

BLUE DOLPHIN ENERGY CO
Form 10-Q
October 12, 2017

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, 2017
or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____
Commission File No. 0-15905

BLUE DOLPHIN ENERGY COMPANY
(Exact name of registrant as specified in its charter)

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

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

(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, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

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Large accelerated filer Accelerated filer

Non-accelerated filer Smaller reporting company

(Do not check if a
smaller reporting
company)

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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 October 12, 2017: 10,818,371

BLUE DOLPHIN ENERGY COMPANY FORM 10-Q 6/30/17

TABLE OF CONTENTS

GLOSSARY OF SELECTED OIL AND GAS TERMS	3
PART I. FINANCIAL INFORMATION	5
ITEM 1. FINANCIAL STATEMENTS	5
Consolidated Balance Sheets (Unaudited)	5
Consolidated Statements of Operations (Unaudited)	6
Consolidated Statements of Cash Flows (Unaudited)	7
Notes to Consolidated Financial Statements	8
ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS	39
ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK	59
ITEM 4. CONTROLS AND PROCEDURES	59
PART II OTHER INFORMATION	60
ITEM 1. LEGAL PROCEEDINGS	60
ITEM 1A. RISK FACTORS	61
ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS	62
ITEM 3. DEFAULTS UPON SENIOR SECURITIES	62
ITEM 4. MINE SAFETY DISCLOSURES	62
ITEM 5. OTHER INFORMATION	63
ITEM 6. EXHIBITS	63
SIGNATURES	64

BLUE DOLPHIN ENERGY COMPANY FORM 10-Q 6/30/17

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 Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2017 (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 about oil or other liquid hydrocarbons.

Blending. The physical mixture of several 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 like 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 our low-sulfur diesel and 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 per 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.

BLUE DOLPHIN ENERGY COMPANY FORM 10-Q 6/30/17

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.

Product Slate. Represents type and quality of products produced.

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 per 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.

BLUE DOLPHIN ENERGY COMPANY FORM 10-Q 6/30/17

PART I. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

Consolidated Balance Sheets (Unaudited)

BLUE DOLPHIN
ENERGY
COMPANY &
SUBSIDIARIES
CONSOLIDATED
BALANCE SHEET

	June 30,	December 31,
	2017	2016
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	\$65,064	\$1,152,628
Restricted cash	1,481,626	3,347,835
Accounts receivable, net	436,305	2,022,166
Accounts receivable, related party	-	1,161,589
Prepaid expenses and other current assets	1,103,308	1,046,191
Deposits	138,957	138,957
Inventory	3,848,449	2,075,538
Total current assets	7,073,709	10,944,904
Total property and equipment, net	64,313,447	62,324,463
Restricted cash, noncurrent	563,336	1,582,305
Surety bonds	230,000	205,000
Trade name	303,346	303,346
Total long-term assets	65,410,129	64,415,114
TOTAL ASSETS	\$72,483,838	\$75,360,018
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES		
Long-term debt less unamortized debt issue costs, current portion	\$32,311,034	\$ 31,712,336
Interest payable, current portion	2,444,239	323,756

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Long-term debt, related party, current portion	500,000	500,000
Accounts payable	3,677,808	14,552,383
Accounts payable, related party	672,000	369,600
Asset retirement obligations, current portion	17,068	17,510
Accrued expenses and other current liabilities	1,805,266	1,281,582
Accrued arbitration award payable	31,278,563	-
Total current liabilities	72,706,068	48,757,167
Long-term liabilities:		
Asset retirement obligations, net of current portion	2,153,817	2,010,129
Deferred revenues and expenses	62,542	83,390
Long-term debt less unamortized debt issue costs, net of current portion	-	1,300,000
Long-term debt, related party, net of current portion	7,240,372	4,814,690
Long-term interest payable, net of current portion	-	1,691,383
Total long-term liabilities	9,456,731	9,899,592
TOTAL LIABILITIES	82,162,799	58,656,759
Commitments and contingencies (Note 18)		
STOCKHOLDERS' EQUITY		
Common stock (\$0.01 par value, 20,000,000 shares authorized; 10,818,371 and 10,624,714 shares issued at June 30, 2017 and December 31, 2016, respectively)	108,184	106,248
Additional paid-in capital	36,877,604	36,818,528
Accumulated deficit	(46,664,749)	(19,421,517)
Treasury stock (0 and 150,000 shares at cost at June 30, 2017 and December 31, 2016, respectively)	-	(800,000)
Total stockholders' equity	(9,678,961)	16,703,259
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$72,483,838	\$75,360,018

See accompanying notes to consolidated financial statements.

BLUE DOLPHIN ENERGY COMPANY FORM 10-Q 6/30/17

Consolidated Statements of Operations (Unaudited)

BLUE DOLPHIN
ENERGY
COMPANY &
SUBSIDIARIES
CONSOLIDATED
STATEMENTS OF
OPERATIONS

Three Months Ended June 30, Six Months Ended June 30,

2017 2016 2017 2016

REVENUE FROM OPERATIONS

Refined petroleum product sales	\$56,632,620	\$41,402,286	\$108,534,658	\$72,595,423
Tank rental revenue	703,711	615,487	1,407,422	906,974
Other operations	-	24,687	-	52,339
Total revenue from operations	57,336,331	42,042,460	109,942,080	73,554,736

COST OF OPERATIONS

Cost of refined products sold	54,624,947	42,633,298	106,399,449	73,626,775
Refinery operating expenses	1,651,663	2,877,748	4,464,766	6,314,763
Joint Marketing Agreement profit share	-	97,527	-	(573,565)
Other operating expenses	54,282	103,650	115,126	197,592
Arbitration award and associated fees	24,338,628	-	24,338,628	-
General and administrative expenses	708,391	255,319	1,614,481	612,323
Depletion, depreciation and amortization	449,318	470,347	900,343	910,800
Bad debt recovery	-	-	-	(139,868)
Accretion expense	71,844	28,186	143,688	56,372
Total cost of operations	81,899,073	46,466,075	137,976,481	81,005,192
Loss from operations	(24,562,742)	(4,423,615)	(28,034,401)	(7,450,456)

OTHER INCOME (EXPENSE)

Easement, interest and other income	1,089	126,097	383,082	257,860
Interest and other expense	(831,629)	(399,559)	(1,426,413)	(819,466)
Gain on disposal of property	-	-	1,834,500	-
Total other income (expense)	(830,540)	(273,462)	791,169	(561,606)

Loss before income taxes	(25,393,282)	(4,697,077)	(27,243,232)	(8,012,062)
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Income tax benefit	-	1,534,341	-	2,700,242
Net loss	\$(25,393,282)	\$(3,162,736)	\$(27,243,232)	\$(5,311,820)
Loss per common share:				
Basic	\$(2.39)	\$(0.30)	\$(2.58)	\$(0.51)
Diluted	\$(2.39)	\$(0.30)	\$(2.58)	\$(0.51)
Weighted average number of common shares outstanding:				
Basic	10,637,101	10,459,996	10,556,356	10,458,895
Diluted	10,637,101	10,459,996	10,556,356	10,458,895

See accompanying notes to consolidated financial statements.

BLUE DOLPHIN ENERGY COMPANY FORM 10-Q 6/30/17

Consolidated Statements of Cash Flows (Unaudited)

BLUE DOLPHIN
ENERGY
COMPANY &
SUBSIDIARIESCONSOLIDATED
CASH FLOW
STATEMENT

	Six Months Ended June 30,	
	2017	2016
OPERATING ACTIVITIES		
Net loss	\$(27,243,232)	\$(5,311,820)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depletion, depreciation and amortization	900,343	910,800
Unrealized gain on derivatives	-	(385,350)
Deferred tax benefit	-	(2,700,242)
Amortization of debt issue costs	64,242	64,243
Accretion of asset retirement obligations	143,688	56,372
Common stock issued for services	30,000	50,000
Recovery of bad debt	-	(139,868)
Changes in operating assets and liabilities		
Accounts receivable	1,585,862	(3,535,787)
Accounts receivable, related party	1,161,589	-
Prepaid expenses and other current assets	(57,117)	298,001
Deposits and other assets	(25,000)	446,449
Inventory	(1,772,911)	(1,875,803)
Accounts payable, accrued expenses and other liabilities	19,943,605	13,256,568
Accounts payable, related party	302,400	561,963
Net cash provided by (used in) operating activities	(4,966,531)	1,695,526
INVESTING ACTIVITIES		
Capital expenditures	(1,407,701)	(7,072,978)
Net cash used in investing activities	(1,407,701)	(7,072,978)
FINANCING ACTIVITIES		
Payments on debt	(855,204)	(944,865)
Net activity on related-party debt	3,256,694	

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Net cash provided by (used in) financing activities	2,401,490	(944,865)
Net decrease in cash, cash equivalents, and restricted cash	(3,972,742)	(6,322,317)

CASH, CASH EQUIVALENTS, AND RESTRICTED CASH AT BEGINNING OF PERIOD	6,082,768	20,645,652
CASH, CASH EQUIVALENTS, AND RESTRICTED CASH AT END OF PERIOD	\$2,110,026	\$14,323,335

Supplemental Information:

Non-cash investing and financing activities:

Financing of capital expenditures via accounts payable	\$1,481,626	\$2,593,379
Financing of guaranty fees via long-term debt, related party	\$110,700	\$-
Conversion of accounts payable to short-term notes	\$-	\$-
Conversion of related-party notes to common stock	\$831,012	\$-
Interest paid	\$1,332,653	\$988,979
Income taxes paid	\$-	\$-

See accompanying notes to consolidated financial statements.

BLUE DOLPHIN ENERGY COMPANY FORM 10-Q 6/30/17

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 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 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”). LEH operates and manages all our properties pursuant to an Amended and Restated Operating Agreement (the “Amended and Restated 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. Together LEH and Jonathan Carroll own approximately 81% of our common stock, par value \$0.01 per share (the “Common Stock”). (See “Note (8) Related Party Transactions,” “Note (10) Long-Term Debt, Net” and “Note (18) Commitments and Contingencies – Financing Agreements” for additional disclosures related to LEH, the Amended and Restated 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 I, Item 1. Business and Item 2. Properties” in our Annual Report on Form 10-K for the fiscal year ended December 31, 2016 (the “Annual Report”) as filed with the Securities and Exchange Commission (the “SEC”) for additional information regarding our operating subsidiaries, principal facilities, and assets.

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.

Going Concern. Management has determined that certain factors raise substantial doubt about our ability to continue as a going concern. These factors include the following:

Final GEL Arbitration Award. As previously disclosed, we have been involved in arbitration proceedings (the “GEL Arbitration”) with GEL Tex Marketing, LLC (“GEL”), an affiliate of Genesis Energy, LP (“Genesis”), related to a contractual dispute involving a Crude Oil Supply and Throughput Services Agreement (the “Crude Supply Agreement”) and a Joint Marketing Agreement (the “Joint Marketing Agreement”), each between LE and GEL and dated August 12, 2011. On August 11, 2017, the arbitrator delivered its final award in the GEL Arbitration (the “Final Arbitration Award”). The Final Arbitration Award denied all of LE’s claims against GEL and granted substantially all of the relief requested by GEL in its counterclaims. Among other matters, the Final Arbitration Award awarded damages, legal and administrative fees and court costs to GEL in the aggregate amount of approximately \$31.3 million. This resulted in a net increase in current liabilities of approximately \$24.3 million on our consolidated balance sheet at June 30, 2017.

BLUE DOLPHIN ENERGY COMPANY FORM 10-Q 6/30/17
Notes to Consolidated Financial Statements (Continued)

A hearing on confirmation of the Final Arbitration Award was scheduled to occur on September 18, 2017 in state district court in Harris County, Texas. Prior to the scheduled hearing, LE and GEL jointly notified the court that the hearing would be continued for a period of no more than 90 days after September 18, 2017 (the “Continuance Period”), to facilitate settlement discussions between the parties. On September 26, 2017, LE and Blue Dolphin, together with LEH and Jonathan Carroll, entered into a Letter Agreement with GEL, effective September 18, 2017 (the “GEL Letter Agreement”), confirming the parties’ agreement to the continuation of the confirmation hearing during the Continuance Period, subject to the terms of the GEL Letter Agreement. GEL may terminate the GEL Letter Agreement on the 45th day of the Continuance Period, or November 1, 2017, if GEL determines, in its sole discretion, that settlement discussions between the parties are not advancing to an acceptable resolution. If we are unable to reach an acceptable settlement with Genesis and GEL and GEL seeks to confirm and enforce the Final Arbitration Award, our business, financial condition and results of operations will be materially affected, and we likely would be required to seek protection under bankruptcy laws.

Sovereign Bank (“Sovereign”) has delivered to us notices of default under our secured loan agreements with Sovereign, stating that the Final Arbitration Award constitutes an event of default under the secured loan agreements. The occurrence of an event of default permits Sovereign to declare the amounts owed under these loan agreements immediately due and payable, exercise its rights with respect to collateral securing our obligations under these loan agreements, and/or exercise any other rights and remedies available. Sovereign has informed us that it not currently exercising its rights and remedies under the secured loan agreements in light of the ongoing settlement discussions with GEL and the continuance of the hearing on confirmation of the Final Arbitration Award and to allow Sovereign to evaluate any proposed settlement agreement related to the Final Arbitration Award, which would require Sovereign’s approval. However, Sovereign expressly reserved all of its rights, privileges and remedies related to events of default under the secured loan agreements and informed us that it would consider a final confirmation of the Final Arbitration Award to be a material event of default under the loan agreements. Any exercise by Sovereign of its rights and remedies under the secured loan agreements would have a material adverse effect on our business, financial condition and results of operations and likely would require us to seek protection under bankruptcy laws. The debt associated with loans under secured loan agreements was classified within the current portion of long-term debt on our consolidated balance sheet at June 30, 2017 due to existing or potential events of default related to the Final Arbitration Award as well as the uncertainty of our ability to meet financial covenants in the secured loan agreements in the future.

We are currently evaluating the effects of the Final Arbitration Award on our business, financial condition and results of operations. In addition to the matters described above, the Final Arbitration Award could materially and adversely affect our ability to procure adequate amounts of crude oil and condensate and our relationships with our customers.

For additional information regarding the Final Arbitration Award, the GEL Letter Agreement, and their potential effects on our business, financial condition and results of operations, see “Note (10) Long-Term Debt, Net,” “Note (18) Commitments and Contingencies” and “Note (19) Subsequent Events.”

Operating Risks. Successful execution of our business plan depends on several key factors, including having adequate crude oil and condensate supplies, increasing sales of refined petroleum products, and meeting contractual obligations. For the three and six months ended June 30, 2017, execution of our business plan was negatively impacted by several factors, including:

Net Losses – For the three months ended June 30, 2017, we reported a net loss of \$25,393,282, or a loss of \$2.39 per share, compared to a net loss of \$3,162,736, or a loss of \$0.30 per share, for the three months ended June 30,

2016. The \$2.09 per share increase in net loss between the periods was primarily the result of the Final Arbitration Award in the current three-month period. For the six months ended June 30, 2017, we reported a net loss of \$27,243,232, or a loss of \$2.58 per share, compared to a net loss of \$5,311,820, or a loss of \$0.51 per share, for the six months ended June 30, 2016. The \$2.07 per share increase in net loss between the periods was primarily the result of the Final Arbitration Award.

BLUE DOLPHIN ENERGY COMPANY FORM 10-Q 6/30/17
Notes to Consolidated Financial Statements (Continued)

Working Capital Deficits – We had a working capital deficit of \$65,632,359 at June 30, 2017 compared to a working capital deficit of \$37,812,263 at December 31, 2016. Excluding long-term debt, we had a working capital deficit of \$32,821,325 at June 30, 2017, compared to working capital of \$5,599,927 at December 31, 2016. The significant increase in working capital deficit between the periods primarily related to recording a current liability of \$31,278,563 related to the Final Arbitration Award, a decrease in cash and cash equivalents, and a decrease in accounts receivable.

Termination of Relationship with Genesis and GEL – As previously disclosed and discussed elsewhere in this Quarterly Report, we ceased purchases of crude oil and condensate from GEL under the Crude Supply Agreement in November 2016 and suspended the marketing and sale of refined petroleum products under the Joint Marketing Agreement following the processing of all crude oil and condensate supplied by GEL.

Crude Supply Issues – We currently have in place a month-to-month evergreen crude supply contact with a major integrated oil and gas company. This new supplier currently provides us with adequate amounts of crude oil and condensate, and we expect the supplier to continue to do so for the foreseeable future. However, our ability to purchase adequate amounts of crude oil and condensate is dependent on our liquidity and access to capital, which have been adversely affected by the contract-related dispute with GEL and other factors, as noted above. The Final Arbitration Award could have a material adverse effect on our ability to procure adequate amounts and crude oil and condensate from our current supplier or otherwise.

Financial Covenant Defaults – In addition to existing or potential events of default related to the Final Arbitration Award, at June 30, 2017, we were in violation of certain financial covenants in our secured loan agreements with Sovereign. Covenant defaults under the secured loan agreements would permit Sovereign to declare the amounts owed under these loan agreements immediately due and payable, exercise its rights with respect to collateral securing our obligations under these loan agreements, and/or exercise any other rights and remedies available. Sovereign waived the financial covenant defaults as of June 30, 2017. However, the debt associated with these loans was classified within the current portion of long-term debt on our consolidated balance sheet at June 30, 2017 due to existing or potential events of default related to the Final Arbitration Award as well as the uncertainty of our ability to meet the financial covenants in the future. There can be no assurance that Sovereign will provide a waiver of events of default related to the Final Arbitration Award, consent to any proposed settlement with GEL or provide future waivers of any financial covenant defaults, which may have an adverse impact on our financial position and results of operations.

We continued aggressive actions during the second quarter of 2017 to improve operations and liquidity. We began selling all of our jet fuel to LEH immediately following production, which minimizes inventory, improves cash flow, and reduces commodity risk. We also completed construction of several new petroleum storage tanks at the Nixon Facility. Increasing petroleum storage capacity: (i) assists with de-bottlenecking the facility, which supports future increased refinery throughput to approximately 17,000 bpd without substantial capital expense, and (ii) provides an opportunity to generate additional tank rental revenue by leasing to third-parties. Additional ongoing efforts to improve operations and liquidity include increasing jet fuel and HOBM sales volumes, the latter of which is prime for export to Mexico, and restructuring customer contracts on more favorable terms as they come up for renewal. Management believes that it is taking the appropriate steps to improve our financial stability. However, there can be no assurance that our plan will be successful, LEH and its affiliates will continue to fund our working capital needs, or that we will be able to obtain additional financing on commercially reasonable terms or at all. Among

other factors, the Final Arbitration Award could prevent us from successfully executing our plan.

BLUE DOLPHIN ENERGY COMPANY FORM 10-Q 6/30/17
Notes to Consolidated Financial Statements (Continued)

For additional disclosures related to the contract-related dispute with GEL, the Final Arbitration Award, the GEL Letter Agreement, defaults under secured loan agreements, and risk factors that could materially affect our future business, financial condition and results of operations, refer to the following sections within this Quarterly Report:

Part I, Item 1. Financial Statements, Notes to Consolidated Financial Statements:

- Note (8) Related Party Transactions
- Note (10) Long-Term Debt, Net
- Note (18) Commitments and Contingencies – Legal Matters
- Note (19) Subsequent Events

Part I, Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations:

- GEL Contract - Related Dispute and Final Arbitration Award
- Results of Operations
- Liquidity and Capital Resources

Part II, Item 1. Legal Proceedings

Part II, Item 1A. Risk Factors

(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, 2016 was 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, 2017 are not necessarily indicative of the results that may be expected for the fiscal year ending December 31, 2017, 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 several 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. We believe our current estimates are reasonable and appropriate, however, 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 were \$65,064 at June 30, 2017 compared to cash and cash equivalents of \$1,152,628 at December 31, 2016.

BLUE DOLPHIN ENERGY COMPANY FORM 10-Q 6/30/17
Notes to Consolidated Financial Statements (Continued)

Restricted Cash. 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. At June 30, 2017, total restricted cash was \$2,044,962, comprised of restricted cash (current portion) totaling \$1,481,626 and restricted cash, noncurrent totaling \$563,336. At December 31, 2016, total restricted cash was \$4,930,140, comprised of restricted cash (current portion) totaling \$3,347,835 and restricted cash, noncurrent totaling \$1,582,305 (See “Note (10) Long-Term Debt, Net” for additional disclosures related to our loan agreements with Sovereign.)

Accounts Receivable and Allowance for Doubtful Accounts. Our accounts receivable consists of customer obligations due in the ordinary course of business. Since we have a small number of customers with individually large amounts due on any given date, we evaluate potential and existing customers’ financial condition, credit worthiness, and payment history to minimize credit risk. Allowance for doubtful accounts is based on a combination of current sales and specific identification methods. If necessary, we establish an allowance for doubtful accounts to estimate the amount of probable credit losses. Allowance for doubtful accounts totaled \$0 at June 30, 2017 and December 31, 2016.

Inventory. Our inventory primarily consists of refined petroleum products, crude oil and condensate, and chemicals. Inventory is valued at lower of cost or net realizable value with cost being determined by the average cost method, and net realizable value being determined based on estimated selling prices less any associated delivery costs. If the net realizable value of our refined petroleum products inventory 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.)

Property and Equipment.

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

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.

Pipelines and Facilities. Our pipelines and facilities are recorded 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 Financial Accounting Standards Board (“FASB”) ASC guidance on accounting for the impairment or disposal of long-lived assets, management performed periodic impairment testing of our pipeline and facilities assets in the fourth quarter of 2016. Upon completion of that testing, our pipeline assets were fully impaired. All pipeline transportation services to third-parties have ceased, existing third-party wells along our

pipeline corridor have been permanently abandoned, and no new third-party wells are being drilled near our pipelines. However, management believes our pipeline assets have future value based on large-scale, third-party production facility expansion projects near the pipelines.

BLUE DOLPHIN ENERGY COMPANY FORM 10-Q 6/30/17
Notes to Consolidated Financial Statements (Continued)

Oil and Gas Properties. Our oil and gas properties are accounted for 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. All leases associated with our oil and gas properties have expired, and our oil and gas properties were fully impaired in 2011.

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. Trade name, an intangible asset, represents the “Blue Dolphin Energy Company” brand name. At June 30, 2017 and December 31, 2016, trade name totaled \$303,346. 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 2016. Upon completion of that testing, we determined that no impairment was necessary at December 31, 2016.

Debt Issue Costs. We have debt issue costs related to certain refinery and facilities assets debt. Debt issue costs are capitalized and amortized over the term of the related debt using the straight-line method, which approximates the effective interest method. Debt issue costs are presented net with the related debt liability. (See “Note (10) Long-Term Debt, Net” for additional disclosures related to debt issue costs.)

Revenue Recognition.

Refined Petroleum Products Revenue. Revenue from the sale of refined petroleum products 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. We lease petroleum storage tanks to both related parties and third-parties. Tank rental fees are invoiced monthly in accordance with the terms of the related lease agreement. Tank rental revenue is recognized on a straight-line basis as earned.

Easement Revenue. Revenue from land easement fees was associated with a Master Easement Agreement between BDPL and FLNG Land II, Inc., a Delaware corporation (“FLNG”). Easement revenue was recognized monthly as earned and was included in other income. In February 2017, BDPL sold approximately 15 acres of certain property owned by BDPL located in Brazoria County Texas to FLIQ Common Facilities, LLC, an affiliate of FLNG. In conjunction with the sale of real estate, the Master Easement Agreement was terminated.

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

services to third-parties have ceased, existing third-party wells along our pipeline corridor have been permanently abandoned, and no new third-party wells are being drilled near our pipelines. (See “Note (4) Business Segment Information” for further discussion related to pipeline transportation revenue.)

Deferred Revenue. In 2014, we recognized \$850,000 in deferred revenue related to cash collateral for supplemental pipeline bonds. Deferred revenue is recognized on a straight-line basis as earned.

BLUE DOLPHIN ENERGY COMPANY FORM 10-Q 6/30/17
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 Months 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 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. A significant piece of objective negative evidence evaluated was the cumulative loss incurred over the three-year period ended December 31, 2016. Such objective evidence limits the ability to consider other subjective evidence, such as our projections for future growth. Based on this evaluation, we recorded a full valuation allowance against the deferred tax assets as of December 31, 2016.

FASB ASC guidance related to income taxes 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.

BLUE DOLPHIN ENERGY COMPANY FORM 10-Q 6/30/17
Notes to Consolidated Financial Statements (Continued)

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.)

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 denominator 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.)

Treasury Stock. We accounted for treasury stock under the cost method. In May 2017, our treasury stock was re-issued. The net change in share price after acquisition of the treasury stock was 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. Recently adopted ASUs include:

ASU 2016-18, Statement of Cash Flows (Topic 230: Restricted Cash (a Consensus of the FASB Emerging Issues Task Force. In November 2016, FASB issued ASU 2016-18, which requires that a statement of cash flows explain the change during the period in the total of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. We adopted this accounting pronouncement effective December 31, 2016. Accordingly, our consolidated statement of cash flows for the six months ended June 30, 2016 was changed to combine restricted cash with cash and cash equivalents.

ASU 2015-11, Inventory (Topic 330): Simplifying the Measurement of Inventory. In July 2015, FASB issued ASU 2015-11, which requires an entity to measure inventory at the lower of cost or net realizable value. We adopted this accounting pronouncement effective January 1, 2017. The adoption of ASU 2015-11 did not have a significant impact on our consolidated financial statements.

BLUE DOLPHIN ENERGY COMPANY FORM 10-Q 6/30/17
Notes to Consolidated Financial Statements (Continued)

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

ASU 2017-04, Intangibles – Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment. In January 2017, FASB issued ASU 2017-04. This guidance simplifies the subsequent measurement of goodwill by eliminating Step 2 from the goodwill impairment test. For public business entities that are SEC filers, the amendments in ASU 2017-04 are effective for the annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2019. ASU 2017-04 should be applied prospectively, and early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. We do not expect adoption of this guidance to have a significant impact on our consolidated balance sheets.

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.

ASU 2014-09, Revenue from Contracts with Customers. In May 2014, FASB issued ASU 2014-09 and has since amended the standard with ASU 2015-14, Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date; ASU 2016-08, Revenue from Contracts with Customers (Topic 606): Principal Versus Agent Considerations (Reporting Revenue Gross Versus Net); ASU 2016-10, Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing; 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); ASU 2016-12, Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients; and ASU 2016-20, Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers. These standards replace existing revenue recognition rules with a single comprehensive model to use in accounting for revenue arising from contracts with customers. We are evaluating the impact that adoption of these ASU's will have on our consolidated financial statements.

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

Reclassification. Effective January 1, 2017, we reclassified amounts associated with our Pipeline Transportation operations to Corporate and Other. (See "Note (4) Business Segment Information" for disclosures related to Corporate and Other.)

BLUE DOLPHIN ENERGY COMPANY FORM 10-Q 6/30/17
Notes to Consolidated Financial Statements (Continued)

(4) Business Segment Information

Effective January 1, 2017, we began reporting as a single business segment – Refinery Operations. Business activities related to our Refinery Operations business segment are conducted at the Nixon Facility. Due to their small size, current and prior three months' amounts associated with Pipeline Transportation operations were reclassified to Corporate and Other. Pipeline Transportation operations diminished significantly as services to third-parties ceased and third-party wells along our pipeline corridor were permanently abandoned. Business segment information for the periods indicated (and as of the dates indicated), was as follows:

	Three Months Ended June 30,					
	2017			2016		
	Segment		Total	Segment		Total
Refinery Operations	Corporate & Other	Refinery Operations		Corporate & Other		
Revenue from operations	\$57,336,331	\$-	\$57,336,331	\$42,017,773	\$24,687	\$42,042,460
Less: cost of operations(1)	(81,054,127)	(395,628)	(81,449,755)	(45,534,109)	(364,092)	(45,898,201)
Other non-interest income(2)	-	-	-	-	125,000	125,000
Less: JMA Profit Share(3)	-	-	-	(97,527)	-	(97,527)
EBITDA(4)	\$(23,717,796)	\$(395,628)		\$(3,613,863)	\$(214,405)	
Depletion, depreciation and amortization			(449,318)			(470,347)
Interest expense, net			(830,540)			(398,462)
Loss before income taxes			(25,393,282)			(4,697,077)
Income tax benefit			-			1,534,341
Net loss			\$(25,393,282)			\$(3,162,736)
Capital expenditures	\$858,233	\$-	\$858,233	\$4,920,507	\$-	\$4,920,507
Identifiable assets	\$71,436,425	\$1,047,413	\$72,483,838	\$93,402,963	\$5,760,191	\$99,163,154

(1)

Operation cost within the Refinery Operations segment includes related general and administrative 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), as well as expenses associated with our pipeline assets and oil and/or gas leasehold interests (such as accretion and impairment expenses).

(2) Other non-interest income reflects FLNG easement revenue.

The JMA Profit Share represents the GEL Profit Share plus the Performance Fee for the period pursuant to the

(3) Joint Marketing Agreement, under which marketing activities have ceased. (See “Note (18) Commitments and Contingencies – Legal matters” for further discussion related to the contract-related dispute with GEL.)

EBITDA is a non-GAAP financial measure. See “Part I, Item 2. Management’s Discussion and Analysis of

(4) Financial Condition and Results of Operations – Results of Operations – Non-GAAP Financial Measures” for additional information related to EBITDA.

BLUE DOLPHIN ENERGY COMPANY FORM 10-Q 6/30/17
Notes to Consolidated Financial Statements (Continued)

	Six Months Ended June 30,					
	2017			2016		
	Segment			Segment		
	Refinery	Corporate &	Total	Refinery	Corporate &	Total
Operations	Other	Operations		Other		
Revenue from operations	\$109,942,080	\$-	\$109,942,080	\$73,502,397	\$52,339	\$73,554,736
Less: cost of operations(1)	(136,249,888)	(826,250)	(137,076,138)	(79,956,962)	(710,995)	(80,667,957)
Other non-interest income(2)	-	-	-	-	255,665	255,665
Less: JMA Profit Share(3)	-	2,216,251	2,216,251	573,565	-	573,565
EBITDA(4)	\$(26,307,808)	\$1,390,001		\$(5,881,000)	\$(402,991)	
Depletion, depreciation and amortization			(900,343)			(910,800)
Interest expense, net			(1,425,082)			(817,271)
Loss before income taxes			(27,243,232)			(8,012,062)
Income tax benefit			-			2,700,242
Net loss			\$(27,243,232)			\$(5,311,820)
Capital expenditures	\$2,889,327	\$-	\$2,889,327	\$10,304,149	\$-	\$10,304,149
Identifiable assets	\$71,436,425	\$1,047,413	\$72,483,838	\$93,402,963	\$5,760,191	\$99,163,154

Operation cost within the Refinery Operations segment includes related general and administrative expenses. Operation cost within Corporate and Other includes general and administrative expenses associated

(1) with corporate maintenance costs (such as accounting fees, director fees, and legal expense), as well as expenses associated with our pipeline assets and oil and/or gas leasehold interests (such as accretion and impairment expenses).

(2) Other non-interest income reflects FLNG easement revenue.

The JMA Profit Share represents the GEL Profit Share plus the Performance Fee for the period pursuant to the

(3) Joint Marketing Agreement, under which marketing activities have ceased. (See "Note (18) Commitments and Contingencies – Legal matters" for further discussion related to the contract-related dispute with GEL.)

EBITDA is a non-GAAP financial measure. See “Part I, Item 2. Management’s Discussion and Analysis of (4) Financial Condition and Results of Operations – Results of Operations – Non-GAAP Financial Measures” for additional information related to EBITDA.

(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,
	2017	2016
Prepaid crude oil and condensate	\$732,078	\$-
Prepaid insurance	371,230	248,853
Short-term tax bond	-	505,000
Prepaid exise taxes	-	292,338
	\$1,103,308	\$1,046,191

BLUE DOLPHIN ENERGY COMPANY FORM 10-Q 6/30/17
Notes to Consolidated Financial Statements (Continued)

(6) Inventory

Inventory as of the dates indicated consisted of the following:

	June 30,	December 31,
	2017	2016
HOBM	\$2,263,477	\$212,987
Crude oil and condensate	878,339	26,123
Chemicals	299,860	182,751
AGO	238,742	143,362
Naphtha	136,584	533,580
Propane	14,212	11,318
Jet fuel	10,977	964,124
LPG mix	6,258	1,293
	\$3,848,449	\$2,075,538

(7) Property, Plant and Equipment, Net

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

	June 30,	December 31,
	2017	2016
Refinery and facilities	\$51,432,434	\$50,814,309
Land	566,159	602,938
Other property and equipment	652,795	652,795
	52,651,388 -	52,070,042
Less: Accumulated depletion, depreciation, and amortization	(7,585,586)	(6,685,244)
	45,065,802	45,384,798
Construction in progress	19,247,645	16,939,665

\$64,313,447 \$62,324,463

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 \$2,966,647 and \$2,108,298 at June 30, 2017 and December 31, 2016, respectively.

BLUE DOLPHIN ENERGY COMPANY FORM 10-Q 6/30/17
Notes to Consolidated Financial Statements (Continued)

(8) Related Party Transactions

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

Related Parties.

LEH. LEH is our controlling shareholder. Jonathan Carroll, Chairman of the Board, Chief Executive Officer, and President of Blue Dolphin, is the majority owner of LEH. Together LEH and Jonathan Carroll own approximately 81% of our Common Stock. We are currently party to an Amended and Restated Operating Agreement, a Jet Fuel Sales Agreement, a Loan and Security Agreement, and an Amended and Restated Promissory Note with LEH.

Ingleside Crude, LLC ("Ingleside"). Ingleside is a related party of LEH and Jonathan Carroll. We are currently party to an Amended and Restated Promissory Note with Ingleside.

Lazarus Marine Terminal I, LLC ("LMT"). LMT is a related party of LEH and Jonathan Carroll. We are currently party to a Tolling Agreement with LMT.

Jonathan Carroll. Jonathan Carroll is Chairman of the Board, Chief Executive Officer, and President of Blue Dolphin. We are currently party to Amended and Restated Guaranty Fee Agreements and an Amended and Restated Promissory Note with Jonathan Carroll.

Operations Related Agreements.

Amended and Restated Operating Agreement. LEH operates and manages all our properties pursuant to the Amended and Restated Operating Agreement. The Amended and Restated Operating Agreement, which was restructured following cessation of crude supply and marketing activities under the Crude Supply Agreement and Joint Marketing Agreement with GEL, expires: (i) April 1, 2020, (ii) upon written notice of either party to the Amended and Restated Operating Agreement of a material breach by the other party, or (iii) upon 90 days' notice by the Board if the Board determines that the Amended and Restated Operating Agreement is not in our best interest. We reimburse LEH at cost plus five percent (5%) for all reasonable Blue Dolphin expenses incurred while LEH performs the services. Amounts expensed as fees to LEH are reflected within refinery operating expenses in our consolidated statements of operations. Fees owed to LEH under the Amended and Restated Operating Agreement, if any, are reflected within long-term debt, related party, net of current portion in our consolidated balance sheets.

Jet Fuel Sales Agreement. We sell jet fuel and other products to LEH pursuant to a Jet Fuel Sales Agreement. LEH resells these products to a government agency. In support of the Jet Fuel Sales Agreement, we previously leased Nixon Facility petroleum storage tanks to LEH for the storage of the jet fuel under a Terminal Services Agreement (as described below). The Jet Fuel Sales Agreement terminates on the earliest to occur of: (a) a one-year term expiring March 31, 2018 plus a 30-day carryover or (b) delivery of a maximum quantity of jet fuel as defined therein. Sales to LEH under the Jet Fuel Sales Agreement are reflected within refined petroleum product sales in our consolidated statements of operations.

Terminal Services Agreement. Pursuant to a Terminal Services Agreement, LEH leased petroleum storage tanks at the Nixon Facility for the storage of Blue Dolphin purchased jet fuel under the Jet Fuel Sales Agreement (as described above). The Terminal Services Agreement was terminated in April 2017. Rental fees received from LEH under the

Terminal Services Agreement are reflected within tank rental revenue in our consolidated statements of operations.

Amended and Restated Tank Lease Agreement. Pursuant to an Amended and Restated Tank Lease Agreement with Ingleside, we leased petroleum storage tanks to meet periodic, additional storage needs. The Amended and Restated Tank Lease Agreement was terminated in April 2017. Rental fees owed to Ingleside under the tank lease agreement are reflected within long-term debt, related party, net of current portion in our consolidated balance sheets. Amounts expensed as rental fees to Ingleside under the Amended and Restated Tank Lease Agreement are reflected within refinery operating expenses in our consolidated statements of operations.

BLUE DOLPHIN ENERGY COMPANY FORM 10-Q 6/30/17
Notes to Consolidated Financial Statements (Continued)

Tolling Agreement. In May 2016, we entered a Tolling Agreement with LMT to facilitate loading and unloading of our petroleum products by barge at LMT's dock facility in Ingleside, Texas. The Tolling Agreement has a five-year term and may be terminated at any time by the agreement of both parties. We pay LMT a flat monthly reservation fee of \$50,400. The monthly reservation fee includes tolling volumes up to 84,000 gallons per day. Tolling volumes totaling more than 210,000 gallons per quarter are billed to us at \$0.02 per gallon. Amounts expensed as tolling fees to LMT under the Tolling Agreement are reflected in cost of refined products sold in our consolidated statements of operations.

Financial Agreements.

Loan and Security Agreement. In August 2016, BDPL entered a loan and security agreement with LEH as evidenced by a promissory note in the original principal amount of \$4.0 million (the "LEH Loan Agreement"). The LEH Loan Agreement matures in August 2018, and accrues interest at rate of 16.00%. Under the LEH Loan Agreement, BDPL makes a payment to LEH of \$500,000 per year. A final balloon payment is due at maturity.

The proceeds of the LEH Loan Agreement were used for working capital. There are no financial maintenance covenants associated with the LEH Loan Agreement. The LEH Loan Agreement is secured by the BDPL Property. Outstanding principal and interest less associated debt issue costs owed to LEH under the LEH Loan Agreement are reflected in long-term debt, related party, current portion and long-term debt, related party, net of current portion in our consolidated balance sheets.

Promissory Notes. We currently rely on LEH and its affiliates (including Jonathan Carroll) to fund our working capital requirements. The below promissory notes represent advances to fund our working capital requirements. There can be no assurance that LEH and its affiliates will continue to fund our working capital requirements.

June LEH Note – In March 2017, Blue Dolphin entered a promissory note with LEH in the original principal amount of \$440,815 (the "March LEH Note"). In June 2017, the March LEH Note was amended and restated to increase the amount by \$2,043,482 (the "June LEH Note"). Interest under the June LEH Note, which is compounded annually and accrued at a rate of 8.00%, was paid in kind and added to the outstanding balance. The June LEH Note has a maturity date of January 2019. Under the June LEH Note, prepayment, in whole or in part, is permissible at any time and from time to time, without premium or penalty. Outstanding principal and interest owed to LEH under the June LEH Note are reflected in long-term debt, related party, net of current portion in our consolidated balance sheets. At June 30, 2017 and December 31, 2016, the outstanding principal and interest owed to LEH under a promissory note was \$2,484,297 and \$0, respectively.

March Ingleside Note – In March 2017, a promissory note between Blue Dolphin and Ingleside was amended and restated (the "March Ingleside Note") to increase the principal amount by \$473,445 and extend the maturity date to January 2019. Interest under the March Ingleside Note, which is compounded annually and accrued at a rate of 8.00%, was paid in kind and added to the outstanding balance. Under the March Ingleside Note, prepayment, in whole or in part, is permissible at any time and from time to time, without premium or penalty. Outstanding principal and interest owed to Ingleside under the March Ingleside Note are reflected in long-term debt, related party, net of current portion in our consolidated balance sheets. At June 30, 2017 and December 31, 2016, the outstanding principal and interest owed to Ingleside under the March Ingleside Note was \$1,143,803 and \$722,278, respectively.

March Carroll Note – In March 2017, a promissory note between Blue Dolphin and Jonathan Carroll was amended and restated (the “March Carroll Note”) to increase the principal amount by \$183,030, revise the payment terms to reflect payment in cash and shares of Blue Dolphin Common Stock, and extend the maturity date to January 2019. Interest under the March Carroll Note, which is compounded annually and accrued at a rate of 8.00%, was paid in kind and added to the outstanding balance. Under the March Carroll Note, prepayment, in whole or in part, is permissible at any time and from time to time, without premium or penalty. Outstanding principal and interest owed to Jonathan Carroll under the March Carroll Note are reflected in long-term debt, related party, net of current portion in our consolidated balance sheets. At June 30, 2017 and December 31, 2016, the outstanding principal and interest owed to Jonathan Carroll under the March Carroll Note was \$112,272 and \$592,412, respectively.

BLUE DOLPHIN ENERGY COMPANY FORM 10-Q 6/30/17
Notes to Consolidated Financial Statements (Continued)

Amended and Restated Guaranty Fee Agreements. Pursuant to Amended and Restated 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 certain loan agreements. Amounts owed to Jonathan Carroll under Amended and Restated Guaranty Fee Agreements are reflected within long-term debt, related party, net of current portion in our consolidated balance sheets. Amounts expensed related to Amended and Restated Guarantee Fee Agreements are reflected within interest and other expense in our consolidated statements of operations. (See "Note (10) Long-Term Debt, Net" for further discussion related to these guaranty fee agreements.)

Financial Statements Impact.

Consolidated Balance Sheets. At June 30, 2017 and December 31, 2016, accounts receivable, related party from LEH totaled \$0 and \$1,161,589. Accounts payable, related party to LMT associated with the Tolling Agreement was \$672,000 and \$369,600 at June 30, 2017 and December 31, 2016, respectively. Long-term debt, related party associated with the LEH Loan Agreement, June LEH Note, March Ingleside Note, and March Carroll Note as of the dates indicated was as follows:

	June 30,	December 31,
	2017	2016
LEH	\$6,484,297	\$4,000,000
Ingleside	1,143,803	722,278
Jonathan Carroll	112,272	592,412
	7,740,372	5,314,690
Less: Long-term debt, related party, current portion	(500,000)	(500,000)
	\$7,240,372	\$4,814,690

Accrued interest associated with the LEH Loan Agreement was \$565,333 and \$243,556 at June 30, 2017 and December 31, 2016, respectively. Accrued interest associated with the LEH Loan Agreement is reflected in accounts payable, related party. Accrued interest associated with the June LEH Note, the March Ingleside Note, and the March Carroll Note are reflected in long-term debt.

Consolidated Statements of Operations. Related party revenue from LEH associated with:

Three Months Ended June Six Months Ended June 30,
30,

	2017	2016	2017	2016
Jet fuel sales	\$20,157,974	\$8,912,074	\$35,557,967	\$8,912,074
Jet fuel storage fees	375,000	324,000	750,000	324,000
HOBM sales	-	-	3,656,638	-
	\$20,532,974	\$9,236,074	\$39,964,605	\$9,236,074

Related party cost of goods sold associated with the Tolling Agreement with LMT totaled \$151,200 and \$0 for the three months ended June 30, 2017 and 2016; related party cost of goods sold for the six months ended June 30, 2017 and 2016 totaled \$302,400 and \$0.

BLUE DOLPHIN ENERGY COMPANY FORM 10-Q 6/30/17
Notes to Consolidated Financial Statements (Continued)

Related party refinery operating expenses associated with the Amended and Restated Operating Agreement with LEH and the Amended and Restated Tank Lease Agreement with Ingleside for the periods indicated were as follows:

Three Months Ended June 30,

	2017		2016	
	Amount	Per bbl	Amount	Per bbl
LEH	\$1,651,663	\$1.53	\$2,427,748	\$3.42
Ingleside	-	-	450,000	0.63
	\$1,651,663	\$1.53	\$2,877,748	\$4.05

Six Months Ended June 30,

	2017		2016	
	Amount	Per bbl	Amount	Per bbl
LEH	\$4,464,766	\$2.14	\$5,589,763	\$2.95
Ingleside	-	-	725,000	0.38
	\$4,464,766	\$2.14	\$6,314,763	\$3.33

Interest expense associated with the LEH Loan Agreement and Amended and Restated Guaranty Fee Agreements for the periods indicated was as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016

LEH	\$234,391	\$-	\$441,685	\$-
Jonathan Carroll	166,270	174,243	334,095	350,631
	\$400,661	\$174,243	\$775,780	\$350,631

BLUE DOLPHIN ENERGY COMPANY FORM 10-Q 6/30/17
Notes to Consolidated Financial Statements (Continued)

(9) 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,
	2017	2016
Unearned revenue	\$911,983	\$408,770
Customer deposits	450,000	450,000
Board of director fees payable	171,429	136,429
Other payable	108,247	189,719
Property taxes	67,736	4,694
Excise and income taxes payable	67,473	24,187
Insurance	28,398	67,783
	\$1,805,266	\$1,281,582

(10) Long-Term Debt, Net

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

	June 30,	December 31,
	2017	2016
First Term Loan Due 2034	\$23,551,966	\$23,924,607
Second Term Loan Due 2034	9,607,032	9,729,853
Notre Dame Debt	1,300,000	1,300,000
Term Loan Due 2017	-	184,994
Capital Leases	50,790	135,879
	\$34,509,788	\$35,275,333
Less: Current portion of long-term debt, net	(32,311,034)	(31,712,336)
Less: Unamortized debt issue costs	(2,198,754)	(2,262,997)

\$- \$1,300,000

BLUE DOLPHIN ENERGY COMPANY FORM 10-Q 6/30/17
Notes to Consolidated Financial Statements (Continued)

Unamortized debt issue costs, which relate to secured loan agreements with Sovereign, as of the dates indicated consisted of the following:

	June 30,	December 31,
	2017	2016
First Term Loan Due 2034	\$1,673,545	\$1,673,545
Second Term Loan Due 2034	767,673	767,673
Less: Accumulated amortization	(242,464)	(178,221)
	\$2,198,754	\$2,262,997

Amortization expense associated with our long-term debt, net, which is included in interest expense, was \$32,121 and \$32,121 for the three months ended June 30, 2017 and 2016, respectively. Amortization expense was \$64,242 and \$63,990 for the six months ended June 30, 2017 and 2016, respectively.

Accrued interest associated with our long-term debt, net is reflected as interest payable, current portion and long-term interest payable, net of current portion in our consolidated balance sheets and includes related party interest. Accrued interest as of the dates indicated consisted of the following:

	June 30,	December 31,
	2017	2016
Notre Dame Debt	\$1,794,534	\$1,691,383
LEH Loan Agreement (related party)	565,333	243,556
Second Term Loan Due 2034	47,904	44,984
First Term Loan Due 2034	36,135	33,866
Capital Leases	423	1,165
Term Loan Due 2017	-	185
	2,444,329	2,015,139
Less: Interest payable, current portion	(2,444,329)	(323,756)

\$- \$1,691,383

Related Party. See “Note (8) Related Party Transactions” for additional disclosures with respect to related party long-term debt.

First Term Loan Due 2034. In 2015, LE entered 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 \$195,329, 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.

BLUE DOLPHIN ENERGY COMPANY FORM 10-Q 6/30/17
Notes to Consolidated Financial Statements (Continued)

As described elsewhere in this Quarterly Report, Sovereign has notified us that the Final Arbitration Award constitutes an event of default under the First Term Loan Due 2034. In addition to existing or potential events of default related to the Final Arbitration Award, at June 30, 2017, LE was in violation of the debt service coverage ratio, the current ratio, and debt to net worth ratio financial covenants related to the first Term Loan Due 2034. LE also failed to replenish a payment reserve account as required. The occurrence of events of default under the First Term Loan Due 2034 permits Sovereign to declare the amounts owed under the First Term Loan Due 2034 immediately due and payable, exercise its rights with respect to collateral securing LE's obligations under the loan agreement, and/or exercise any other rights and remedies available. Sovereign waived the financial covenant defaults as of June 30, 2017. Sovereign has informed us that it is not currently exercising its rights, privileges and remedies under the First Term Loan Due 2034 in light of the ongoing settlement discussions with GEL and the continuance of the hearing on confirmation of the Final Arbitration Award and to allow Sovereign to evaluate any proposed settlement agreement related to the Final Arbitration Award, which would require Sovereign's approval. However, Sovereign expressly reserved all of its rights, privileges and remedies related to events of default under the First Term Loan Due 2034 and informed us that it would consider a final confirmation of the Final Arbitration Award to be a material event of default under the loan agreement. Any exercise by Sovereign of its rights and remedies under the First Term Loan Due 2034 would have a material adverse effect on our business, financial condition and results of operations and likely would require us to seek protection under bankruptcy laws. (See "Note (1) Organization – Going Concern and Operating Risks" and "Note (19) Subsequent Events" for additional disclosures related to the First Term Loan Due 2034, the Final Arbitration Award 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 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. Effective in April 2017, the Guaranty Fee Agreement associated with the First Term Loan Due 2034 was amended and restated to reflect payment in cash and shares of Blue Dolphin Common Stock. For the three months ended June 30, 2017 and 2016, guaranty fees related to the First Term Loan Due 2034 totaled \$118,080 and \$121,739, respectively. For the six months ended June 30, 2017 and 2016, guaranty fees related to the First Term Loan Due 2034 totaled \$237,071 and \$244,372, 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) Related Party Transactions" for additional disclosures related to LEH and Jonathan Carroll; see "Note (19) Subsequent Events" for further discussion related to guaranty fee agreements.)

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 bank facilities of this type.

Second Term Loan Due 2034. In 2015, LRM entered 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.

As described elsewhere in this Quarterly Report, Sovereign has notified us that the Final Arbitration Award constitutes an event of default under the Second Term Loan Due 2034. In addition to existing or potential events of default related to the Final Arbitration Award, at June 30, 2017, LRM was in violation of the debt service coverage ratio, the current ratio, and debt to net worth ratio financial covenants related to the Second Term Loan Due 2034. The occurrence of events of default under the Second Term Loan Due 2034 permits Sovereign to declare the amounts owed under the Second Term Loan Due 2034 immediately due and payable, exercise its rights with respect to collateral securing LRM's obligations under the loan agreement, and/or exercise any other rights and remedies available. Sovereign waived the financial covenant defaults as of June 30, 2017. Sovereign has informed us that it is not currently exercising its rights, privileges and remedies under the Second Term Loan Due 2034 in light of the ongoing settlement discussions with GEL and the continuance of the hearing on confirmation of the Final Arbitration Award and to allow Sovereign to evaluate any proposed settlement agreement related to the Final Arbitration Award, which would require Sovereign's approval. However, Sovereign expressly reserved all of its rights, privileges and remedies related to events of default under the Second Term Loan Due 2034 and informed us that it would consider a final confirmation of the Final Arbitration Award to be a material event of default under the loan agreement. Any exercise by Sovereign of its rights and remedies under the Second Term Loan Due 2034 would have a material adverse effect on our business, financial condition and results of operations and likely would require us to seek protection under bankruptcy laws. (See "Note (1) Organization – Going Concern and Operating Risks" and "Note (19) Subsequent Events" for additional disclosures related to the First Term Loan Due 2034, the Final Arbitration Award and financial covenant violations.)

BLUE DOLPHIN ENERGY COMPANY FORM 10-Q 6/30/17
Notes to Consolidated Financial Statements (Continued)

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 a Guaranty Fee Agreement with Jonathan Carroll whereby hereceives a fee equal to 2.00% per annum, paid monthly, of the outstanding principal balance owed under the Second Term Loan Due 2034. Effective in April 2017, the Guaranty Fee Agreement associated with the Second Term Loan Due 2034 was amended and restated to reflect payment in cash and shares of Blue Dolphin Common Stock. For the three months ended June 30, 2017 and 2016, guaranty fees related to the Second Term Loan Due 2034 totaled \$48,190 and \$49,420, respectively. For the six months ended June 30, 2017 and 2016, guaranty fees related to the Second Term Loan Due 2034 totaled \$96,613 and \$99,168, 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) Related Party Transactions” 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 bank facilities of this type.

Notre Dame Debt. LE entered 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 a Loan and Security Agreement with Sovereign in 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 had a monthly principal payment of \$61,665 plus interest. The Term Loan Due 2017 was paid off in March 2017.

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 a Guaranty Fee Agreement with Jonathan Carroll whereby he received a fee equal to 2.00% per annum, paid monthly, of the outstanding principal balance owed under the Term Loan Due 2017. Effective in April 2017, the Guaranty Fee Agreement associated with

the Term Loan Due 2017 was amended and restated to reflect payment in cash and shares of Blue Dolphin Common Stock. (Guaranty Fee Agreements associated with the First Term Loan Due 2034, Second Term Loan Due 2034, and Term Loan Due 2017 are collectively referred to in this Quarterly Report as the “Amended and Restated Guaranty Fee Agreements”). For the three months ended June 30, 2017 and 2016, guaranty fees related to the Term Loan Due 2017 totaled \$0 and \$3,083, respectively. For the six months ended June 30, 2017 and 2016, guaranty fees related to the Term Loan Due 2017 totaled \$411 and \$7,091, respectively. Guaranty fees are recognized monthly as incurred and are included in interest and other expense in our consolidated statements of operations.

BLUE DOLPHIN ENERGY COMPANY FORM 10-Q 6/30/17
Notes to Consolidated Financial Statements (Continued)

Capital Leases. LRM entered 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,
	2017	2016
Boiler equipment	\$538,598	\$538,598
Less: accumulated depreciation	-	-
	\$538,598	\$538,598

(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.

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,
	2017	2016

Asset retirement obligations, at the beginning of the period	\$2,027,639	\$1,985,864
Liabilities settled	(442)	(70,969)
Accretion expense	143,688	112,744
	2,170,885	2,027,639
Less: asset retirement obligations, current portion	(17,068)	(17,510)
Long-term asset retirement obligations, at the end of the period	\$2,153,817	\$2,010,129

Liabilities settled represents amounts paid for plugging and abandonment costs against the asset's ARO liability. At June 30, 2017 and December 31, 2016, we recognized \$442 and \$70,969, respectively, in liabilities settled.

Abandonment expense represents amounts paid for plugging and abandonment costs that exceed the asset's ARO liability. For the three and six months ended June 30, 2017 and 2016, we recognized \$0 in abandonment expense.

BLUE DOLPHIN ENERGY COMPANY FORM 10-Q 6/30/17
Notes to Consolidated Financial Statements (Continued)

(12) Treasury Stock

At June 30, 2017 and December 31, 2016, we had 0 and 150,000 shares of treasury stock, respectively. In May 2017, we issued 150,000 shares of treasury stock to Jonathan Carroll as payment of amounts due under the March Carroll Note.

(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. At June 30, 2017 and December 31, 2016, we had cash balances (including restricted cash) of more than the FDIC insurance limit per depositor in the amount of \$1,597,835 and \$5,372,689, respectively.

Key Supplier.

We purchased light crude oil and condensate for the Nixon Facility from GEL pursuant to the Crude Supply Agreement. As discussed elsewhere in this Quarterly Report, we ceased purchases of crude oil and condensate from GEL under the Crude Supply Agreement in November 2016. (See "Part I, Item 1 Financial Statements – Note (18) Commitments and Contingencies – Legal Matters" in this Quarterly Report for disclosures related to the Crude Supply Agreement, the current contract-related dispute with GEL, and the Final Arbitration Award.)

We currently have in place a month-to-month evergreen crude supply contract with a major integrated oil and gas company. This new supplier currently provides us with adequate amounts of crude oil and condensate, and we expect the supplier to continue to do so for the foreseeable future. However, our ability to purchase crude oil and condensate is dependent on our liquidity and access to capital, which have been adversely affected by net losses, working capital deficits, the contract-related dispute with GEL, and financial covenant defaults in secured loan agreements. The Final Arbitration Award could have a material adverse effect on our ability to procure adequate amounts and crude oil and condensate from our current supplier or otherwise.

Significant Customers. We routinely assess the financial strength of our customers and have not experienced significant write-downs in our accounts receivable balances. Therefore, we believe that our accounts receivable credit risk exposure is limited.

For the three months ended June 30, 2017, we had 4 customers that accounted for approximately 80% of our refined petroleum product sales. LEH, a related party, was 1 of these 4 significant customers and accounted for approximately 36% of our refined petroleum product sales. At June 30, 2017, these 4 customers represented approximately \$0.3 million in accounts receivable. LEH represented approximately \$0 million in accounts receivable.

For the three months ended June 30, 2016, we had 4 customers that accounted for approximately 71% of our refined petroleum product sales. LEH was one of these 4 significant customers and accounted for approximately 22% of our refined petroleum product sales. At June 30, 2016, these 4 customers represented approximately \$6.2 million in accounts receivable.

For the six months ended June 30, 2017, we had 3 customers that accounted for approximately 76% of our refined petroleum product sales. LEH was 1 of these 3 significant customers and accounted for approximately 36% of our

refined petroleum product sales. At June 30, 2017, these 3 customers represented approximately \$0.1 million in accounts receivable. LEH represented approximately \$0 million in accounts receivable.

BLUE DOLPHIN ENERGY COMPANY FORM 10-Q 6/30/17
Notes to Consolidated Financial Statements (Continued)

For the six months ended June 30, 2016, we had 4 customers that accounted for approximately 64% of our refined petroleum product sales. LEH was one of these 4 significant customers and accounted for approximately 12% of our refined petroleum product sales. At June 30, 2016, these 4 customers represented approximately \$6.2 in accounts receivable. LEH represented approximately \$0 million in accounts receivable. LEH purchases our jet fuel and resells the jet fuel to a government agency. Occasionally, LEH purchases HOBM to resell to U.S.-based customers. (See “Note (8) Related Party Transactions” for additional disclosures related to our sale of jet fuel to LEH under the Jet Fuel Sales Agreement and the associated storage of LEH’s purchased jet fuel under the Terminal Services Agreement.)

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 some of our 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,				
	2017		2016	2017		2016		
LPG mix	\$-	0.0%	\$133,757	0.3%	\$120,542	0.1%	\$384,304	0.8%
Naphtha	13,253,969	23.4%	7,287,804	17.6%	27,016,913	24.9%	16,313,325	28.9%
Jet fuel	20,157,974	35.6%	17,539,473	42.4%	35,557,968	32.8%	26,045,786	27.3%
HOBM	10,883,053	19.2%	7,889,499	19.1%	21,568,793	19.9%	11,052,994	10.1%
Reduced Crude	-	0.0%	546,112	1.3%	-	0.0%	3,791,919	10.4%
AGO	12,337,624	21.8%	8,005,641	19.3%	24,270,442	22.3%	15,007,095	22.5%
	\$56,632,620	100.0%	\$41,402,286	100.0%	\$108,534,658	100.0%	\$72,595,423	100.0%

(14)Leases

Our company headquarters is 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 had a 10-year term expiring in September 2017, but we extended the lease until December 2017. We are currently exploring our leasing options. Rent expense is recognized on a straight-line basis. For the three months ended June 30, 2017 and 2016, rent expense totaled \$45,092 and \$29,857, respectively. For the six months ended June 30, 2017 and 2016, rent expense totaled \$76,173 and \$59,715, respectively.

(15)Income Taxes

Income Tax Benefit. For the three months ended June 30, 2017 and 2016, we recognized an income tax benefit of \$0 and \$1,534,341, respectively. For the six months ended June 30, 2017 and 2016, we recognized an income tax benefit of \$0 and \$2,700,242, respectively.

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 paid. NOL carryforwards and deferred tax

assets represent amounts available to reduce future taxable income.

BLUE DOLPHIN ENERGY COMPANY FORM 10-Q 6/30/17
Notes to Consolidated Financial Statements (Continued)

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 \$16.3 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 for a period of 20 years in addition to available amounts of NOL carryforwards generated prior to the ownership change.

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 because of the IRC Section 382 limitation):

Net Operating Loss Carryforward

	Pre-Ownership Change	Post-Ownership Change	Total
Balance at December 31, 2015	\$9,614,449	\$9,616,941	\$19,231,390
Net operating losses	-	13,945,128	13,945,128
Balance at December 31, 2016	\$9,614,449	\$23,562,069	\$33,176,518
Net operating losses	-	9,477,523	9,477,523
Balance at June 30, 2017	\$9,614,449	\$33,039,592	\$42,654,041

BLUE DOLPHIN ENERGY COMPANY FORM 10-Q 6/30/17
Notes to Consolidated Financial Statements (Continued)

Deferred Tax Assets and Liabilities. At June 30, 2017 and December 31, 2016, we had \$0 of net deferred tax assets available for future use. Significant components of deferred tax assets and liabilities as of the dates indicated were as follow:

	June 30, 2017	December 31, 2016
Deferred tax assets:		
Net operating loss and capital loss carryforwards	\$16,772,696	\$13,550,338
Accrued arbitration award payable	6,674,017	-
Start-up costs (Nixon Facility)	1,304,695	1,373,363
Asset retirement obligations liability/deferred revenue	759,366	717,751
AMT credit and other	233,572	266,522
Total deferred tax assets	25,744,346	15,907,974
Deferred tax liabilities:		
Basis differences in property and equipment	(6,469,616)	(5,895,943)
Total deferred tax liabilities	(6,469,616)	(5,895,943)
	19,274,730	10,012,031
Valuation allowance	(19,274,730)	(10,012,031)
Deferred tax assets, net	\$-	\$-

Valuation Allowance. 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 some portion or all the deferred tax assets will be realized, which is dependent upon the generation of future taxable income prior to the expiration of any NOL carryforwards. At June 30, 2017 and December 31, 2016, management determined that cumulative losses incurred over the prior three-year period provided significant objective evidence that limited the ability to consider other subjective evidence, such as projections for future growth. Based on this evaluation, we recorded a full valuation allowance against the deferred tax assets as of June 30, 2017 and December 31, 2016.

BLUE DOLPHIN ENERGY COMPANY FORM 10-Q 6/30/17
Notes to Consolidated Financial Statements (Continued)

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, 2017 and 2016. Our federal income tax returns are subject to examination by the Internal Revenue Service for tax years ending December 31, 2013, or after and by the state of Texas for tax years ending December 31, 2012, 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,	
	2017	2016	2017	2016
Net loss	\$(25,393,282)	\$(3,162,736)	\$(27,243,232)	\$(5,311,820)
Basic and diluted income per share	\$(2.39)	\$(0.30)	\$(2.58)	\$(0.51)
Basic and Diluted Weighted average number of shares of common stock outstanding and potential dilutive shares of common stock	10,637,101	10,459,996	10,556,356	10,458,895

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, 2017 and 2016 was the same as basic EPS as there were no stock options or other dilutive instruments outstanding.

(17) Inventory Risk Management

We began selling all of our jet fuel to LEH immediately following production, which minimizes inventory, improves cash flow, and reduces commodity risk. Previously, Genesis/GEL used commodity futures contracts to mitigate the volatile change in value for certain of our refined petroleum products inventory.