in ASU 2016-13 are effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Early application as of the fiscal years beginning after December 15, 2018, including interim periods within those fiscal years, is permitted. We are evaluating the impact that adoption of this guidance will have on our consolidated financial statements.

ASU 2016-02, Leases (Topic 842). In February 2016, FASB issued ASU 2016-02. This guidance increases transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. For a public business entity, the amendments in ASU 2016-02 are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early application is permitted. We are evaluating the impact that adoption of this guidance will have on our consolidated balance sheets.

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ASU 2015-11, Inventory (Topic 330): Simplifying the Measurement of Inventory. In July 2015, FASB issued ASU 2015-11. Current guidance requires an entity to measure inventory at the lower of cost or market. Market could be replacement cost, net realizable value, or net realizable value less an approximately normal profit margin. Under ASU 2015-11, an entity should measure inventory at the lower of cost or net realizable value. Net realizable value is the estimated selling price in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. Amendments under ASU 2015-11 more closely align the measurement of inventory in GAAP with the measurement of inventory in International Financial Reporting Standards. For public business entities, ASU 2015-11 is effective for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years. ASU 2015-11 should be applied prospectively with earlier application permitted as of the beginning of an interim or annual reporting period. We do not anticipate adoption of this guidance to have a material effect on our consolidated financial statements.

ASU 2014-15, Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern (Subtopic 205-40). In August 2014, FASB issued ASU 2014-15, which requires management to perform interim and annual assessments of an entity's ability to continue as a going concern for a one-year period subsequent to the date of the financial statements. An entity must provide certain disclosures if conditions or events raise substantial doubt about the entity's ability to continue as a going concern. The guidance is effective for all entities for the first annual period ending after December 15, 2016 and interim periods thereafter, with early adoption permitted. We do not anticipate adoption of this guidance to have a material effect on our consolidated financial statements.

ASU 2014-09, Revenue from Contracts with Customers (Topic 606). In May 2014, FASB and the International Accounting Standards Board (the "IASB") issued ASU 2014-09, a converged standard on recognition of revenue from contracts with customers. In June 2014, the FASB and the IASB (collectively, the "Accounting Boards") formed the FASB-IASB Joint Transition Resource Group for Revenue Recognition (the "TRG"). The primary objective of the TRG is to inform the Accounting Boards about potential implementation issues that could arise when organizations implement the new revenue guidance. Resultant ASU's as part of the TRG process include:

August 2015 – ASU 2015-14, Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date, which defers the effective date of ASU 2014-09 for all entities by one year. The effective date for public business entities is annual reporting periods beginning after December 15, 2017. Public business entities would apply the new revenue standard to interim reporting periods after December 15, 2017. As such, for a public business entity with a calendar year-end, ASU 2014-09 would be effective on January 1, 2018, for both its interim and annual reporting periods. This represents a one-year deferral from the original effective date. The new effective date guidance allows early adoption for all entities as of the original effective date (December 15, 2016).

March 2016 – ASU 2016-08, Revenue from Contracts with Customers (Topic 606): Principal Versus Agent Considerations (Reporting Revenue Gross Versus Net), which clarifies the implementation guidance on principal versus agent considerations. When another party, along with the entity, is involved in providing a good or a service to a customer, the entity must determine whether the nature of its promise is to provide that good or service to the customer (e.g., entity as principal) or to arrange for the good or service to be provided to the customer by the other party (e.g., entity as agent). Such determination is based upon whether the entity controls the good or the service before it is transferred to the customer.

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April 2016 – ASU 2016-10, Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing. This ASU: (i) clarifies when promised goods or services are separately identifiable (i.e., distinct within the context of a contract), an important step in determining whether goods and services should be accounted for as separate performance obligations, (ii) allows entities to disregard goods or services that are immaterial in the context of a contract and provide an accounting policy election for accounting for certain shipping and handling activities, (iii) clarifies how an entity should evaluate the nature of its promise in granting a license of intellectual property, which will determine whether the entity recognizes revenue over time or at a point in time, and (iv) revises the guidance to address how entities should apply the exception for sales and usage-based royalties to licenses of intellectual property, recognize revenue for licenses that are not separate performance obligations, and evaluate different types of license restrictions (e.g., time-based, geography-based).

May 2016 – ASU 2016-11, Revenue Recognition (Topic 605) and Derivatives and Hedging (Topic 815): Rescission of SEC Guidance Because of Accounting Standards Updates 2014-09 and 2014-16 Pursuant to Staff Announcements at the March 3, 2016 EITF Meeting (SEC Update). Upon the adoption of ASU 2014-16, Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share Is More Akin to Debt or to Equity, and ASU 2014-09, several ASC guidance standards related to revenue recognition will be rescinded as no longer needed. These include ASC guidance standards for determining the nature of a host contract related to a hybrid financial instrument issued in the form of a share, revenue and expense recognition for freight services in process, accounting for shipping and handling fees and costs, accounting for consideration given by a vendor to a customer, and accounting for gas-balancing arrangements.

May 2016 – ASU 2016-12, Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients addresses issues such as collectability, contract modifications, completed contracts at transition, and noncash considerations as they relate to the new revenue recognition standard.

We are evaluating the impact that adoption of ASU 2014-09, ASU 2015-14, ASU 2016-08, ASU 2016-10, ASU 2016-11, and 2016-12, all of which relate to Revenue from Contracts with Customers (Topic 606), will have on our consolidated financial statements.

Other new pronouncements issued but not effective until after June 30, 2016 are not expected to have a material impact on our financial position, results of operations, or liquidity.

Reclassification. We have reclassified certain prior year amounts to conform to our 2016 presentation.

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Notes to Consolidated Financial Statements (Continued)

(4) Business Segment Information

We have two reportable business segments: (i) Refinery Operations and (ii) Pipeline Transportation. Business activities related to our Refinery Operations business segment are conducted at the Nixon Facility. Business activities related to our Pipeline Transportation business segment are primarily conducted in the Gulf of Mexico through our Pipeline Assets and leasehold interests in oil and gas properties.

Business segment information for the periods indicated (and as of the dates indicated), was as follows:

	Three Months Ended June 30, 2016				Three Months Ended June 30, 2015			
	Segment		Segment		Segment		Segment	
	Refinery	Pipeline	Corporate &	Total	Refinery	Pipeline	Corporate &	Total
	Operations	Transportation	Other	Total	Operations	Transportation	Other	Total
Revenue from operations	\$42,017,773	\$24,687	\$-	\$42,042,460	\$59,126,052	\$35,562	\$-	\$59,161,614
Less: cost of operations(1)	(45,534,109)	(131,836)	(232,256)	(45,898,201)	(56,504,401)	(127,704)	(283,467)	(56,915,572)
Other non-interest income(2)	-	125,000	-	125,000	-	62,500	-	62,500
Adjusted EBITDA(3)	(3,516,336)	17,851	(232,256)	(3,730,741)	2,621,651	(29,642)	(283,467)	2,308,542
Less: JMA Profit Share(4)	(97,527)	-	-	(97,527)	(938,661)	-	-	(938,661)
EBITDA(3)	\$(3,613,863)	\$17,851	\$(232,256)		\$1,682,990	\$(29,642)	\$(283,467)	
Depletion, depreciation, and amortization				(470,347)				(402,933)
Interest expense, net				(398,462)				(728,333)
Income (loss) before income taxes				(4,697,077)				238,608
				1,534,341				(100,722)

Income tax
benefit
(expense)

Net income
(loss)

\$(3,162,736)

\$137,879

Capital
expenditures

\$3,433,333

\$-

\$-

\$3,433,333

\$4,967,579

\$-

\$-

\$4,967,579

Identifiable
assets(5)

\$93,402,963

\$1,867,687

\$3,892,504

\$99,163,154

\$73,643,964

\$2,788,381

\$4,046,157

\$80,478,381

- Operation cost within the Refinery Operations and Pipeline Transportation segments includes related general, administrative, and accretion expenses. Operation cost within Corporate and Other includes general and administrative expenses associated with corporate maintenance costs, such as accounting fees, director fees, and legal expense.
- (1) Other non-interest income reflects FLNG easement revenue. (See “Note (19) Commitments and Contingencies – FLNG Master Easement Agreement” for further discussion related to FLNG.)
- Adjusted EBITDA and EBITDA are non-GAAP financial measures. See “Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations – Results of Operations – Non-GAAP Financial Measures” for additional information related to adjusted EBITDA and EBITDA.
- (2) The JMA Profit Share represents the GEL TEX Marketing, LLC Profit Share plus the Performance Fee for the period pursuant to the Joint Marketing Agreement. (See “Note (19) Commitments and Contingencies – Genesis Agreements” for further discussion related to the Joint Marketing Agreement.)
- (3) Identifiable assets for the prior year period reflect reclassification of debt issue costs as a reduction in long-term debt to conform to the 2016 presentation.
- (4)
- (5)

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Business segment information for the periods indicated (and as of the dates indicated), was as follows:

	Six Months Ended June 30, 2016				Six Months Ended June 30, 2015			
	Segment				Segment			
	Refinery Operations	Pipeline Transportation	Corporate & Other	Total	Refinery Operations	Pipeline Transportation	Corporate & Other	Total
Revenue from operations	\$73,502,397	\$52,339	\$-	\$73,554,736	\$120,480,006	\$73,957	\$-	\$120,553,963
Less: cost of operations(1)	(79,956,962)	(253,964)	(457,031)	(80,667,957)	(108,763,871)	(181,616)	(691,515)	(109,637,002)
Other non-interest income(2)	-	255,665	-	255,665	-	125,000	-	125,000
Adjusted EBITDA(3)	(6,454,565)	54,040	(457,031)	(6,857,556)	11,716,135	17,341	(691,515)	11,041,961
Less: JMA Profit Share(4)	573,565	-	-	573,565	(3,377,298)	-	-	(3,377,298)
EBITDA(3)	\$(5,881,000)	\$54,040	\$(457,031)	\$(5,283,991)	\$8,338,837	\$17,341	\$(691,515)	\$7,664,663
Depletion, depreciation and amortization				(910,800)				(802,100)
Interest expense, net				(817,271)				(932,900)
Income (loss) before income taxes				(8,012,062)				5,929,663
Income tax benefit (expense)				2,700,242				(2,090,000)
Net income (loss)				\$(5,311,820)				\$3,839,663
Capital expenditures	\$7,072,978	\$-	\$-	\$7,072,978	\$6,259,494	\$-	\$-	\$6,259,494

Identifiable assets(5)	\$93,402,963	\$1,867,687	\$3,892,504	\$99,163,154	\$73,643,964	\$2,788,381	\$4,046,157	\$80,478
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- (1) Operation cost within the Refinery Operations and Pipeline Transportation segments includes related general, administrative, and accretion expenses. Operation cost within Corporate and Other includes general and administrative expenses associated with corporate maintenance costs, such as accounting fees, director fees, and legal expense.
- (2) Other non-interest income reflects FLNG easement revenue. (See “Note (19) Commitments and Contingencies – FLNG Master Easement Agreement” for further discussion related to FLNG.)
- (3) Adjusted EBITDA and EBITDA are non-GAAP financial measures. See “Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations – Results of Operations – Non-GAAP Financial Measures” for additional information related to adjusted EBITDA and EBITDA.
- (4) The JMA Profit Share represents the GEL TEX Marketing, LLC Profit Share plus the Performance Fee for the period pursuant to the Joint Marketing Agreement. (See “Note (19) Commitments and Contingencies – Genesis Agreements” for further discussion related to the Joint Marketing Agreement.)
- (5) Identifiable assets for the prior year period reflect reclassification of debt issue costs as a reduction in long-term debt to conform to the 2016 presentation.

(5) Prepaid Expenses and Other Current Assets

Prepaid expenses and other current assets as of the dates indicated consisted of the following:

	June 30,	December 31,
	2016	2015
Prepaid related party operating expenses	\$402,671	\$624,570
Prepaid insurance	231,518	315,120
Unrealized hedging gains	201,950	-
Prepaid listing fees	7,500	-
	\$843,639	\$939,690

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Notes to Consolidated Financial Statements (Continued)

(6) Inventory

Inventory as of the dates indicated consisted of the following:

	June 30,	December 31,
	2016	2015
HOBM	\$6,382,469	\$5,007,576
Jet fuel	1,438,134	2,045,784
Crude oil and condensate	936,301	19,041
Naphtha	333,627	309,850
AGO	288,707	278,278
Chemicals	282,562	122,777
Propane	17,299	17,860
LPG mix	5,022	7,152
	\$9,684,121	\$7,808,318

(7) Property, Plant and Equipment, Net

Property, plant and equipment, net, as of the dates indicated consisted of the following:

	June 30,	December 31,
	2016	2015
Refinery and facilities	\$47,660,502	\$40,195,928
Pipelines and facilities	2,127,207	2,127,207
Onshore separation and handling facilities	325,435	325,435
Land	602,938	602,938
Other property and equipment	652,795	644,795
	51,368,877	43,896,303
Less: Accumulated depletion, depreciation, and amortization	(7,144,961)	(6,234,161)
	44,223,916	37,662,142

Construction in progress	13,373,453	11,179,670
	\$57,597,369	\$48,841,812

We capitalize interest cost incurred on funds used to construct property, plant, and equipment. The capitalized interest is recorded as part of the asset to which it relates and is depreciated over the asset's useful life. Interest cost capitalized was \$1,363,536 and \$556,032 as of June 30, 2016 and December 31, 2015, respectively.

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Notes to Consolidated Financial Statements (Continued)

(8) Accounts Payable, Related Party

Accounts payable, related party as of the dates indicated consisted of the following:

	June 30,	December 31,
	2016	2015
Ingleside	\$554,389	\$300,000
Jonathan Carroll	307,574	-
	\$861,963	\$300,000

Accounts payable, related party correspond to the following:

Ingleside Crude, LLC (“Ingleside”). Pursuant to a Tank Lease Agreement with Ingleside, we lease petroleum storage tanks to meet periodic, additional storage needs. The Tank Lease Agreement had an initial term of 30 days and automatically renews for 30 day periods. The parties may terminate the tank lease agreement upon 30 days written notice. Amounts owed to Ingleside under the tank lease agreement are reflected within accounts payable, related party in our consolidated balance sheets. Amounts expensed as fees to Ingleside are reflected within refinery operating expenses in our consolidated statements of operations. Ingleside is a related party of LEH and Jonathan Carroll.

For the three months ended June 30, 2016 and 2015, fees to Ingleside totaled \$450,000 (approximately \$0.63 per bbl of throughput) and \$0, respectively. For the six months ended June 30, 2016 and 2015, fees to Ingleside totaled \$725,000 (approximately \$0.38 per bbl of throughput) and \$0, respectively.

LEH. We are party to an Operating Agreement, a Product Sales Agreement, and a Terminal Services Agreement with LEH. LEH, our controlling shareholder, owns approximately 81% of our Common Stock. Jonathan Carroll, Chairman of the Board, Chief Executive Officer, and President of Blue Dolphin, is the majority owner of LEH.

Operating Agreement. LEH manages and operates all of our properties pursuant to the Operating Agreement. The Operating Agreement expires upon the earliest to occur of: (a) the date of the termination of the Joint Marketing Agreement pursuant to its terms, (b) August 2018, or (c) upon written notice of either party to the Operating Agreement of a material breach of the Operating Agreement by the other party. For services rendered under the Operating Agreement, LEH receives reimbursements and fees as follows:

Reimbursements – For management and operation of all properties excluding the Nixon Facility, LEH is reimbursed at cost for all reasonable expenses incurred while performing the services. Unsettled reimbursements to LEH are either reflected within prepaid expenses and other current assets or accounts payable, related party in our consolidated balance sheets. As of June 30, 2016 and December 31, 2015, prepaid related party operating expenses to LEH totaled \$402,671 and \$624,570, respectively. (See “Note (5) Prepaid Expenses and Other Current Assets” for additional

disclosures with respect to prepaid related party operating expenses.)

Fees – For management and operation of the Nixon Facility, LEH receives: (i) weekly payments from GEL to cover direct expenses incurred in an amount not to exceed \$750,000 per month (the “Operations Payments”), (ii) \$0.25 for each bbl processed at the Nixon Facility up to a maximum quantity of 10,000 bbls per day determined on a monthly basis, and (iii) \$2.50 for each bbl processed at the Nixon Facility in excess of 10,000 bbls per day determined on a monthly basis. Amounts expensed as fees to LEH are reflected within refinery operating expenses in our consolidated statements of operations. For the three months ended June 30, 2016 and 2015, fees to LEH totaled \$2,427,748 (approximately \$3.42 per bbl of throughput) and \$2,586,151 (approximately \$2.83 per bbl of throughput), respectively. For the six months ended June 30, 2016 and 2015, fees to LEH totaled \$5,589,763 (approximately \$2.95 per bbl of throughput) and \$5,467,122 (approximately \$2.76 per bbl of throughput), respectively.

Product Sales Agreement. Under a Product Sales Agreement, LEH purchases jet fuel from the Nixon Facility for resale to third parties. Sales to LEH are reflected within refined petroleum product sales in our consolidated statements of operations. For the three months ended June 30, 2016 and 2015, sales to LEH totaled \$8,912,074 and \$0, respectively. For the six months ended June 30, 2016 and 2015, sales to LEH totaled \$8,912,074 and \$0, respectively.

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Notes to Consolidated Financial Statements (Continued)

Terminal Services Agreement. Pursuant to a Terminal Services Agreement, LEH leases a petroleum storage tank at the Nixon Facility. The Terminal Services Agreement has an initial term of 12 months and automatically renews for additional terms of 6 months. The parties may terminate the Terminal Services Agreement upon 45 days written notice. Fees from LEH are reflected within tank rental revenue in our consolidated statements of operations. For the three months ended June 30, 2016 and 2015, fees from LEH totaled \$324,000 and \$0, respectively. For the six months ended June 30, 2016 and 2015, fees from LEH totaled \$324,000 and \$0, respectively.

Jonathan Carroll. Pursuant to Guaranty Fee Agreements, Jonathan Carroll receives fees for providing his personal guarantee on certain of our long-term debt. Jonathan Carroll was required to guarantee repayment of funds borrowed and interest accrued under the loan agreements. Amounts owed to Jonathan Carroll under Guaranty Fee Agreements are reflected within accounts payable, related party in our consolidated balance sheets. Jonathan Carroll is Chairman of the Board, Chief Executive Officer, and President of Blue Dolphin. (See "Note (9) Long-Term Debt, Net" for further discussion related to the Guaranty Fee Agreements.)

We believe these related party transactions were consummated on terms equivalent to those that prevail in arm's-length transactions.

(9) Long-Term Debt, Net

Effective January 1, 2016, we adopted the provisions of the FASB ASC guidance that requires debt issue costs to be presented as an offset to their related debt. Accordingly, our consolidated balance sheet as of December 31, 2015 has been changed to reclassify approximately \$2.4 million previously reported debt issue costs as a direct deduction of long-term debt.

Long-term debt, net, which represents the outstanding principal and interest of long-term debt less associated debt issue costs, as of the dates indicated consisted of the following:

	June 30, 2016			December 31, 2015		
		Debt Issue	Long-Term		Debt Issue	Long-Term
	Principal	Costs	Debt, Net	Principal	Costs	Debt, Net
First Term Loan Due 2034	\$24,289,190	\$(1,579,769)	\$22,709,421	\$24,643,081	\$(1,623,810)	\$23,019,271
Second Term Loan Due 2034	9,862,663	(747,471)	9,115,192	10,000,000	(767,672)	9,232,328
Notre Dame Debt	1,300,000	-	1,300,000	1,300,000	-	1,300,000
Term Loan Due 2017	554,982	-	554,982	924,969	-	924,969
Capital Leases	220,969	-	220,969	304,618	-	304,618
	\$36,227,804	\$(2,327,240)	\$33,900,564	\$37,172,668	\$(2,391,482)	\$34,781,186

Less: Long-term debt less unamortized debt issue costs, current portion	(32,551,240)	(1,934,932)
	\$1,349,324	\$32,846,254

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Notes to Consolidated Financial Statements (Continued)

Accrued interest related to our long-term debt, net (reflected as interest payable, current portion and long-term interest payable, net of current portion in our consolidated balance sheets) as of the dates indicated consisted of the following:

	June 30,	December 31,
	2016	2015
Notre Dame Debt	\$1,586,522	\$1,482,801
Second Term Loan Due 2034	42,610	39,193
First Term Loan Due 2034	32,226	34,883
Capital Leases	1,894	2,612
Term Loan Due 2017	463	4,779
	1,663,715	1,564,268
Less: Interest payable, current portion	(77,193)	(81,467)
	\$1,586,522	\$1,482,801

First Term Loan Due 2034. In June 2015, LE entered into a loan agreement and related security agreement with Sovereign as administrative agent and lender, providing for a term loan in the principal amount of \$25.0 million (the "First Term Loan Due 2034"). The First Term Loan Due 2034 matures in June 2034, has a current monthly payment of principal and interest of \$188,416, and accrues interest at a rate based on the Wall Street Journal Prime Rate plus 2.75%. Pursuant to a construction rider in the First Term Loan Due 2034, proceeds available for use were placed in a disbursement account whereby Sovereign makes payments for construction related expenses. Amounts held in the disbursement account are reflected as restricted cash (current portion) and restricted cash, noncurrent in our consolidated balance sheets.

As of June 30, 2016, LE was in violation of the debt service coverage ratio, the current ratio, and debt to net worth ratio financial covenants under the First Term Loan Due 2034. Accordingly, the First Term Loan Due 2034 was classified within the current portion of long-term debt on our consolidated balance sheet as of June 30, 2016. (See "Note (1) Organization – Operating Risks" and "Note (20) Subsequent Events" for additional disclosures related to the First Term Loan Due 2034 and financial covenant violations.)

As a condition of the First Term Loan Due 2034, Jonathan Carroll was required to guarantee repayment of funds borrowed and interest accrued under the loan. For his personal guarantee, LE entered into a Guaranty Fee Agreement with Jonathan Carroll whereby he receives a fee equal to 2.00% per annum, paid monthly, of the outstanding principal balance owed under the First Term Loan Due 2034. For the three months ended June 30, 2016 and 2015, guaranty fees related to the First Term Loan Due 2034 totaled \$121,739 and \$0, respectively. For the six months ended June 30, 2016 and 2015, guaranty fees related to the First Term Loan Due 2034 totaled \$244,372 and \$0, respectively. Guaranty fees are recognized monthly as incurred and are included in interest and other expense in our consolidated statements of operations. LEH, LRM and Blue Dolphin also guaranteed the First Term Loan Due 2034. (See "Note (8) Accounts Payable, Related Party" for additional disclosures related to LEH and Jonathan Carroll.)

A portion of the proceeds of the First Term Loan Due 2034 were used to refinance approximately \$8.5 million of debt owed under a previous debt facility with American First National Bank. Remaining proceeds are being used primarily to construct new petroleum storage tanks at the Nixon Facility. The First Term Loan Due 2034 is secured by: (i) a first lien on all Nixon Facility business assets (excluding accounts receivable and inventory), (ii) assignment of all Nixon Facility contracts, permits, and licenses, (iii) absolute assignment of Nixon Facility rents and leases, including tank rental income, (iv) a \$1.0 million payment reserve account held by Sovereign, and (v) a pledge of \$5.0 million of a life insurance policy on Jonathan Carroll. The First Term Loan Due 2034 contains representations and warranties, affirmative, restrictive, and financial covenants, as well as events of default which are customary for credit facilities of this type.

Second Term Loan Due 2034. In December 2015, LRM entered into a loan agreement and related security agreement with Sovereign as administrative agent and lender, providing for a term loan in the principal amount of \$10.0 million (the "Second Term Loan Due 2034"). The Second Term Loan Due 2034 matures in December 2034, has a current monthly payment of principal and interest of \$74,111, and accrues interest at a rate based on the Wall Street Journal Prime Rate plus 2.75%. Pursuant to a construction rider in the Second Term Loan Due 2034, proceeds available for use were placed in a disbursement account whereby Sovereign makes payments for construction related expenses. Amounts held in the disbursement account are reflected as restricted cash (current portion) and restricted cash, noncurrent in our consolidated balance sheets.

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Notes to Consolidated Financial Statements (Continued)

As of June 30, 2016, LRM was in violation of the debt service coverage ratio, the current ratio, and the debt to net worth ratio financial covenants under the Second Term Loan Due 2034. Accordingly, the Second Term Loan Due 2034 was classified within the current portion of long-term debt on our consolidated balance sheets. (See “Note (1) Organization – Operating Risks” and “Note (20) Subsequent Events” for additional disclosures related to the Second Term Loan Due 2034 and financial covenant violations.)

As a condition of the Second Term Loan Due 2034, Jonathan Carroll was required to guarantee repayment of funds borrowed and interest accrued under the loan. For his personal guarantee, LRM entered into a Guaranty Fee Agreement with Jonathan Carroll whereby he receives a fee equal to 2.00% per annum, paid monthly, of the outstanding principal balance owed under the Second Term Loan Due 2034. For the three months ended June 30, 2016 and 2015, guaranty fees related to the Second Term Loan Due 2034 totaled \$49,420 and \$0, respectively. For the six months ended June 30, 2016 and 2015, guaranty fees related to the Second Term Loan Due 2034 totaled \$99,168 and \$0, respectively. Guaranty fees are recognized monthly as incurred and are included in interest and other expense in our consolidated statements of operations. LEH, LE and Blue Dolphin also guaranteed the Second Term Loan Due 2034. (See “Note (8) Accounts Payable, Related Party” for additional disclosures related to LEH and Jonathan Carroll.)

A portion of the proceeds of the Second Term Loan Due 2034 were used to refinance a previous bridge loan from Sovereign in the amount of \$3.0 million. Remaining proceeds are being used primarily to construct additional new petroleum storage tanks at the Nixon Facility. The Second Term Loan Due 2034 is secured by: (i) a second priority lien on the rights of LE in the Nixon Facility and the other collateral of LE pursuant to a security agreement; (ii) a first priority lien on the real property interests of LRM; (iii) a first priority lien on all of LRM’s fixtures, furniture, machinery and equipment; (iv) a first priority lien on all of LRM’s contractual rights, general intangibles and instruments, except with respect to LRM’s rights in its leases of certain specified tanks, with respect to which Sovereign has a second priority lien in such leases subordinate to a prior lien granted by LRM to Sovereign to secure obligations of LRM under the Term Loan Due 2017; and (v) all other collateral as described in the security documents. The Second Term Loan Due 2034 contains representations and warranties, affirmative, restrictive, and financial covenants, as well as events of default which are customary for credit facilities of this type.

Notre Dame Debt. LE entered into a loan with Notre Dame Investors, Inc. as evidenced by a Promissory Note in the original principal amount of \$8.0 million, which is currently held by John Kissick (the “Notre Dame Debt”). The Notre Dame Debt matures in January 2018, and accrues interest at a rate of 16.00%.

The Notre Dame Debt is secured by a Deed of Trust, Security Agreement and Financing Statements (the “Subordinated Deed of Trust”), which encumbers the Nixon Facility and general assets of LE. There are no financial maintenance covenants associated with the Notre Dame Debt. Pursuant to a Subordination Agreement dated June 2015, the holder of the Notre Dame Debt agreed to subordinate any security interest and liens on the Nixon Facility, as well as its right to payments, in favor of Sovereign as holder of the First Term Loan Due 2034.

Term Loan Due 2017. LRM entered into a Loan and Security Agreement with Sovereign in May 2014, for a term loan facility in the principal amount of \$2.0 million (the “Term Loan Due 2017”). The Term Loan Due 2017 was amended in March 2015, pursuant to a Loan Modification Agreement (the “March Loan Modification Agreement”). Under the March Loan Modification Agreement, the interest rate was modified to be the greater of the Wall Street Journal Prime Rate plus 2.75% or 6.00%, and the due date was extended to March 2017. Pursuant to the March Loan Modification Agreement, the Term Loan Due 2017 has a current monthly principal payment of \$61,665 plus interest. Due to its maturity date, the Term Loan Due 2017 was classified within the current portion of long-term debt on our consolidated balance sheet as of June 30, 2016.

As a condition of the Term Loan Due 2017, Jonathan Carroll was required to guarantee repayment of funds borrowed and interest accrued under the loan. For his personal guarantee, LRM entered into a Guaranty Fee Agreement with Jonathan Carroll whereby he receives a fee equal to 2.00% per annum, paid monthly, of the outstanding principal balance owed under the Term Loan Due 2017. For the three months ended June 30, 2016 and 2015, guaranty fees related to the Term Loan Due 2017 totaled \$3,083 and \$0, respectively. For the six months ended June 30, 2016 and 2015, guaranty fees related to the Term Loan Due 2017 totaled \$7,091 and \$0, respectively. Guaranty fees are recognized monthly as incurred and are included in interest and other expense in our consolidated statements of operations.

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Notes to Consolidated Financial Statements (Continued)

The proceeds of the Term Loan Due 2017 were used primarily to finance costs associated with refurbishment of the Nixon Facility's naphtha stabilizer and depropanizer units. The Term Loan Due 2017 is: (i) subject to a financial maintenance covenant pertaining to debt service coverage ratio and (ii) secured by the assignment of certain leases of LRM and certain assets of LEH. (See "Note (8) Accounts Payable, Related Party" for additional disclosures related to LEH and Jonathan Carroll.)

Capital Leases. LRM entered into a 36-month build-to-suit capital lease in August 2014 for the purchase of new boiler equipment for the Nixon Facility. The equipment, which was delivered in December 2014, was added to construction in progress. Once placed in service, the equipment will be reclassified to refinery and facilities and depreciation will begin. The capital lease, which requires a quarterly payment in the amount of \$44,258, is guaranteed by Blue Dolphin.

A summary of equipment held under long-term capital leases as of the dates indicated follows:

	June 30,	December 31,
	2016	2015
Boiler equipment	\$538,598	\$538,598
Less: accumulated depreciation	-	-
	\$538,598	\$538,598

(10) Accrued Expenses and Other Current Liabilities

Accrued expenses and other current liabilities as of the dates indicated consisted of the following:

	June 30,	December 31,
	2016	2015
Unearned revenue	\$332,055	\$781,859
Excise and income taxes payable	273,735	1,290,101
Other payable	152,914	157,714
Transportation and inspection	123,337	-
Board of director fees payable	101,429	86,429
Property taxes	61,178	-
Insurance	25,756	103,024
Inspection fees	17,250	-

Genesis JMA Profit Share payable	-	388,364
Unrealized hedging loss	-	183,400
	\$1,087,654	\$2,990,891

(11) Asset Retirement Obligations

Refinery and Facilities. Management has concluded that there is no legal or contractual obligation to dismantle or remove the refinery and facilities assets. Management believes that the refinery and facilities assets have indeterminate lives under FASB ASC guidance for estimating AROs because dates or ranges of dates upon which we would retire these assets cannot reasonably be estimated at this time. When a legal or contractual obligation to dismantle or remove the refinery and facilities assets arises and a date or range of dates can reasonably be estimated for the retirement of these assets, we will estimate the cost of performing the retirement activities and record a liability for the fair value of that cost using present value techniques.

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Notes to Consolidated Financial Statements (Continued)

Pipelines and Facilities and Oil and Gas Properties. We have AROs associated with the dismantlement and abandonment in place of our pipelines and facilities assets, as well as the plugging and abandonment of our oil and gas properties. We recorded a discounted liability for the fair value of an ARO with a corresponding increase to the carrying value of the related long-lived asset at the time the asset was installed or placed in service. We depreciate the amount added to property and equipment and recognize accretion expense in connection with the discounted liability over the remaining life of the asset. Plugging and abandonment costs are recorded during the period incurred or as information becomes available to substantiate actual and/or probable costs.

Changes to our ARO liability for the periods indicated were as follows:

	June 30,	December 31,
	2016	2015
Asset retirement obligations, at the beginning of the period	\$1,985,864	\$1,866,770
New asset retirement obligations and adjustments	-	49
Liabilities settled	(59,247)	(92,330)
Accretion expense	56,372	211,375
	1,982,989	1,985,864
Less: asset retirement obligations, current portion	(26,399)	(38,644)
Long-term asset retirement obligations, at the end of the period	\$1,956,590	\$1,947,220

Liabilities settled represents amounts paid for plugging and abandonment costs against the asset's ARO liability and are reflected in our consolidated balance sheets. As of June 30, 2016 and December 31, 2015, we recognized \$59,247 and \$92,330, respectively, in liabilities settled. Abandonment expense represents amounts paid for plugging and abandonment costs that exceed the asset's ARO liability and are reflected in our consolidated statements of operations. For the three months ended June 30, 2016 and 2015, we recognized \$0 in abandonment expense. For the six months ended June 30, 2016 and 2015, we recognized \$0 in abandonment expense.

(12) Treasury Stock

As of June 30, 2016 and December 31, 2015, we had 150,000 shares of treasury stock.

(13) Concentration of Risk

Bank Accounts. Financial instruments that potentially subject us to concentrations of risk consist primarily of cash, trade receivables and payables. We maintain our cash balances at financial institutions located in Houston, Texas. In the U.S., the Federal Deposit Insurance Corporation (the "FDIC") insures certain financial products up to a maximum of \$250,000 per depositor. We had cash balances in excess of the FDIC insurance limit per depositor in the amount of \$13,716,774 and \$19,594,883 as of June 30, 2016 and December 31, 2015, respectively.

Key Supplier. Under a Crude Oil and Supply Throughput Services Agreement dated in August 2011 (the “Crude Supply Agreement”), GEL supplies crude oil and condensate to the Nixon Facility. The initial term of the Crude Supply Agreement was to expire in August 2014. However, in October 2013, we entered into a Letter Agreement Regarding Certain Advances and Related Agreements with GEL and Milam Services, Inc., another Genesis affiliate (“Milam”), (the “October 2013 Letter Agreement”), effective in October 2013. In accordance with the terms of the October 2013 Letter Agreement, we agreed not to terminate the Crude Supply Agreement and GEL agreed to automatically renew the Crude Supply Agreement at the end of the initial term for successive one year periods until August 2019, unless sooner terminated by GEL with 180 days prior written notice.

(See “Note (19) Commitments and Contingencies – Genesis Agreements” and “Legal Matters” for a summary of the Crude Supply Agreement and a discussion of the current contractual dispute with Genesis.)

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Notes to Consolidated Financial Statements (Continued)

Significant Customers. We routinely assess the financial strength of our customers and have not experienced significant write-downs in our accounts receivable balances. As a result, we believe that our accounts receivable credit risk exposure is limited. For the three months ended June 30, 2016, we had 4 customers that accounted for approximately 71% of our refined petroleum products sales. These 4 customers represented approximately \$6.2 million in accounts receivable as of June 30, 2016. For the three months ended June 30, 2015, we had 5 customers that accounted for approximately 82% of our refined petroleum products sales. These 5 customers represented approximately \$5.2 million in accounts receivable as of June 30, 2015.

For the six months ended June 30, 2016, we had 4 customers that accounted for approximately 64% of our refined petroleum products sales. These 4 customers represented approximately \$6.2 million in accounts receivable as of June 30, 2016. For the six months ended June 30, 2015, we had 3 customers that accounted for approximately 58% of our refined petroleum products sales. These 3 customers represented approximately \$3.2 million in accounts receivable as of June 30, 2015.

Refined Petroleum Product Sales. Our refined petroleum products are primarily sold in the U.S. However, with the opening of the Mexican diesel market to private companies, we began exporting low sulfur diesel to Mexico during the second quarter of 2016. Total refined petroleum product sales by distillation (from light to heavy) for the periods indicated consisted of the following:

	Three Months Ended June 30,				Six Months Ended June 30,			
	2016		2015		2016		2015	
LPG mix	\$133,757	0.3%	\$234,184	0.4%	\$384,304	0.8%	\$291,492	0.2%
Naphtha	7,287,804	17.6%	13,413,484	22.7%	16,313,325	28.9%	26,829,683	22.4%
Jet fuel	17,539,473	42.4%	17,411,470	29.6%	26,045,786	27.3%	33,930,973	28.3%
HOBM	7,889,499	19.1%	13,622,360	23.2%	11,052,994	10.1%	31,031,439	25.9%
Reduced Crude	546,112	1.3%	-	0.0%	3,791,919	10.4%	-	0.0%
AGO	8,005,641	19.3%	14,157,662	24.1%	15,007,095	22.5%	27,822,635	23.2%
	\$41,402,286	100.0%	\$58,839,160	100.0%	\$72,595,423	100.0%	\$119,906,222	100.0%

(14) Leases

Our company headquarters is located in downtown Houston, Texas. We lease 13,878 square feet of office space, 7,389 square feet of which is used and paid for by LEH. The office lease has a 10-year term that expires in September 2017. The lease included a free rent period, has escalating rent payment provisions, and requires payment of a portion of operating expenses. Rent expense is recognized on a straight-line basis. For the three months ended June 30, 2016 and 2015, rent expense totaled \$29,857 and \$57,060, respectively. For the six months ended June 30, 2016 and 2015, rent

expense totaled \$59,715 and \$82,889, respectively.

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(15) Income Taxes

Income Tax Benefit (Expense). Income tax benefit (expense) for the periods indicated consisted of the following:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
Current:				
Federal	\$-	\$14,038	\$-	\$(85,242)
State	-	(29,701)	-	(112,554)
Deferred:				
Federal	1,534,341	(85,066)	2,653,721	(1,892,551)
	\$1,534,341	\$(100,729)	\$2,653,721	\$(2,090,347)

The state of Texas has a Texas margins tax (“TMT”), which is a form of business tax imposed on gross margin. Although TMT is imposed on an entity’s gross margin rather than on its net income, certain aspects of TMT make it similar to an income tax. Accordingly, TMT is treated as an income tax for financial reporting purposes.

Deferred Income Taxes. Deferred income tax balances reflect the effects of temporary differences between the carrying amounts of assets and liabilities and their tax basis, as well as from NOL carryforwards. We state those balances at the enacted tax rates we expect will be in effect when taxes are actually paid. NOL carryforwards and deferred tax assets represent amounts available to reduce future taxable income.

NOL Carryforwards. Under Section 382 of the Internal Revenue Code of 1986, as amended (“IRC Section 382”), a corporation that undergoes an “ownership change” is subject to limitations on its use of pre-change NOL carryforwards to offset future taxable income. Within the meaning of IRC Section 382, an “ownership change” occurs when the aggregate stock ownership of certain stockholders (generally 5% shareholders, applying certain look-through rules) increases by more than 50 percentage points over such stockholders' lowest percentage ownership during the testing period (generally three years). For income tax purposes, we experienced ownership changes in 2005, in connection with a series of private placements, and in 2012, as a result of a reverse acquisition, that limit the use of pre-change NOL carryforwards to offset future taxable income. In general, the annual use limitation equals the aggregate value of common stock at the time of the ownership change multiplied by a specified tax-exempt interest rate. The 2012 ownership change will subject approximately \$18.8 million in NOL carryforwards that were generated prior to the ownership change to an annual use limitation of \$638,196 per year. Unused portions of the annual use limitation amount may be used in subsequent years. As a result of the annual use limitation, approximately \$6.7 million in NOL carryforwards that were generated prior to the 2012 ownership change will expire unused. NOL carryforwards that were generated after the 2012 ownership change are not subject to an annual use limitation under IRC Section 382 and may be used in addition to available amounts of NOL carryforwards generated prior to the ownership change.

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NOL carryforwards that remained available for future use for the periods indicated were as follow (amounts shown are net of NOLs that will expire unused as a result of the IRC Section 382 limitation):

	Net Operating Loss Carryforward		
	Pre-Ownership Change	Post-Ownership Change	Total
Balance at December 31, 2014	\$10,766,912	\$12,145,789	\$22,912,701
Net operating loss carryforwards utilized	(1,152,463)	(2,528,848)	(3,681,311)
Balance at December 31, 2015	\$9,614,449	\$9,616,941	\$19,231,390
Net operating losses	-	5,871,350	5,871,350
Balance at March 31, 2016	\$9,614,449	\$15,488,291	\$25,102,740
Net operating losses	-	4,230,763	4,230,763
Balance at June 30, 2016	\$9,614,449	\$19,719,054	\$29,333,503

Deferred Tax Assets and Liabilities. As of June 30, 2016 and December 31, 2015, approximately \$6.3 million and \$3.6 million, respectively, of net deferred tax assets remained available for future use. Significant components of deferred tax assets and liabilities as of the dates indicated were as follow:

	June 30, 2016	December 31, 2015
Deferred tax assets:		
Net operating loss and capital loss carryforwards	\$12,243,743	\$8,815,794
Start-up costs (Nixon Facility)	1,442,032	1,510,699
Asset retirement obligations liability/deferred revenue	709,657	717,723
Unrealized hedges	-	62,356
AMT credit and other	275,857	302,086
Total deferred tax assets	14,671,289	11,408,658

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Deferred tax liabilities:		
Fair market value adjustments	(46,116)	(46,116)
Unrealized hedges	(68,663)	-
Basis differences in property and equipment	(5,978,709)	(5,484,983)
Total deferred tax liabilities	(6,093,488)	(5,531,099)
	8,577,801	5,877,559
Valuation allowance	(2,270,322)	(2,270,322)
Deferred tax assets, net	\$6,307,479	\$3,607,237

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Valuation Allowance. As of each reporting date, management considers new evidence, both positive and negative, that could impact management's view with regard to future realization of deferred tax assets. As of June 30, 2016 and December 31, 2015, management determined that sufficient positive evidence existed to conclude that it was more likely than not that net deferred tax assets of approximately \$6.3 million and \$3.6 million, respectively, were realizable, and as a result, reflected a valuation allowance of \$2.3 million at each date.

Current Versus Long-Term. Effective April 1, 2016, we adopted the provisions of the FASB ASC guidance that simplifies the presentation of deferred income taxes by requiring that deferred tax liabilities and assets be classified as noncurrent instead of separated into current and noncurrent. Accordingly, our consolidated balance sheet as of December 31, 2015 has been changed to reclassify approximately \$3.5 million previously reported as deferred tax assets, current portion, net to deferred tax assets, net.

Uncertain Tax Positions. We adopted the provisions of the FASB ASC guidance on accounting for uncertainty in income taxes. The guidance clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements. The guidance 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 standard also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition.

As part of this guidance, we record income tax related interest and penalties, if applicable, as a component of the provision for income tax benefit (expense). However, there were no amounts recognized relating to interest and penalties in the consolidated statements of operations for the three and six months ended June 30, 2016 and 2015. Our federal income tax returns are subject to examination by the Internal Revenue Service for tax years ending December 31, 2012, or after and by the state of Texas for tax years ending December 31, 2011, or after. We believe there are no uncertain tax positions for both federal and state income taxes.

(16) Earnings Per Share

A reconciliation between basic and diluted income per share for the periods indicated was as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
Net income (loss)	\$(3,162,736)	\$137,879	\$(5,311,820)	\$3,839,243
Basic and diluted income per share	\$(0.30)	\$0.01	\$(0.51)	\$0.37
Basic and Diluted Weighted average number of shares of common stock	10,459,996	10,450,210	10,458,895	10,444,829

outstanding and potential dilutive shares of common stock

Diluted EPS is computed by dividing net income available to common stockholders by the weighted average number of shares of common stock outstanding. Diluted EPS for the three and six months ended June 30, 2016 and 2015 was the same as basic EPS as there were no stock options or other dilutive instruments outstanding.

(17) Fair Value Measurement

The purchase and sale of financial instruments may be executed for the purpose of economically hedging commodity price risks associated with our refined petroleum products and the purchase of crude oil and condensate. When executed these financial instruments are direct contractual obligations of our crude supplier and not us. However, we financially benefit from any gains and financially bear any losses associated with the purchase and/or sale of such financial instruments. Because such instruments represent embedded derivatives for the purpose of financial reporting, we account for such embedded derivatives in our financial records by utilizing the market approach when measuring fair value of our financial instruments (typically in current assets and/or liabilities, as discussed below). The market approach uses prices and other relevant information generated by such market transactions executed on our behalf involving identical or comparable assets or liabilities.

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Notes to Consolidated Financial Statements (Continued)

Generally accepted accounting principles establish a framework for measuring fair value. That framework provides a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The fair value hierarchy consists of the following three levels:

Level 1 Inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities.

Level 2 Inputs are quoted prices for similar assets or liabilities in an active market, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable and market-corroborated inputs, which are derived principally from or corroborated by observable market data.

Level 3 Inputs are derived from valuation techniques in which one or more significant inputs or value drivers are unobservable and cannot be corroborated by market data or other entity-specific inputs.

The carrying amounts of accounts receivable, accounts payable, and accrued liabilities approximated their fair values as of June 30, 2016 and December 31, 2015 due to their short-term maturities. The fair value of our long-term debt, net including the current portion as of June 30, 2016 and December 31, 2015 was \$36,227,804 and \$37,172,668, respectively. The fair value of our debt was determined using a Level 3 hierarchy.

The following table represents our assets and liabilities measured at fair value on a recurring basis as of June 30, 2016 and December 31, 2015 and the basis for the measurement:

Fair Value Measurement at June 30, 2016 Using

Financial assets (liabilities):	Carrying Value at June 30, 2016	Quoted Prices in Active Markets for Identical Assets or Liabilities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Commodity contracts	\$201,950	\$201,950	\$-	\$-

Fair Value Measurement at December 31, 2015 Using

Financial assets (liabilities):	Carrying Value at December 31, 2015	Quoted Prices in Active Markets for Identical Assets or Liabilities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
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Commodity contracts	\$(183,400)	\$(183,400)	\$-	\$-
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Carrying amounts of commodity contracts are reflected as other current assets or other current liabilities in our consolidated balance sheets.

(18) Inventory Risk Management

Management periodically determines whether to maintain, increase, or decrease inventory levels based on various factors, including the crude pricing market in the U.S. Gulf Coast region, the refined petroleum products market in the same region, the relationship between these two markets, fulfilling contract demands, and other factors that may impact our operations, financial condition, and cash flows. Under our inventory risk management policy, commodity futures contracts may be used to mitigate the change in value for certain of our refined petroleum product inventories subject to market price fluctuations in our inventory. The physical inventory volumes are not exchanged, and these contracts are net settled with cash.

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The fair value of commodity futures contracts is reflected in our consolidated balance sheets and the related net gain or loss is recorded within cost of refined products sold in our consolidated statements of operations. Quoted prices for identical assets or liabilities in active markets (Level 1) are considered to determine the fair values for the purpose of marking to market the financial instruments at each period end.

Commodity transactions are executed to minimize transaction costs, monitor consolidated net exposures, and allow for increased responsiveness to changes in market factors. Due to mark-to-market accounting during the term of the commodity futures contracts, significant unrealized non-cash net gains and losses could be recorded in our results of operations.

As of June 30, 2016, we had the following obligations based on futures contracts of refined petroleum products and crude oil and condensate that were entered into as economic hedges. The information presents the notional volume of open commodity instruments by type and year of maturity (volumes in bbls):

	Notional Contract Volumes by Year of Maturity		
	2016	2017	2018
Inventory positions (futures):			

Refined petroleum products and crude oil -

net short positions	330,000	-	-
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The following table provides the location and fair value amounts of derivative instruments that are reported in our consolidated balance sheets as of June 30, 2016 and December 31, 2015:

Asset Derivatives	Balance Sheets Location	Fair Value	
		June 30, 2016	December 31, 2015
Commodity contracts	Prepaid expenses and other current assets (accrued expenses and other current liabilities)	\$201,950	\$(183,400)

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The following table provides the effect of derivative instruments in our consolidated statements of operations for the three and six months ended June 30, 2016 and 2015:

Derivatives	Statements of Operations Location	Loss Recognized			
		2016	2015	2016	2015
Commodity contracts	Cost of refined products sold	\$(3,852,100)	\$(1,370,293)	\$(3,359,572)	\$(442,709)

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Notes to Consolidated Financial Statements (Continued)

(19) Commitments and Contingencies

Operating Agreement. (See “No