

China Natural Gas, Inc.
Form 10-K
March 16, 2009

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2008

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

For the transition period from _____ to _____

Commission File Number: 000-31539

CHINA NATURAL GAS, INC.
(Exact Name of Registrant as specified in its charter)

Delaware
(State or other jurisdiction of
Incorporation or organization)

98-0231607
(I.R.S. Employer
Identification Number)

19th Floor, Building B, Van Metropolis
Tang Yan Road, Hi-Tech Zone
Xi'an, 710065, Shaanxi Province, China
(Address of principal executive office)

Registrant's telephone number, including area code: 86-29-88323325

Securities registered under Section 12(b) of the Exchange Act: None

Securities registered under Section 12(g) of the Exchange Act:
Common Stock, \$.0001 par value per share
(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.
Yes No

Indicate by check mark whether the registrant (1) has 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

Edgar Filing: China Natural Gas, Inc. - Form 10-K

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (section 229.405 of this chapter) is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer
Non-accelerated filer Smaller reporting
company

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

The aggregate market value of the voting and non-voting stock held by non-affiliates of the registrant, as of June 30, 2008, was approximately \$139,612,648. All executive officers and directors of the registrant have been deemed, solely for the purpose of the foregoing calculation, to be "affiliates" of the registrant.

As of March 10, 2009, there were 29,200,304 shares of the issuer's common stock, \$0.0001 par value per share, issued and outstanding.

FORM 10-K

FOR THE FISCAL YEAR ENDED DECEMBER 31, 2007

INDEX

| | Page |
|---|------|
| PART I | |
| ITEM 1. DESCRIPTION OF BUSINESS | 1 |
| ITEM 1A. RISK FACTORS | 9 |
| ITEM 2. DESCRIPTION OF PROPERTY | 17 |
| ITEM 3. LEGAL PROCEEDINGS | 18 |
| ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITYHOLDERS | 18 |
| PART II | |
| ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND SMALL BUSINESS ISSUER PURCHASES OF EQUITY SECURITIES | 19 |
| ITEM 6. SELECTED FINANCIAL DATA | 20 |
| ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION | 21 |
| ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK | 30 |
| ITEM 8. FINANCIAL STATEMENTS | 31 |
| ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE | 32 |
| ITEM 9A(T). CONTROLS AND PROCEDURES | 32 |
| ITEM 9B. OTHER INFORMATION | 36 |
| PART III | |
| ITEM 10. DIRECTORS, EXECUTIVE OFFICERS, PROMOTERS AND CONTROL PERSONS; COMPLIANCE WITH SECTION 16(a) OF THE EXCHANGE ACT | 36 |
| ITEM 11. EXECUTIVE COMPENSATION | 39 |
| ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS | 41 |
| ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS | 42 |
| ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES | 42 |
| ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES | 43 |

STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

In this annual report, references to "China Natural Gas," "CHNG," "the Company," "we," "us," and "our" refer to China Natural Gas, Inc.

Except for the historical information contained herein, some of the statements in this Report contain forward-looking statements that involve risks and uncertainties. These statements are found in the sections entitled "Business," "Management's Discussion and Analysis or Plan of Operation," and "Risk Factors." They include statements concerning: our business strategy; expectations of market and customer response; liquidity and capital expenditures; future sources of revenues; expansion of our proposed product line; and trends in industry activity generally. In some cases, you can identify forward-looking statements by words such as "may," "will," "should," "expect," "plan," "could," "anticipate," "intend," "believe," "estimate," "predict," "potential," "goal," or "continue" or similar terminology. These statements are only predictions and involve known and unknown risks, uncertainties and other factors, including, but not limited to, the risks outlined under "Risk Factors," that may cause our or our industry's actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by such forward-looking statements. For example, assumptions that could cause actual results to vary materially from future results include, but are not limited to: our ability to successfully develop and market our products to customers; our ability to generate customer demand for our products in our target markets; the development of our target markets and market opportunities; our ability to manufacture suitable products at competitive cost; market pricing for our products and for competing products; the extent of increasing competition; technological developments in our target markets and the development of alternate, competing technologies in them; and sales of shares by existing shareholders. Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. Unless we are required to do so under US federal securities laws or other applicable laws, we do not intend to update or revise any forward-looking statements.

PART I

ITEM 1. DESCRIPTION OF BUSINESS

Organizational History

We were incorporated in the state of Delaware on March 31, 1999, as Bullet Environmental Systems, Inc. On May 25, 2000 we changed our name to Liquidpure Corp. and on February 14, 2002 we changed our name to Coventure International, Inc.

On December 6, 2005, we issued an aggregate of 4 million shares to all of the registered shareholders of Xi'an Xilan Natural Gas Co., Ltd., and entered into exclusive arrangements with Xi'an Xilan Natural Gas Co., Ltd. and these shareholders that give us the ability to substantially influence Xi'an Xilan Natural Gas' daily operations and financial affairs, appoint its senior executives and approve all matters requiring shareholder approval. On December 19, 2005, we changed our name to China Natural Gas, Inc.

On February 21, 2006, we formed Xilan Natural Gas Equipment Ltd., ("Xilan Equipment") as a wholly owned foreign enterprise (WOFE). We then, through Xilan Equipment, entered into exclusive arrangements with Xi'an Xilan Natural Gas Co., Ltd. and these shareholders that give us the ability to substantially influence Xi'an Xilan Natural Gas' daily operations and financial affairs, appoint its senior executives and approve all matters requiring shareholder approval. We memorialized these arrangements on August 17, 2007. As a result, the Company consolidates the financial results of Xi'an Xilan Natural Gas as variable interest entity pursuant to FASB Interpretation No. 46R, "Consolidation of Variable Interest Entities."

We distribute and sell natural gas to commercial, industrial and residential customers in the Xi'an area, including Lantian County and the Lintong and Baqiao Districts, of Shaanxi province of The Peoples' Republic of China ("China" or the "PRC") through a network of approximately 120 km of high pressure pipelines. We also distribute and sell CNG as vehicular fuel through a network of CNG fueling stations in Shaanxi and Henan Provinces. As of December 31, 2008, we owned and operated 23 CNG fueling stations in Shaanxi Province and 12 CNG fueling stations in Henan Province.

We operate four primary business lines:

- Distribution and sale of compressed natural gas (CNG) through Company-owned CNG fueling stations for hybrid (natural gas/gasoline) powered vehicles (35 stations as of December 31, 2008);
- Installation, distribution and sale of piped natural gas to residential, commercial and industrial customers through Company-owned pipelines. The Company distributes and sells natural gas to approximately 96,033 homes and businesses as of December 31, 2008;
- Distribution and sale of gasoline through using Company-owned CNG fueling stations for hybrid(natural gas/gasoline) powered vehicles(5 gasoline selling stations by December 31, 2008), and
- Conversion of gasoline-fueled vehicles to hybrid (natural gas/gasoline) powered vehicles at our Auto Conversion Division.

We buy all of the natural gas that we sell and distribute to our customers from government owned enterprises and private sources. We do not mine or produce any of our own natural gas and have no plans to do so during the next 12 months. The natural gas that we buy is available in two forms: (i) piped natural gas; and (ii) CNG. In 2008, the Company entered into multiple agreements to purchase compressed natural gas of about 160,696,901 cubic meters.

Commitments and Contingencies

The Company has existing long-term natural gas purchase agreements with its major suppliers. However, none of those agreements stipulate any specific purchase amount or quota each year, thus giving the Company flexibility to constantly look for lower-cost source of natural gas supply. Therefore, the Company is not legally bound in purchase commitments by those agreements.

Our Products, Services and Customers

Our Pipeline Distribution System

We own and operate a network of approximately 120 km of high pressure pipeline in the Xi'an area. The network connects to a high pressure pipeline network of the government operated Shaanxi Natural Gas Company, which supplies natural gas directly from a gas field in the northern region of the province. Our high pressure pipeline then feed into city-gate "let-down" stations at Hongqing and Lantian County, where the pressure is reduced and natural gas is transported through a network of low-pressure distribution pipes to supply our residential, commercial and industrial customers in Lantian County and the Lintong and Baqiao Districts. The spur also feeds our compressor station at Hongqing and Xianyan where CNG is collected by tankers to supply CNG fueling stations.

Each of our pipeline customers is physically connected to our pipeline network through Company installed and maintained connection equipment and natural gas usage monitoring systems, from which we generate additional revenues.

We believe that we are currently the sole authorized provider of natural gas to residential customers in our service area and the only privately owned company in the Shaanxi province to own and operate this type of high pressure pipeline.

CNG Fueling Stations

As of December 31, 2008, we own and operate 23 CNG natural gas fueling stations in the Xi'an metropolitan area and 12 natural gas fueling stations in Henan province. Through these company-owned fueling stations, CNG is sold to taxis, buses and private cars that operate on CNG technology. Currently, we purchase natural gas for 1.22 RMB/cubic meter and sell each cubic meter for 2.35 RMB net of value added taxes in Shannxi province.

We continue expanding our CNG fueling station base by constructing new stations as well as acquiring existing stations. We can construct a CNG fueling station in approximately 60 days for a cost of approximately US\$900,000. We are evaluating additional sites for CNG fueling stations in Xi'an and in other regions such as Henan province.

The Company also owns three compressor stations: two located in Xi'an: Hongqing station, acquired in July 2005, near our pipeline; Changsheng station, acquired in September 2008; and the other one in Xianyang city, acquired in January 2008. A compressor station compresses natural gas and allows trucks to transport CNG to fueling stations. The Company currently has the daily processing capacity of 250,000 cubic meters of CNG.

Our Liquefied Natural Gas (LNG) Project

During 2008, we made significant progress to move into the processing, distribution and sale of LNG. The Company spent about \$20 million in the LNG project during 2008, including technology licensing fees, prepayment of equipment purchases, land requisition, and other constructions. We plan to raise the remaining \$20 million investment from our cash reserve, internal operating cash flow, prepayments from our customers, and credit facility from Chinese commercial banks. We believe that adding LNG to our product offerings will expand our geographic sales footprint and improve revenues and profitability. The facility construction work is expected to be completed around June, 2009, and processing equipment installation and testing will be finished by October, 2009. So far the project is on schedule for commercial operation towards the end of 2009.

Both CNG and LNG are natural gas compressed into canisters for convenient transportation, usually by tank trucks, to locations of distribution or consumption. Typically CNG is compressed at 200 times atmospheric pressure and can be transported at normal temperatures to distances of up to 300 kilometers. LNG is compressed at up to 625 times atmospheric pressure and must be transported at sub-zero degree temperatures. The cost of compressing and processing LNG is higher than those of CNG, but LNG can be transported over longer distance and per unit transportation costs are therefore lower.

In September 2007 we have started the construction of an LNG processing and distribution plant in Jingbian, Shaanxi province (the "LNG Project"). We estimate that the LNG Project will cost approximately \$40 million (RMB 309 million). As of March 10, 2008, we have secured such financing and we believe that the plant can be completed by 2009. We have obtained the required permits and approvals to build the LNG plant from local government authorities.

The approval process for LNG plant construction of this type is lengthy and arduous—a factor which we believe is a significant barrier to entry to potential competitors and which better positions our company for long-term growth. This project also allows us to diversify our business and focus on two high-growth areas: CNG fueling station business and LNG production, distribution, and sale. We believe that the PRC's clean energy policies will bolster demand for natural gas in China and we have government support to be a leader in this area.

Our CNG Market

We estimate that currently there are approximately 50,000 vehicles using CNG in the Xi'an area. Currently it is estimated that there are 6,000 buses and 20,000 taxis using CNG in Xi'an. Each bus uses an average of 100 cubic meters of CNG per day and taxis use an average of 40 cubic meters of CNG per day (Source: Xi'an Clean Fuel Vehicles Commission 2007) The PRC government estimates in its Eleventh Five Year Plan (2006-2010) that current total demand for CNG as a vehicular fuel in the Xi'an area is approximately 1,070,000 cubic meters per day. Compared to gasoline and diesel, natural gas as vehicular fuel is cheaper, cleaner and safer. The PRC government's Clean Energy Policy encourages the use of CNG as a vehicular fuel.

We estimate that the average CNG station in Xi'an pumps approximately 15,000 cubic meters of CNG per day. In the end of 2008, there were 64 CNG fueling stations in Xi'an. We estimate that approximately 940,500 cubic meters of CNG is pumped per day during the year, a figure well below estimated total demand. As a result, we believe that there is significant unmet demand for CNG as vehicular fuel in the Xi'an area that provides us great opportunities for profit and growth.

We believe that our vertically integrated operations, proprietary pipeline and secured supply contracts give us greater access to CNG supplies and customers and a unique competitive position as a major supplier of CNG vehicular fuel in the Xi'an area.

Our Pipeline Network Customers

As of December 31, 2008 we had approximately 96,033 customers, including residential, industrial and commercial customers. We are continuing to expand our customer base in Xi'an's newly developed business and residential areas including Xihan and Chanliu. Our industrial customers, including the Xiwei Aluminum Company and the Hungtian Company, use natural gas as a raw material for their production process. We are not dependent upon any single customer or group of customers for a material portion of our natural gas sales or revenues.

Our pipeline customers purchase natural gas by prepaid cards that can be inserted into the connection equipment to initiate gas flow.

The Company entered into agreements with Xi'an International Port Administrative Committee and the Town of Tangyu in April and October 2008, respectively, to provide natural gas to local residents and businesses on an exclusive basis. The international Port project is estimated to involve the development of approximately 13.5 square miles of business district and the investment of up to \$30 million over the next several years, based on the Port Committee's planning schedule. The Tangyu project involves supplying natural gas to potentially 50,000 residential and commercial users of this well-known tourist attraction.

Our Subsidiaries and Variable Interest Entities

On October 24, 2006, Xi'an Xilan Natural Gas formed a wholly-owned subsidiary, Shaanxi Jingbian Liquefied Natural Gas Co., Ltd., a limited liability company organized under the laws of the PRC to administer the production and sales of LNG.

In 2006, Xi'an Xilan Natural Gas, through its wholly-owned subsidiary, Shaanxi Jingbian Liquefied Natural Gas Co., Ltd, received a letter from PetroChina Company Limited pursuant to which PetroChina agreed in principle, subject to the negotiation and execution of a final contract, to supply up to 150,000,000 cubic meters of natural gas annually upon the completion of our LNG project.

In 2006, we formed a wholly-owned subsidiary, Xi'an Xilan Natural Gas Equipment Ltd., a limited liability company organized under the laws of the PRC ("Xilan Equipment"), to provide equipment to our own CNG fueling stations.

Effective March 8, 2006, we also established a variable interest entity, Xi'an Xilan Natural Gas by entering into exclusive arrangement with Xi'an Xilan Natural Gas through our subsidiary Xilan Equipment. Pursuant to the exclusive arrangement, the Company, through Xilan Equipment, has the ability to substantially influence Xi'an Xilan Natural Gas' daily operations and financial affairs, appoint its senior executives and approve all matters requiring shareholder approval. As a result, based on FASB Interpretation No. 46R, Consolidation of Variable Interest Entities, the Company is able to treat Xi'an Xilan Natural Gas as a variable interest entity of the Company and consolidate its financial results.

In May 2007, Xi'an Xilan Natural Gas formed a wholly-owned subsidiary, Xi'an Xilan Auto Body Shop.

In December 2008, we completed 100% acquisition of Henan Lingbao Yuxi Natural Gas Limited which owns exclusive operation right to supply natural gas to the city of Lingbao for residential, industrial, commercial and vehicular uses. According to the official website of Lingbao Municipal Government (www.lbwbw.com), the City has a total population of about 800,000 among which 200,000 are urban residents and 600,000 are countryside residents. There are about 80,000 urban households, and an estimated annual consumption of natural gas of 20,000,000 cubic meters.

Suppliers

The Company purchases all of the natural gas for resale mainly from four vendors, PetroChina Changqing Oilfield Company, Jiyuan Yuhai Natural Company, Shaanxi Natural Gas Co. Ltd., and Jingcheng City Mingshi Coal Bed Methane Exploitation Ltd. The Company has long-term supply agreements with PetroChina Changqing Oilfield Company and Jingcheng City Mingshi Coal Bed Methane Exploitation Ltd. with no minimum purchase requirements. The price of natural gas is strictly controlled by the government and has remained stable over the past 3 years.

On October 19, 2006, we received a letter from PetroChina Company Limited pursuant to which PetroChina agreed in principle to supply up to 150 million cubic meters of natural gas annually to our subsidiary subject to the negotiation of a final agreement once our LNG plant is built.

According to the general business practices of PetroChina, the above-mentioned approval of 150 million cubic meters' annual supply quota should ensure our LNG project the amount of annual supply from PetroChina's wholly-owned subsidiary Changqing Oil Field Group Limited which has a 14 billion-cubic-meter natural gas purification facility next door to our LNG project. The supply agreement for 2009 will be based on our LNG plant's expected processing capability for this year and will be entered between the company and Changqing Oil Field Group Limited around third quarter of this year because once the supply amount is stipulated in the agreement, the company would need to pay full fee for the amount no matter we could use them or not.

We do not expect any difficulty in continuing to renew our supply contracts during the next 12 months.

PRC Natural Gas Industry Overview

China's rapidly expanding economy is stretching the limits of its energy resources. The country is the world's second largest energy consumer after the United States, with an annual energy consumption growth rate as high as 12.8% between 2002 and 2006 and slowed down slightly to 10.8% between 2006-2008 due to Chinese government's national policy of "saving energy and reducing emission". During the same period, natural gas consumption grows at 13.3% annually. Natural gas currently accounts for only 3% of the country's total energy usage, compared to the world

average 23%.

5

According to China's Ministry of Science & Technology and World Petroleum Council's China Committee's 2009 report, for the next 20 years, China's energy consumption elasticity index remains at 0.45-0.50, among which coal is 0.30, petroleum is 0.50, natural gas is 1.4-1.5, and non-renewable electricity is 0.50-0.60. China's natural gas represents the fastest-growing energy source. With the operation of China's West-East Natural Gas Pipeline" project, it is estimated that China's natural gas consumption grows at 15% per year and will reach a volume of 100 billion cubic meters in 2010, representing 400%-500% growth over 2000.

China's 11th Five-Year Plan (2006-2010) has made the development of natural gas engine for heavy-load trucks as a national key development project, demonstrating Chinese central government's decision to reply on natural gas as a major alternate fuel source for high-consumption vehicles.

In order to meet the demand for natural gas, the PRC government has encouraged private companies to invest in and build the necessary transportation, distribution and sale infrastructure for natural gas. On February 24, 2005, China's State Council issued an opinion encouraging and supporting private sectors to get involved into industries that were previously monopolized by state-owned enterprises only. Those industries open to private sectors include oil and natural gas distribution. The opinion provided a legal framework for private urban natural gas distribution.

Sources of Energy

Traditionally, the PRC has relied heavily on coal and crude oil as its primary energy sources. According to China Statistical Yearbook, in 2006, coal, crude oil, hydro-electricity and natural gas accounted for 69.40%, 20.40%, 7.20% and 3.00%, respectively, of the PRC's total energy consumption. During the PRC government's Eleventh Five Year Plan (2006-2010), the percentage of coal, crude oil and hydro-electricity would go down to 66.1%, 20.5% and 6.8% respectively, while that of natural gas would increase to 5.1%. Traditionally, a large portion of natural gas is consumed as raw material for production of fertilizer. A little over 10% of natural gas is consumed as fuel. (Source: The Institute of Energy Economics of Japan).

The PRC's heavy reliance on coal exceeds world consumption rates for the same period, which was 22.2% (Source: Energy Information Administration, U.S. Department of Energy). The use of coal, however, causes air pollution and other negative consequences to the environment. In the PRC, the heavy use of unwashed coal has led to large emissions of sulfur dioxide and particulate matter. An air pollution study conducted by the World Health Organization in 2006 showed that seven of the 10 most polluted cities in the world were located in the PRC. As such, there have been serious environmental concerns in many countries around the world, resulting in a global trend to reduce coal usage. In consideration of such trends, in 2006, the PRC presented a plan to raise the share of natural gas in the country's energy mix (Source: 11th Five-Year Plan (2006-2010)). In many locations where natural gas supply is available, local governments often require all new residential buildings to install piped gas connections as a condition to the issuance of the construction or occupancy permits. Before 2006, local municipal governments controlled gas distribution. Since then, the industry has been opened to private companies, whose investments have fostered an increase in the use of natural gas in the PRC. The PRC government has deemed the natural gas industry a suitable industry for public and private investments.

China's Natural Gas Reserves and Gas Pipeline Infrastructure

Recognizing the serious problems caused by the heavy reliance on coal usage, the PRC government has aggressively moved to reduce coal usage by substituting coal with other, more environmentally friendly forms of fuel, such as natural gas. The PRC abounds in rich natural gas reserves, which are distributed among Xinjiang, Sichuan, and Shaanxi Provinces, as well as Inner Mongolia. China's Ministry of Science & Technology and World Petroleum Council's China Committee's 2009 report, by the end of 2007, natural gas reserves in China are estimated to be 4.7 trillion cubic meters with 3.1 trillion cubic meters explorable. According to relevant forecast, from 2009 to 2020,

China's natural gas reserve will increase another 3.0 trillion cubic meters with cumulative reserves exceeding 6.0 trillion cubic meters (Source: official website of PRC Ministry of Science & Technology: www.most.gov.cn).

Because China's largest reserves of natural gas are located in western and north-central China, in 2002, the Chinese government initiated the construction of a 4,000 kilometer long high pressure pipeline project in order to transport natural gas from Xinjiang and Shaanxi in the northwestern parts of China to Beijing, Shanghai, and other cities in the southern and eastern regions of China which are economically stronger and thus account for more energy consumption. The pipeline network, which runs across 9 provinces on Chinese mainland, started operation in December 2004, and has significantly optimized the energy infrastructure of China. The natural gas pipeline presented great business opportunity for natural gas distributors at the major junctures, such as Shaanxi province.

Demand for Natural Gas

Currently, natural gas consumption in the PRC accounts for less than 3% of its total energy consumption. However, driven by environmental pressures, improvements in social infrastructure fueled by economic growth, and a stable energy supply, it is anticipated that the use of natural gas will grow very rapidly in the PRC over the next 20 years.

According to China's National Natural Gas Overall Plan by the State Council, the number of cities pipelined with natural gas would increase from 140 in 2005 to 270 in 2010 and by the middle of the 21st century, 70% of all the cities in China would be pipelined. Annual natural gas output will crease from currently 70 billion cubic meters to 120 billion – 150 billion cubic meters by 2020. According to IFA's forecast, natural gas will be the fastest-growing energy in the 21st century. Its consumption will exceed petroleum by the middle of the century, accounting for 51% of the world's energy consumption and thus becoming the real "first energy" of the world.

Intellectual Property

We have applied for a service mark on the "Xilan" name, which is used in connection with all our products and services.

Research and Development

We have not had and do not anticipate having any material research and development expenses. The funding for all research and development expenses is expected to come from operating cash flows.

Governmental and Environmental Regulation

To date, we comply with all registrations and requirements for the issuance and maintenance of all licenses required by the applicable governing authorities in China. These licenses include:

- Xi'an Natural Gas Operations License, authorized by the Shaanxi Municipal Management Committee, effective from November 25, 2008 to February 28, 2010.(License number XR157)
- License to Supply, Install Equipment and Maintain Gas Fuel Lines issued by the local Gas Fuels for Heating Bureau, an agency of the Ministry of Construction and the Xi'an Natural Gas Management Bureau. License number: XIRAN 136)
- Safety and Inspection Regulation for Special Equipment Safety Inspection Standards for High Pressure Pipeline and Technical Safety Inspection Regulations from the Shaanxi Quality and Technology Inspection Bureau for compressor stations and pressure storage tank system. (Approval letter reference: 2004SHAANGUOCHUHAN033)

- Annual Safety Inspection of Lightning Conductor Equipment approved by the Shaanxi Meteorology Bureau. (Certificate number 0005274) The City-gate and Compressor Stations are approved by the local office of the Ministry of Construction.
 - Business license to operate Xilan Equipment effective from February 22, 2006 to February 21, 2021.
 - Business license to operate Xilan Liquefied Natural Gas effective from October 24, 2006 to October 23, 2036.
 - Business license to operate Xi'an Xilan Auto Bodyshop effective as of May 15, 2007.
 - Business license to operate Xi'an Xilan Natural Gas effective as of January 8, 2000.

Fuel service station standards are subject to regulation by the Ministry of Construction, the General Administration of Quality Supervision, and the Bureau of Inspection and Quarantine of the People's Republic of China. Upon satisfactory inspection of service stations, certificates will be issued.

Various standards must be met for fueling stations, including the handling and storage of CNG, tanker handling, and compressor operation. The Local Ministry of Construction and the Gas Field Operation Department of the Municipal Administration Committee regulate these standards. The Municipal Development and Reform Commission, which issues certificates for the handling of dangerous chemical agents, carries out inspections.

Standards for the design and construction of fueling stations must conform to GB50156-2202 and technology standard BJJ84-2000.

Competition

The three largest state owned energy companies, CNPC (China National Petroleum Corporation) Group, SINOPEC (China Petroleum and Chemical Corporation Group), and CNOOC (China National Offshore Oil Corporation Group) are principally engaged in the upstream supply of energy and are material competitors in the exploration and transportation of oil and gas. They build much of the country's high-pressure pipeline infrastructure. Natural gas is distributed to smaller regional firms that redistribute the gas to the end user, either through lower pressure pipeline networks, or via tankers in the form of liquid natural gas (LNG).

With respect to our pipeline gas services in Xi'an, the Company and its competitors each serves a designated city area by local government on a exclusive basis, therefore there is no direct competition in our pipeline gas services. Other pipeline gas service provider in the city of Xi'an include Qin Hua Natural Gas Limited

With respect to our CNG fueling station market, currently, there are approximately 64 CNG fueling stations in Xi'an City. Among those 64, 15 of these stations are state owned enterprises, and the other 28 stations are privately owned with the majority of these being single station operators. We believe that we effectively compete with the stations based upon our scale, network, stable source of gas supply, compressing capabilities, and brand awareness.

With respect to our LNG business, our major competitor is Xinjiang Guanghui LNG Development Limited. It is located in China's Xinjiang Uygur Autonomous Region and has an annual capacity around 300 million cubic meters. Both the Company and the competitor's major target market for the LNG business is South China's economically-developed Guangdong Province and its surrounding regions. However, the distance to the target market for our LNG business is only one third of our competitors', thus giving us significant cost advantage in transportation.

Employees

Currently, we have 710 employees, including, 50 in management; 150 in sales, and 510 in finance, accounting, and operations. We have not experienced any industrial actions and we have excellent relationships with our employees. We are not a party to any collective bargaining agreements.

Legal Proceedings

A former member of the board of directors filed a lawsuit against the Company in New York State Supreme Court, Nassau County, in which he has sought, among other things; to recover a portion of his monthly compensation plus 20,000 options that he alleges are due to him pursuant to a written agreement. After the plaintiff rejected an offer by the Company that included the options that plaintiff alleged were due to him, the Company moved to dismiss the complaint. The judge ordered the Company to issue the 20,000 options to the plaintiff subject to any restrictions required by applicable securities laws, which was essentially what the Company had previously offered, and dismissed all of the plaintiff's remaining claims against the Company. The current board of directors has complied with the court's decision by tendering an options agreement to the plaintiff consistent with the court's decision, but the plaintiff has refused to execute the agreement, and instead has filed an appeal. Regardless of the outcome of the appeal, the Company believes that any liability it would incur will not have a materially adverse effect on its financial condition or its results of operations.

Available Information

We file quarterly and annual reports, proxy statements and other information with the SEC. You may read and copy any document that we file at the public reference facilities of the SEC in Washington, D.C. You may call the SEC at 1-800-SEC-0330 for further information on the public reference rooms. Our SEC filings are also available to the public from the SEC's website at <http://www.sec.gov>.

ITEM 1A. RISK FACTORS

RISK FACTORS

An investment in our common stock is speculative and involves a high degree of risk and uncertainty. You should carefully consider the risks described below, together with the other information contained in this prospectus, including the consolidated financial statements and notes thereto of our Company, before deciding to invest in our common stock. The risks described below are not the only ones facing our Company. Additional risks not presently known to us or that we presently consider immaterial may also adversely affect our Company. If any of the following risks occur, our business, financial condition and results of operations and the value of our common stock could be materially and adversely affected.

Risks Related to Our Business

Prices of natural gas can be subject to significant fluctuations, which may affect our ability to provide supplies to our customers.

We obtain most of our supplies of natural gas from a government owned entity and our supply contracts are subject to review every six months. However, our costs for natural gas are strictly controlled by the government and have remained stable over the past 3 years. Management does not expect any difficulty in continuing to renew the supply contracts during the next 12 months. The price of natural gas can fluctuate in response to changing national or international market forces. Accordingly, price levels of natural gas may rise or fall significantly over the short to

medium term due to political events, OPEC actions and other factors, industry economics over the long term.

We are dependent on supplies of natural gas to deliver to our customers.

With the exception of certain compressed and liquid natural gas supplies, we obtain our supplies of natural gas from one supplier, which is a government owned entity. The ability to deliver our product is dependent on a sufficient supply of natural gas and if we are unable to obtain a sufficient natural gas supply, it could prevent us making deliveries to our customers. While we have supply contracts, we do not control the government owned or other suppliers, nor are we able to control the amount of time and effort they put forth on our behalf. It is possible that our suppliers will not perform as expected, and that they may breach or terminate their agreements with us. It is also possible that, after a semi-annual review of our primary supply contract, they will choose to provide services to a competitor. Any failure to obtain supplies of natural gas could prevent us from delivering such to our customers and could have a material adverse affect on our business and financial condition.

We may need to raise capital to fund our operations, and our failure to obtain funding when needed may force us to delay, reduce or eliminate acquisitions and business development plans.

If in the future, we are not capable of generating sufficient revenues from operations and our capital resources are insufficient to meet future requirements, we may have to raise funds to continue the development, commercialization and marketing of our business.

We cannot be certain that funding will be available. To the extent that we raise additional funds by issuing equity securities, our stockholders may experience significant dilution. Any debt financing, if available, may involve restrictive covenants that impact our ability to conduct our business. If we are unable to raise additional capital if required or on acceptable terms, we may have to delay, scale back, discontinue our planned acquisitions or business development plans or obtain funds by entering into agreements on unattractive terms.

Our business operations are subject to a high degree of risk and insurance may not be adequate to cover liabilities resulting from accidents or injuries that may occur.

Our operations are subject to potential hazards incident to the gathering, processing, separation and storage of natural gas, such as explosions, product spills, leaks, emissions and fires. These hazards can cause personal injury and loss of life, severe damage to and destruction of property and equipment, and pollution or other environmental damage, and may result in curtailment or suspension of our operations.

The occurrence of a significant event for which we are not fully insured or indemnified, and/or the failure of a party to meet its indemnification obligations, could materially and adversely affect our operations and financial condition. Moreover, no assurance can be given that we will be able to maintain adequate insurance in the future at rates it considers reasonable. To date, however, we have maintained adequate coverage at reasonable rates and have experienced no material uninsured losses.

Changes in the regulatory atmosphere could adversely affect our business.

The distribution of natural gas and operations of fueling stations are highly regulated requiring registrations for the issuance of licenses required by various governing authorities in China. In addition, various standards must be met for fueling stations including handling and storage of natural gas, tanker handling, and compressor operation which are regulated. The costs of complying with regulations in the future may harm our business. Furthermore, future changes in environmental laws and regulations could result in stricter standards and enforcement, larger fines and liability, and increased capital expenditures and operating costs, any of which could have a material adverse effect on our financial condition or results of operations.

We depend on our senior management's experience and knowledge of the industry and would be adversely affected by the loss of any of our senior managers.

We are dependent on the continued efforts of our senior management team. If, for any reason, our senior executives do not continue to be active in management, our business, or the financial condition of our Company, our results of operations could be adversely affected. In addition, we do not maintain life insurance on our senior executives and other key employees.

Risks Related to the People's Republic of China

China's economic policies could affect our business.

Substantially all of our assets are located in China and substantially all of our revenue is derived from our operations in China. Accordingly, our results of operations and prospects are subject, to a significant extent, to the economic, political and legal developments in China.

While China's economy has experienced a significant growth in the past twenty years, growth has been irregular, both geographically and among various sectors of the economy. The Chinese government has implemented various measures to encourage economic growth and guide the allocation of resources. Some of these measures benefit the overall economy of China, but may also have a negative effect on us. For example, our operating results and financial condition may be adversely affected by the government control over capital investments or changes in tax regulations.

The economy of China has been transitioning from a planned economy to a more market-oriented economy. In recent years the Chinese government has implemented measures emphasizing the utilization of market forces for economic reform and the reduction of state ownership of productive assets and the establishment of corporate governance in business enterprises; however, a substantial portion of productive assets in China are still owned by the Chinese government. In addition, the Chinese government continues to play a significant role in regulating industry development by imposing industrial policies. It also exercises significant control over China's economic growth through the allocation of resources, controlling payment of foreign currency-denominated obligations, setting monetary policy and providing preferential treatment to particular industries or companies.

Capital outflow policies in The People's Republic of China may hamper our ability to remit income to the United States.

The PRC government imposes controls on the convertibility of Renminbi into foreign currencies and, in certain cases, the remittance of currency outside of the PRC. We receive substantially all of our revenues in Renminbi. Under our current structure, our income is primarily derived from payments from Xi'an Xilan Natural Gas Co. Shortages in the availability of foreign currency may restrict the ability of Xi'an Xilan Natural Gas to remit sufficient foreign currency to pay dividends or other payments to us, or otherwise satisfy its foreign currency denominated obligations. Under existing PRC foreign exchange regulations, payments of current account items, including profit distributions, interest payments and expenditures from trade-related transactions, can be made in foreign currencies without prior approval from the PRC State Administration of Foreign Exchange by complying with certain procedural requirements. However, approval from appropriate government authorities is required in those cases in which Renminbi is to be converted into foreign currency and remitted out of the PRC to pay capital expenses, such as the repayment of bank loans denominated in foreign currencies. The PRC government also may at its discretion restrict access in the future to foreign currencies for current account transactions. If the foreign exchange control system prevents us from obtaining sufficient foreign currency to satisfy our currency demands, we may not be able to pay dividends in foreign currencies to our shareholders.

Although we do not import goods into or export goods out of The People's Republic of China, fluctuation of the RMB may indirectly affect our financial condition by affecting the volume of cross-border money flow.

The value of the RMB fluctuates and is subject to changes in the People's Republic of China political and economic conditions. Since July 2005, the conversion of RMB into foreign currencies, including USD, has been based on rates set by the People's Bank of China which are set based upon the interbank foreign exchange market rates and current exchange rates of a basket of currencies on the world financial markets. As of December 31, 2008, the exchange rate between the RMB and the United States dollar was 6.82 RMB to every one USD.

We may face obstacles from the communist system in The People's Republic of China.

Foreign companies conducting operations in The People's Republic of China face significant political, economic and legal risks. The Communist regime in The People's Republic of China, including a stifling bureaucracy may hinder Western investment.

We may have difficulty establishing adequate management, legal and financial controls in The People's Republic of China.

The People's Republic of China historically has been deficient in Western style management and financial reporting concepts and practices, as well as in modern banking, computer and other control systems. We may have difficulty in hiring and retaining a sufficient number of qualified employees to work in The People's Republic of China. As a result of these factors, we may experience difficulty in establishing management, legal and financial controls, collecting financial data and preparing financial statements, books of account and corporate records and instituting business practices that meet Western standards.

Because our assets and operations are located in China, you may have difficulty enforcing any civil liabilities against us under the securities and other laws of the United States or any state.

We are a holding company, and all of our assets are located in the Republic of China. In addition, our directors and officers are non-residents of the United States, and all or a substantial portion of the assets of these non-residents are located outside the United States. As a result, it may be difficult for investors to effect service of process within the United States upon these non-residents, or to enforce against them judgments obtained in United States courts, including judgments based upon the civil liability provisions of the securities laws of the United States or any state.

There is uncertainty as to whether courts of the Republic of China would enforce:

- Judgments of United States courts obtained against us or these non-residents based on the civil liability provisions of the securities laws of the United States or any state; or
- In original actions brought in the Republic of China, liabilities against us or non-residents predicated upon the securities laws of the United States or any state. Enforcement of a foreign judgment in the Republic of China also may be limited or otherwise affected by applicable bankruptcy, insolvency, liquidation, arrangement, moratorium or similar laws relating to or affecting creditors' rights generally and will be subject to a statutory limitation of time within which proceedings may be brought.

The PRC legal system embodies uncertainties, which could limit law enforcement availability.

The PRC legal system is a civil law system based on written statutes. Unlike common law systems, decided legal cases have little precedence. In 1979, the PRC government began to promulgate a comprehensive system of laws and regulations governing economic matters in general. The overall effect of legislation over the past 27 years has significantly enhanced the protections afforded to various forms of foreign investment in China. Each of our PRC operating subsidiaries and affiliates is subject to PRC laws and regulations. However, these laws and regulations change frequently and the interpretation and enforcement involve uncertainties. For instance, we may have to resort to administrative and court proceedings to enforce the legal protection that we are entitled to by law or contract. However, since PRC administrative and court authorities have significant discretion in interpreting statutory and contractual terms, it may be difficult to evaluate the outcome of administrative court proceedings and the level of law enforcement that we would receive in more developed legal systems. Such uncertainties, including the inability to enforce our contracts, could affect our business and operation. In addition, intellectual property rights and confidentiality protections in China may not be as effective as in the United States or other countries. Accordingly, we cannot predict the effect of future developments in the PRC legal system, particularly with regard to the industries in which we operate, including the promulgation of new laws. This may include changes to existing laws or the interpretation or enforcement thereof, or the preemption of local regulations by national laws. These uncertainties could limit the availability of law enforcement, including our ability to enforce our agreements with the government entities and other foreign investors.

The admission of China into the World Trade Organization could lead to increased foreign competition.

Provincial and central government authorities regulate the natural gas industry for safety and ensure that all areas receive natural gas service. However, as a result of China becoming a member of the World Trade Organization (WTO), restrictions on foreign investment in the industry may be reduced. With China's need to meet growth in natural gas demand and the WTO's requirement for a reduction of restrictions on foreign investment as a condition of membership, such events could lead to increased competition in the natural gas industry.

PRC laws and regulations governing our businesses and the validity of certain of our contractual arrangements are uncertain. If we are found to be in violation, we could be subject to sanctions. In addition, changes in such PRC laws and regulations may materially and adversely affect our business.

There are substantial uncertainties regarding the interpretation and application of PRC laws and regulations, including, but not limited to, the laws and regulations governing our business, or the enforcement and performance of our contractual arrangements with our variable interest entity, Xi'an Xilan Natural Gas, and its shareholders. We are considered a foreign person or foreign invested enterprise under PRC law. As a result, we are subject to PRC law limitations on foreign ownership of Chinese companies. These laws and regulations are relatively new and may be subject to change, and their official interpretation and enforcement may involve substantial uncertainty. The effectiveness of newly enacted laws, regulations or amendments may be delayed, resulting in detrimental reliance by foreign investors. New laws and regulations that affect existing and proposed future businesses may also be applied retroactively.

The PRC government has broad discretion in dealing with violations of laws and regulations, including levying fines, revoking business and other licenses and requiring actions necessary for compliance. In particular, licenses and permits issued or granted to us by relevant governmental bodies may be revoked at a later time by higher regulatory bodies. We cannot predict the effect of the interpretation of existing or new PRC laws or regulations on our businesses. We cannot assure you that our current ownership and operating structure would not be found in violation of any current or future PRC laws or regulations. As a result, we may be subject to sanctions, including fines, and could be required to restructure our operations or cease to provide certain services. Any of these or similar actions

could significantly disrupt our business operations or restrict us from conducting a substantial portion of our business operations, which could materially and adversely affect our business, financial condition and results of operations.

We may be adversely affected by complexity, uncertainties and changes in PRC regulation of natural gas business and companies, including limitations on our ability to own key assets.

The PRC government regulates the natural gas industry including foreign ownership of, and the licensing and permit requirements pertaining to, companies in the natural gas industry. These laws and regulations are relatively new and evolving, and their interpretation and enforcement involve significant uncertainty. As a result, in certain circumstances it may be difficult to determine what actions or omissions may be deemed to be a violation of applicable laws and regulations. Issues, risks and uncertainties relating to PRC government regulation of the bio-pharmaceutical industry include the following:

- we only have contractual control over Xi'an Xilan Natural Gas. We do not own it due to the restriction of foreign investment in Chinese businesses; and
- uncertainties relating to the regulation of the natural gas business in China, including evolving licensing practices, means that permits, licenses or operations at our company may be subject to challenge. This may disrupt our business, or subject us to sanctions, requirements to increase capital or other conditions or enforcement, or compromise enforceability of related contractual arrangements, or have other harmful effects on us.

The interpretation and application of existing PRC laws, regulations and policies and possible new laws, regulations or policies have created substantial uncertainties regarding the legality of existing and future foreign investments in, and the businesses and activities of, natural gas businesses in China, including our business.

In order to comply with PRC laws limiting foreign ownership of Chinese companies, we conduct our natural gas business through Xi'an Xilan Natural Gas by means of contractual arrangements. If the government of the People's Republic of China determines that these contractual arrangements do not comply with applicable regulations, our business could be adversely affected.

The government of the People's Republic of China restricts foreign investment in natural gas businesses in China. Accordingly, we operate our business in China through Xi'an Xilan Natural Gas. Xi'an Xilan Natural Gas holds the licenses and approvals necessary to operate our natural gas business in China. We have contractual arrangements with Xi'an Xilan Natural Gas and its shareholders that allow us to substantially control Xi'an Xilan Natural Gas. We cannot assure you, however, that we will be able to enforce these contracts.

Although we believe we comply with current regulations of the People's Republic of China, we cannot assure you that the government of the People's Republic of China would agree that these operating arrangements comply with the People's Republic of China's licensing, registration or other regulatory requirements, with existing policies or with requirements or policies that may be adopted in the future. If the government of the People's Republic of China determines that we do not comply with applicable law, it could revoke our business and operating licenses, require us to discontinue or restrict our operations, restrict our right to collect revenues, require us to restructure our operations, impose additional conditions or requirements with which we may not be able to comply, impose restrictions on our business operations or on our customers, or take other regulatory or enforcement actions against us that could be harmful to our business.

Our contractual arrangements with Xi'an Xilan Natural Gas and its shareholders may not be as effective in providing control over these entities as direct ownership.

Since the law of the People's Republic of China limits foreign equity ownership in natural gas companies in China, we operate our business through Xi'an Xilan Natural Gas. We have no equity ownership interest in Xi'an Xilan Natural Gas and rely on contractual arrangements to control and operate such businesses. These contractual arrangements may not be effective in providing control over Xi'an Xilan Natural Gas as direct ownership. For example, Xi'an Xilan

Natural Gas could fail to take actions required for our business despite its contractual obligation to do so. If Xi'an Xilan Natural Gas fails to perform under its agreements with us, we may have to incur substantial costs and resources to enforce such arrangements and may have to rely on legal remedies under the law of the People's Republic of China, which may not be effective. In addition, we cannot assure you that Xi'an Xilan Natural Gas' shareholders would always act in our best interests.

Risks Related to Corporate and Stock Matters

Our largest stockholder has significant influence over our management and affairs and could exercise this influence against your best interests.

At December 31, 2008, Mr. Qinan Ji, our founder, Chairman of the Board and Chief Executive Officer and our largest stockholder, beneficially owned approximately 20.3% of our outstanding shares of common stock. As a result, pursuant to our Bylaws and applicable laws and regulations, our controlling shareholder and our other executive officers and directors are able to exercise significant influence over our Company, including, but not limited to, any stockholder approvals for the election of our directors and, indirectly, the selection of our senior management, the amount of dividend payments, if any, our annual budget, increases or decreases in our share capital, new securities issuance, mergers and acquisitions and any amendments to our Bylaws. Furthermore, this concentration of ownership may delay or prevent a change of control or discourage a potential acquirer from making a tender offer or otherwise attempting to obtain control of us, which could decrease the market price of our shares. The limited prior public market and trading market may cause volatility in the market price of our common stock.

The limited trading volume in our stock may cause volatility in the market price of our common stock.

Our common stock is currently traded on a limited basis on the OTCBB under the symbol, "CHNG.OB" The quotation of our common stock on the OTCBB does not assure that a meaningful, consistent and liquid trading market currently exists, and in recent years, such market has experienced extreme price and volume fluctuations that have particularly affected the market prices of many smaller companies like us. Our common stock is thus subject to volatility. In the absence of an active trading market:

- investors may have difficulty buying and selling or obtaining market quotations;
- market visibility for our common stock may be limited; and
- a lack of visibility for our common stock may have a depressive effect on the market for our common stock.

Trading of our stock may be restricted by the SEC's penny stock regulations which may limit a stockholder's ability to buy and sell our stock if our stock trades below \$5.00 per share.

The SEC has adopted Rule 15c-9 which generally defines "penny stock" to be any equity security that has a market price (as defined) less than \$5.00 per share or an exercise price of less than \$5.00 per share, subject to certain exceptions. Our securities are covered by the penny stock rules, which impose additional sales practice requirements on broker-dealers who sell to persons other than established customers and "accredited investors". The term "accredited investor" refers generally to institutions with assets in excess of \$5,000,000 or individuals with a net worth in excess of \$1,000,000 or annual income exceeding \$200,000 or \$300,000 jointly with their spouse. The penny stock rules require a broker-dealer, prior to a transaction in a penny stock not otherwise exempt from the rules, to deliver a standardized risk disclosure document in a form prepared by the SEC which provides information about penny stocks and the nature and level of risks in the penny stock market. The broker-dealer also must provide the customer with current bid and offer quotations for the penny stock, the compensation of the broker-dealer and its salesperson in the transaction and monthly account statements showing the market value of each penny stock held in the customer's account. The bid and offer quotations, and the broker-dealer and salesperson compensation information, must be given to the customer orally or in writing prior to effecting the transaction and must be given to the customer in writing before or with the customer's confirmation. In addition, the penny stock rules require that prior to a transaction in a penny stock not otherwise exempt from these rules, the broker-dealer must make a special written determination that the penny stock is a suitable investment for the purchaser and receive the purchaser's written agreement to the transaction. These disclosure requirements may have the effect of reducing the level of trading activity in the

secondary market for the stock that is subject to these penny stock rules. Consequently, these penny stock rules may affect the ability of broker-dealers to trade our securities. We believe that the penny stock rules discourage investor interest in and limit the marketability of our common stock.

NASD sales practice requirements may also limit a stockholder's ability to buy and sell our stock.

Section 15(g) of the Securities Exchange Act of 1934, as amended, and Rule 15g-2 promulgated thereunder by the SEC require broker-dealers dealing in penny stocks to provide potential investors with a document disclosing the risks of penny stocks and to obtain a manually signed and dated written receipt of the document before effecting any transaction in a penny stock for the investor's account.

Potential investors in our common stock are urged to obtain and read such disclosure carefully before purchasing any shares that are deemed to be "penny stock." Moreover, Rule 15g-9 requires broker-dealers in penny stocks to approve the account of any investor for transactions in such stocks before selling any penny stock to that investor. This procedure requires the broker-dealer to (i) obtain from the investor information concerning his or her financial situation, investment experience and investment objectives; (ii) reasonably determine, based on that information, that transactions in penny stocks are suitable for the investor and that the investor has sufficient knowledge and experience as to be reasonably capable of evaluating the risks of penny stock transactions; (iii) provide the investor with a written statement setting forth the basis on which the broker-dealer made the determination in (ii) above; and (iv) receive a signed and dated copy of such statement from the investor, confirming that it accurately reflects the investor's financial situation, investment experience and investment objectives. Compliance with these requirements may make it more difficult for holders of our common stock to resell their shares to third parties or to otherwise dispose of them in the market or otherwise.

Shares eligible for future sale may adversely affect the market price of our Common stock, as the future sale of a substantial amount of our restricted stock in the public marketplace could reduce the price of our common stock.

From time to time, certain of our stockholders may be eligible to sell all or some of their shares of common stock by means of ordinary brokerage transactions in the open market pursuant to Rule 144, promulgated under the Securities Act ("Rule 144"), subject to certain limitations. In general, pursuant to Rule 144, a stockholder (or stockholders whose shares are aggregated) who has satisfied a one-year holding period may, under certain circumstances, sell within any three-month period a number of securities which does not exceed the greater of 1% of the then outstanding shares of common stock or the average weekly trading volume of the class during the four calendar weeks prior to such sale. Rule 144 also permits, under certain circumstances, the sale of securities, without any limitations, by a non-affiliate of our company that has satisfied a two-year holding period. Any substantial sale of common stock pursuant to Rule 144 or pursuant to any resale prospectus may have an adverse effect on the market price of our securities.

If we fail to maintain an effective system of internal controls, we may not be able to accurately report our financial results. As a result, current and potential stockholders could lose confidence in our financial reporting, which would harm our business and the trading price of our stock.

As a public company, we are subject to report our internal control structure and procedures for financial reporting in our annual reports on Form 10-K, as a requirement of Section 404 of the U.S. Sarbanes-Oxley Act of 2002 by the U.S. Securities and Exchange Commission (the "SEC"). The report must contain an assessment by management about the effectiveness of our internal controls over financial reporting. Moreover, the independent registered public accountants of our Company must attest to and report on management's assessment of the same.

Our management and our independent registered public accountants concluded that our internal controls over our financial reporting are not effective, as required by Section 404 of the U.S. Sarbanes-Oxley Act, for the fiscal year ending December 31, 2008, as such, our independent registered public accountants has issued a report on our internal control measures that is adverse. The Company's management has identified the steps necessary to address the material weakness and has begun to execute remediation plans, as discussed in "Item 9A(T). Controls and Procedures" of this Report.

Any failure to implement and maintain the improvements in the controls over our financial reporting, or difficulties encountered in the implementation of these improvements in our controls, could cause us to fail to meet our reporting obligations. Any failure to improve our internal controls to address these identified weaknesses could also cause investors to lose confidence in our reported financial information, which could have a negative impact on the trading price of our stock.

Stockholders should have no expectation of any dividends.

The holders of our common stock are entitled to receive dividends when declared by the Board of Directors out of funds available. To date, we have not declared nor paid any cash dividends. The Board of Directors does not intend to declare any dividends in the near future, but instead intends to retain all earnings, if any, for use in our business operations.

ITEM 2. DESCRIPTION OF PROPERTY

Our principal executive offices are located at 19th Floor, Building B, Van Metropolis, No. 35 Tangyan Road, Hi-Tech Zone, Xi'an, 710065, Shaanxi Province, People's Republic of China. Our property consists of approximately 818 square meters, which is rented on an annual basis for \$88,225.

We have additional properties located in Lantian County, the districts of Baqiao, Lintong and Gaoxin in the city of Xi'an, and the cities of Jiuyan, Kaifung and Pindingshan, in Henan province. We own a 120km high-pressure underground pipeline network and two Citygate stations (terminals) with accompanying buildings and equipment. We lease the main office building where we are headquartered and all of our CNG fueling station sites. In order to secure sufficient CNG supply, we also own three mother stations in Xi'an city to support our stations. As of December 31, 2008, we own and operate 23 CNG fueling stations in Shaanxi Province and 12 CNG fueling stations in Henan Province.

In February, 2006 we formed our 100%-owned subsidiary, Xilan Equipment, which maintains an office in the No. 3 Xianmen St., Lantian County, Xi'an, Shaanxi Province, China. The office consists of approximately 1001 sq. feet, with annual rental payment of \$1,106.

On October 24, 2006, we formed our 100% owned subsidiary, Xilan Liquefied Natural Gas Co., Ltd., which maintains an office in the Tongwang Road, Zhangjiapan Town, Jingbian County, China. The office consists of approximately 3,921 sq. feet, with annual rental payment of \$5,214.

In October, 2008, the Company acquired Lingbao Yuxi Natural Gas, Co., Ltd. through Xi'an Xilan Natural Gas Co., Ltd. Lingbao Yuxi Natural Gas maintains an office located at Yuxi Natural Gas Co., Ltd, Changan Rd. W, Lingbao, Henan Province, with annual rent of approximately \$3,314.

In May 27, 2008, the Company purchased a 412.10-square-meter properties in Zhengzhou, Henan Province and uses it as office spaces for the local operations in Henan Province.

In August, 2008, the Company purchased a 531.72-square-meter properties in Beijing and uses it as office spaces for local operations in Beijing. Therefore, the Company doesn't incur any rent for Henan and Beijing Offices.

As of December 31, 2008, the Company owned 2 trucks and 33 tankers that the Company used to transport natural gas.

Insurance

The Company carries auto insurance on its vehicles and maintains workers compensation insurance for its fueling station workers. The Company believes this insurance is adequate for its needs. The Company does not carry any product liability insurance or property insurance on its office buildings or other property.

We believe that current facilities are adequate for our current and immediately foreseeable operating needs. We do not have any policies regarding investments in real estate, securities or other forms of property.

The Company also carries directors and officers liability insurance with XL Insurance Company Ltd. with aggregate limit of liability \$15 million to cover its management and directors in the event that any claim may arise against such insured persons due to employment related acts. The insurance will expire on Oct 15th, 2009 and is renewed annually.

ITEM 3. LEGAL PROCEEDINGS

A former member of the board of directors filed a lawsuit against the Company in New York State Supreme Court, Nassau County, in which he has sought, among other things; to recover a portion of his monthly compensation plus 20,000 options that he alleges are due to him pursuant to a written agreement. After the plaintiff rejected an offer by the Company that included the options that plaintiff alleged were due to him, the Company moved to dismiss the complaint. The judge ordered the Company to issue the 20,000 options to the plaintiff subject to any restrictions required by applicable securities laws, which was essentially what the Company had previously offered, and dismissed all of the plaintiff's remaining claims against the Company. The current board of directors has complied with the court's decision by tendering an options agreement to the plaintiff consistent with the court's decision, but the plaintiff has refused to execute the agreement, and instead has filed an appeal. Regardless of the outcome of the appeal, the Company believes that any liability it would incur will not have a materially adverse effect on its financial condition or its results of operations.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITYHOLDERS

None.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

On March 17, 2004, our common stock was approved for listing on the Over-the-Counter Bulletin Board under the symbol "CVNI" and on December 19, 2005 our symbol was changed to "CHNG" and our fiscal year end was changed to December 31. The following table contains information about the range of high and low bid prices for our common stock for each full quarterly period for 2008 and 2007 based upon reports of transactions on the OTC Bulletin Board. The source of this information is the OTC Bulletin Board. The quotations represent inter-dealer prices without retail markup, markdown or commission, and may not necessarily represent actual transactions.

| | COMMON STOCK MARKET PRICE | |
|---|------------------------------|---------|
| | HIGH | LOW |
| FISCAL YEAR ENDED DECEMBER 31, 2008: | | |
| Fourth Quarter | \$ 4.08 | \$ 2.25 |
| Third Quarter | \$ 6.00 | \$ 3.50 |
| Second Quarter | \$ 7.33 | \$ 5.15 |
| First Quarter | \$ 7.25 | \$ 4.75 |
| FISCAL YEAR ENDED DECEMBER 31, 2007: | | |
| Fourth Quarter | \$ 14.95 | \$ 6.50 |
| Third Quarter | \$ 8.34 | \$ 4.39 |
| Second Quarter | \$ 5.06 | \$ 1.85 |
| First Quarter | \$ 3.16 | \$ 1.65 |

As of March 10, 2009, there were approximately 31 holders of record of our common stock.

Dividends

There are no restrictions in our articles of incorporation or bylaws that prevent us from declaring dividends. The Delaware General Corporation Law, however, does prohibit us from declaring dividends where, after giving effect to the distribution of the dividend:

1. We would not be able to pay our debts as they become due in the usual course of business; or
2. Our total assets would be less than the sum of our total liabilities plus the amount that would be needed to satisfy the rights of shareholders who have preferential rights superior to those receiving the distribution.

We have never paid any cash dividends on our common stock. We currently anticipate that we will retain any future earnings for use in our business. Consequently, we do not anticipate paying any cash dividends in the foreseeable future.

The payment of dividends in the future will depend upon our results of operations, as well as our short-term and long-term cash availability, working capital, working capital needs and other factors, as determined by our board of directors. Currently, except as may be provided by applicable laws, there are no contractual or other restrictions on our ability to pay dividends if we were to decide to declare and pay them.

Securities Authorized for Issuance under Equity Compensation Plan

There has been no common stock authorized for issuance with respect to any equity compensation plan as of the fiscal year ended December 31, 2008.

Recent Sales of Unregistered Securities

The Company did not sell any equity securities that were not registered under the Securities Act of 1933, as amended, during the quarter ended December 31, 2008.

ITEM 6. SELECTED FINANCIAL DATA

For the past four years, the increase in the number of our CNG fueling stations doesn't affect our gross margin or per-station based operating margin since the natural gas cost and retail price remains unchanged. Meanwhile, our SG&A also increases in proportion to our scale of operations. Therefore, the increase in the number of our CNG fueling stations doesn't materially affect the comparability of our financial data.

| | Year ended December 31 | | | | |
|---|------------------------|-------------------|-------------------|------------------|------------------|
| | 2008 | 2007 | 2006 | 2005 | 2004 |
| STATEMENT OF OPERATIONS: | | | | | |
| Revenue | | | | | |
| Natural gas revenue | 55,746,893 | 28,278,033 | 13,713,145 | 1,687,154 | 306,306 |
| Gasoline revenue | 4,616,052 | 38,486 | - | - | - |
| Construction / installation and other | 7,357,714 | 7,075,534 | 5,115,645 | 3,163,545 | 578,107 |
| Total revenue | 67,720,659 | 35,392,053 | 18,828,790 | 4,850,699 | 884,413 |
| Cost of revenue | | | | | |
| Natural gas cost | 27,234,508 | 14,838,997 | 7,663,060 | 1,293,585 | 226,944 |
| Gasoline cost | 4,277,458 | 34,747 | - | - | - |
| Construction / installation and other | 3,469,671 | 3,151,331 | 2,054,940 | 1,110,452 | 287,102 |
| | 34,981,637 | 18,025,075 | 9,718,000 | 2,404,037 | 514,046 |
| Gross profit | 32,739,022 | 17,366,978 | 9,110,790 | 2,446,662 | 370,367 |
| Operating expenses | | | | | |
| Selling expenses | 7,651,948 | 3,451,161 | 1,308,464 | 474,855 | 387,768 |
| General and administrative expenses | 4,024,882 | 2,837,768 | 1,287,735 | 500,228 | 142,449 |
| Total operating expenses | 11,676,830 | 6,288,929 | 2,596,199 | 975,083 | 530,217 |
| Income from operations | 21,062,192 | 11,078,049 | 6,514,591 | 1,471,579 | (159,850) |
| Non-operating income (expense): | | | | | |
| Interest income | 209,502 | 70,697 | 41,109 | 2,131 | 1,618 |
| Interest expense | (2,228,244) | - | - | - | - |
| Foreign currency exchange loss | (397,299) | - | - | - | - |
| Other income (expense) | 111,859 | (118,753) | (79,021) | (671) | (3,536) |
| Total non-operating income (expense) | (2,304,182) | 48,056 | (37,912) | 1,460 | (1,918) |
| Income before income tax | 18,758,010 | 11,029,993 | 6,476,679 | 1,473,039 | (161,768) |

Edgar Filing: China Natural Gas, Inc. - Form 10-K

| | | | | | |
|--|-------------|------------|------------|------------|-----------|
| Income tax | 3,567,642 | 1,913,923 | 1,025,584 | 220,956 | - |
| Net income | 15,190,368 | 9,116,070 | 5,541,095 | 1,252,083 | (161,768) |
| Other comprehensive income | | | | | |
| Foreign currency translation gain | 5,184,034 | 2,637,573 | 610,705 | 228,175 | - |
| Comprehensive income | 20,374,402 | 11,753,643 | 6,061,800 | 1,480,258 | (161,768) |
| Weighted average shares outstanding | | | | | |
| Basic | 29,200,304 | 26,200,679 | 23,872,936 | 16,299,469 | 9,275,362 |
| Diluted | 29,290,139 | 26,301,802 | 23,872,936 | 16,299,469 | 9,275,362 |
| Earnings per share | | | | | |
| Basic | 0.52 | 0.35 | 0.23 | 0.08 | (0.02) |
| Diluted | 0.52 | 0.35 | 0.23 | 0.08 | (0.02) |
| BALANCE SHEET DATA (at end of period): | | | | | |
| PROPERTY AND EQUIPMENT, net | 76,028,272 | 32,291,995 | 17,193,728 | 8,267,897 | 20,935 |
| Working Capital | 4,989,447 | 13,581,900 | 5,289,220 | (320,253) | (130,368) |
| TOTAL ASSETS | 118,262,291 | 53,289,998 | 28,466,351 | 10,911,062 | 28,875 |
| Long Term Debt | 42,021,605 | - | - | - | 24,078 |
| Shareholder Equity | 71,648,420 | 51,207,314 | 25,630,204 | 9,675,550 | (133,511) |

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

The information in this report contains forward-looking statements. All statements other than statements of historical fact made in this report are forward looking. In particular, the statements herein regarding industry prospects and future results of operations or financial position are forward-looking statements. These forward-looking statements can be identified by the use of words such as "believes," "estimates," "could," "possibly," "probably," "anticipates," "projects," "expects," "may," "will," or "should" or other variations or similar words. No assurances can be given that the future results anticipated by the forward-looking statements will be achieved. Forward-looking statements reflect management's current expectations and are inherently uncertain. Our actual results may differ significantly from management's expectations.

The following discussion and analysis should be read in conjunction with our financial statements, included herewith. This discussion should not be construed to imply that the results discussed herein will necessarily continue into the future, or that any conclusion reached herein will necessarily be indicative of actual operating results in the future. Such discussion represents only the best present assessment of our management.

Overview

We were incorporated in the state of Delaware on March 31, 1999, as Bullet Environmental Systems, Inc. On May 25, 2000, we changed our name to Liquidpure Corp. and on February 14, 2002, we changed our name to Coventure International Inc.

On December 6, 2005, we issued an aggregate of 4 million shares to all of the registered shareholders of Xi'an Xilan Natural Gas Co., Ltd., and entered into exclusive arrangements with Xi'an Xilan Natural Gas Co., Ltd. and these shareholders that give us the ability to substantially influence Xi'an Xilan Natural Gas' daily operations and financial affairs, appoint its senior executives and approve all matters requiring shareholder approval. On December 19, 2005, we changed our name to China Natural Gas, Inc.

On February 21, 2006, we formed Xilan Natural Gas Equipment Ltd., ("Xilan Equipment") as a wholly owned foreign enterprise (WOFE). We then, through Xilan Equipment, entered into exclusive arrangements with Xi'an Xilan Natural Gas Co., Ltd. and these shareholders that give us the ability to substantially influence Xi'an Xilan Natural Gas' daily operations and financial affairs, appoint its senior executives and approve all matters requiring shareholder approval. We memorialized these arrangements on August 17, 2007. As a result, the Company consolidates the financial results of Xi'an Xilan Natural Gas as variable interest entity pursuant to FASB Interpretation No. 46R, "Consolidation of Variable Interest Entities."

We transport, distribute and sell natural gas to commercial, industrial and residential customers in the Xi'an area, including Lantian County and the districts of Lintong and Baqiao, in the Shaanxi Province of The Peoples' Republic of China ("China" or the "PRC") through a network of high pressure pipelines. We also distribute and sell natural gas through a network of approximately 120 km pipeline in Xi'an, Shaanxi Province. During the year of 2008, the pipeline's average daily throughput capacity is 31,347 cubic meters, comparing to approximately 20,565 cubic meters in the year of 2007. As of December 31, 2008, we own and operate 23 CNG fueling stations in Shaanxi Province and 12 CNG fueling stations in Henan Province. During the year of 2008, we had sold compressed natural gas of 149,412,143 cubic meters through our fueling stations, comparing to 84,744,620 cubic meters in the year of 2007.

We operate four primary business lines:

- Distribution and sale of compressed natural gas (CNG) through Company-owned CNG fueling stations for hybrid (natural gas/gasoline) powered vehicles (35 stations as of December 31, 2008);
- Installation, distribution and sale of piped natural gas to residential, commercial and industrial customers through Company-owned pipelines. The Company distributes and sells natural gas to approximately 96,033 homes and businesses as of December 31, 2008;
- Distribution and sale of gasoline through using Company-owned CNG fueling stations for hybrid(natural gas/gasoline) powered vehicles(5 gasoline selling stations by December 31, 2008), and
- Conversion of gasoline-fueled vehicles to hybrid (natural gas/gasoline) powered vehicles at our Auto Conversion Division.

We buy all of the natural gas that we sell and distribute to our customers. We do not mine or produce any of our own natural gas and have no plans to do so during the next 12 months. The natural gas that we buy is available in two forms: (i) piped natural gas; and (ii) CNG.

On October 24, 2006, Xi'an Xilan Natural Gas formed a wholly-owned subsidiary, Shaanxi Jingbian Liquefied Natural Gas Co., Ltd., for the purpose of constructing a liquefied natural gas facility to be located in Jingbian, Shaanxi Province. We plan to invest approximately \$40 million to construct this facility, and we have secured such funding for this project through security purchase agreement with Abax Lotus Ltd. The LNG plant is under construction and is expected to start operation in 2009. Once completed, the plant has LNG processing capacity of 500,000 cubic meters per day, or approximately 150 million cubic meters on an annual basis.

Critical Accounting Policies

Use of Estimates. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Accounts Receivables. Accounts and other receivables are recorded at net realizable value consisting of the carrying amount less an allowance for uncollectible accounts, as needed. The Company allowance for uncollectible accounts is not significant.

The Company maintains reserves for potential credit losses on accounts receivable. Management reviews the composition of accounts receivable and analyzes historical bad debts, customer concentrations, customer credit worthiness, current economic trends and changes in customer payment patterns to evaluate the adequacy of these reserves. Reserves are recorded primarily on a specific identification basis. The Company's management determined that all receivables are good and there is no need for a bad debt reserve as of December 31, 2008.

Other Receivable – Employee Advances. From time to time, the Company advances predetermined amounts based upon internal Company policy to certain employees and internal units to ensure certain transactions to be performed in a timely manner. The Company has full oversight and control over the advanced accounts. Therefore, no allowance for the uncollectible accounts is needed.

Inventory. Inventory is stated at the lower of cost, as determined on a first-in, first-out basis, or market. Management compares the cost of inventories with the market value, and allowance is made for writing down the inventories to their market value, if lower. Inventory consists of material used in the installation of pipelines and material used in repairing and modifying of vehicles. Inventory also consists of natural gas and gasoline.

Fair Value of Financial Instruments

On January 1, 2008, the Company adopted SFAS 157, Fair Value Measurements. SFAS 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability (i.e., the "exit price") in an orderly transaction between market participants at the measurement date. SFAS 157 establishes a three-level valuation hierarchy for disclosures of fair value measurement and enhances disclosures requirements for fair value measures. The carrying amounts reported in the balance sheets for receivables and current liabilities each qualify as financial instruments and are a reasonable estimate of fair value because of the short period of time between the origination of such instruments and their expected realization and their current market rate of interest. The three levels are defined as follow:

- Level 1 inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.
- Level 2 inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.
- Level 3 inputs to the valuation methodology are unobservable and significant to the fair value measurement.

The Company analyzes all financial instruments with features of both liabilities and equity under SFAS 150, “Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity,” SFAS 133, “Accounting for Derivative Instruments and Hedging Activities” and EITF 00-19, “Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company’s Own Stock.”

As required by SFAS 57, financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement. Depending on the product and the terms of the transaction, the fair value of our notes payable and derivative liabilities were modeled using a series of techniques, including closed-form analytic formula, such as the Black-Scholes option-pricing model, which does not entail material subjectivity because the methodology employed does not necessitate significant judgment, and the pricing inputs are observed from actively quoted markets.

Revenue Recognition. The Company’s revenue recognition policies are in accordance with Staff Accounting Bulletin (SAB) 104. Revenue is recognized when services are rendered to customers when a formal arrangement exists, the price is fixed or determinable, the delivery is completed, no other significant obligations of the Company exist and collectability is reasonably assured. Payments received before all of the relevant criteria for revenue recognition are satisfied are recorded as unearned revenue. Revenue from gas and gasoline sales is recognized when gas and gasoline is pumped through pipelines to the end users. Revenue from installation of pipelines is recorded when the contract is completed and accepted by the customers. The construction contracts are usually completed within one to two months. Revenue from repairing and modifying vehicles is recorded when service are rendered to and accepted by the customers.

Segment Report. The Company’s chief operating decision-makers (i.e. chief executive officer and his direct reports) review financial information presented on a consolidated basis, accompanied by disaggregated information about revenues by business lines for purposes of allocating resources and evaluating financial performance. There are no segment managers who are held accountable for operations, operating results and plans for levels or components below the consolidated unit level. Based on qualitative and quantitative criteria established by SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information, the Company considers itself to be operating within one reportable segment.

Unearned Revenue. Unearned revenue represents prepayments by customers for gas purchases and advance payments on installation of pipeline contracts. The Company records such prepayment as unearned revenue when the payments are received.

CONSOLIDATED RESULTS OF OPERATIONS

Comparing Fiscal Years Ended December 31, 2008 and 2007:

The following table presents certain consolidated statement of operations information. Financial information is presented for the 12-month period ending December 31, 2008 and December 31, 2007.

| | 2008 | 2007 |
|------------------------|---------------|---------------|
| Revenues | \$ 67,720,659 | \$ 35,392,053 |
| Cost of Revenues | \$ 34,981,637 | \$ 18,025,075 |
| Operating Expenses | \$ 11,676,830 | \$ 6,288,929 |
| Income from Operations | \$ 21,062,192 | \$ 11,078,049 |
| Net Income | \$ 15,190,368 | \$ 9,116,070 |

Revenue. We generated approximately 89.14% of our revenues in 2008 from the sale of natural gas and gasoline as well as approximately 10.86% of our revenues from installation fees charged to connect end-user customers to our natural gas distribution system. Sales of natural gas at the Company-owned fueling stations accounted for approximately 78.78% of our total revenues in 2008, or approximately \$53,348,301 which was the largest contribution of our three business lines. Sales of natural gas to end-user customers connected to our pipeline distribution system accounted for approximately 3.70% of our total revenues in 2008, or approximately \$2,505,485. Sale of gasoline accounts for approximately 6.82% of the Company's total revenue, or approximately \$4,616,052. Installation fees charged to end users accounts approximately 7.10% of the Company's total revenue, or approximately \$4,810,107.

The Company started selling gasoline at its CNG filling stations in late 2007 to better cater the diverse needs of vehicle owners. However, natural gas still remains the Company's focus and we expect natural gas revenues continue to increase on both an actual basis and as a percentage of revenue. In 2009, the Company expects to add up to 13,000 pipeline customers and construct or acquire an additional 5 fueling stations, which the Company estimates will increase sales of natural gas by 5 million cubic meters.

We had total revenues of \$ 67,720,659 for the twelve months ended December 31, 2008, an increase of \$32,328,606 or approximately 91.34%, compared to \$ 35,392,053 for the twelve months ended on December 31, 2007. The increase in revenues was due primarily to the addition of 11 new company-owned fueling stations during 2008 as well as an increase in the number of residential, commercial and industrial pipeline customers from approximately 84,500 in 2007 to approximately 96,033 in 2008.

New pipeline customers pay approximately 60% of the installation costs to connect to our pipeline system up front and the balance is payable as part of their monthly natural gas bill. During 2008, our installation revenues increased 3.99% over the previous year and our sales of natural gas increased approximately 97.14% over the previous year. Four customers accounted for approximately 13.37%, 12.81%, 10.98% and 9.91% of the Company's installation revenue for the year ended December 31, 2008.

During the year of 2008, we had sold compressed natural gas of 149,412,143 cubic meters, compared to 84,744,620 cubic meters in the same period of 2007, through Company-owned fueling stations. In terms of average station sales value and volume, in the year of 2008, we had sold approximately \$1,524,237 and 4,268,918 cubic meters of compressed natural gas per station, compared to approximately \$1,500,000 and 4,760,000 cubic meters in the same period of 2007. The decline in per station sales volume is mainly due to the 11 newly added stations didn't contribute full-year in revenue due to construction and tune-ups. As for our natural gas pipeline business, in the year of 2008, we had sold 11,284,758 cubic meters, compared to 7,403,314 cubic meters in the same period of 2007 through our pipeline network.

Cost of Sales. Our cost of sales consists of the cost of natural gas and gasoline sales as well as the cost of installation. Cost of natural gas and gasoline sales consists primarily of the cost that we pay for our suppliers, together with transportation costs and depreciation of equipment. Cost of connection includes certain installation costs related to connecting customers to our pipeline system that are generally expensed when incurred.

Cost of sales in 2008 was \$34,981,637, an increase of \$16,956,562 or approximately 94.07% from 2007. Cost of natural gas sales increased by approximately 83.53% to \$27,234,508 in 2008, as compared with \$14,838,997 in 2007. The increase in our cost of sales was primarily related to a material increase in the amount of gas sold and the price that we paid to our suppliers in 2008. In addition, our installation costs increased in 2008 by 10.10% to \$3,469,671, as compared with \$3,151,331 in 2007 as a result of the addition of new pipeline customers. The price that we paid for natural gas in 2008 remained relatively constant compared to 2007. We had sold natural gas of 160,696,901 cubic meters in 2008, compared to 92,147,935 cubic meters in 2007.

We purchase all of our natural gas for resale mainly from four vendors, PetroChina Changqing Oilfield Company, Shaanxi Natural Gas Co Ltd, Jingcheng city Mingshi Coal Bed Methane Exploitation Ltd and Jiyuan Yuhai Fuel Gas Company. As the government owns all land in China, the government controls and owns all the natural resources coming from the ground, thus the government controls the price and flow of the natural gas. Due to the soaring crude oil price and ever increasing demand for energy consumption, the National Development and Reform Commission, which regulates the energy price in China, adjusted the upstream natural gas price for industrial users and vehicular CNG distributors upward by ¥0.4/CM, or 35% in November 2007. The retail price for vehicular CNG was adjusted upward at a ratio of 0.75:1 to the retail price of #90 gasoline in November 2007. Many large cities see dramatic increase in retail vehicular CNG price, for example 66% in Shanghai and 21% (taxi) and 38% (bus) in Tianjin (Sources: www.qq.com new on November 14, 2007 and www.tj.gov.cn on December 4, 2007). However, natural gas price for residential customers is not adjusted to keep the rate at an affordable level. As China shifts from a centrally planned economy to a market economy, we believe it is the government's intention to keep the prices stable, and maintain an unfluctuating supply situation. The government has also undertaken programs to promote the economy growth of the region in which we are located. Therefore, we expect supply and price to continue to be stable in the future.

Gross profit. The Company earned a gross profit of \$32,739,022 for the twelve months ended December 31, 2008, an increase of \$15,372,044 or 88.51%, compared to \$17,366,978 for the twelve months ended December 31, 2007. The increase in gross profit is due to a material increase in natural gas sales and installation revenues in 2008, partially offset by an increase in cost of sales.

Gross margin. Gross margin for natural gas sold through our filling stations as well as our pipeline increased from 47.52% in twelve months ended December 31, 2007 to 51.15% in twelve months ended December 31, 2008 due to lower natural gas procuring cost in Henan Province. Gross margin for our installation business is 52.84% in 2008 as compared to 55.46% in 2007, and for our auto conversion business 39.74% in 2008 as compared to 39.53% in 2007, both remained roughly flat. Due to increasing weight of gasoline revenue during 2008 (6.82% in 2008 as compared to less than 0.5% in 2007), the total gross margin decreased slightly from 49.07% for year 2007 to 48.34% for year 2008. We started sell gasoline in our CNG stations as a supplement of natural gas to attract more natural gas / gasoline hybrid car owners and natural gas remains the Company's focus.

Operating expenses. The Company incurred operating expenses of \$11,676,830 for the twelve months ended December 31, 2008, an increase of \$5,387,901 or 85.67%, compared to \$6,288,929 for the twelve months ended December 31, 2007. Our operating expenses increased primarily as a result of expenses related to the construction, acquisition, and operation of 11 new fueling stations in 2008, as well as continuing expenses related to the identification of possible locations for additional fueling stations and the governmental licensing and approval process, as well as the evaluation of existing natural gas fueling stations as potential acquisition targets. In addition, sales and marketing costs increased in 2008 as we increased our efforts to obtain new residential and commercial customers and attract customers to our fueling stations. General and administrative expenses increased from \$2,837,768 in 2007 to \$4,024,882 in 2008 due to an increase in personnel as a result of our growth. The opening cost per station during the twelve months ended December 31, 2008 is approximately \$1,200,000, compared to approximately \$900,000 in the year of 2007. In 2008, the transportation cost per million cubic meters is approximately

\$3,137.

For the year ended December 31, 2008, three suppliers accounted for 46.69%, 21.96% and 20.04% of the total equipment we purchased for construction activities. We believe that as a result of our relationships within the construction industry and the construction equipment vendor community, and the availability of other vendors to supply the construction equipment and materials, the loss of any one of these three vendors would not have a material adverse effect on our operations.

26

Net Income. Net income increased 66.63% to \$15,190,368 for the twelve months ended December 31, 2008, an increase of \$6,074,298, from \$9,116,070 for the twelve months ended December 31, 2007. Increase in net income is attributed to our material increase in revenues, partially offset by a higher cost of sales and operating expenses, as well as the non cash expense related to the amortization of offering cost associated with the \$40 million senior notes issued to Abax Lotus, Ltd. in 2008. The company expects revenue from our CNG fueling stations to increase on both an actual basis and as a percentage of revenue. In 2009, the Company expects to add up to 13,000 pipeline customers and construct or acquire an additional 5 fueling stations, which the Company estimates will increase sales of natural gas by 5 million cubic meters.

Income tax was \$3,567,642 for the twelve months ended December 31, 2008, as compared to \$1,913,923 for the twelve months ended December 31, 2007. The increase in income tax was attributed to the growth of installation fees and the sale of natural gas.

Liquidity and Capital Resources

As of December 31, 2008 the Company had \$5,854,383 of cash and cash equivalents on hand compared to \$13,291,729 of cash and cash equivalents as of December 31, 2007.

The primary sources of cash in 2008 were income from operations and financing activities. The Company had net cash flows provided by operations of \$20,916,801 for the twelve months ended December 31, 2008 as compared to net cash provided by operations of \$10,476,441 in the corresponding period last year. The increase in net cash flows from operations in 2008 as compared to 2007 was mainly due to the increase in net income, adjusted for non-cash expense items and changes in working capital.

On January 29, 2007, we completed a private placement offering by issuing senior notes, which generated net proceeds of \$37,877,491, which were used for the construction of natural gas fueling stations, liquefied natural gas facility as well as working capital.

Cash outflows for investing activities increased from \$16,885,340 in 2007 to \$67,606,724 in 2008 due to the equipment purchased in LBNGC and fueling stations, payments made to equipment suppliers for investments necessary to construct fueling stations, and the liquefied natural gas facility.

The Company expects to construct or acquire an additional 5 CNG fueling stations in 2009. The Company expects the funds for these investing activities will come from the Company's operating cash flow.

Based on past performance and current expectations, we believe our cash and cash equivalents, cash generated from operations, as well as future possible cash investments, will satisfy our working capital needs, capital expenditures (other than the LNG Project) and other liquidity requirements associated with our operations for at least the next 12 months.

The majority of the Company's revenues and expenses were denominated primarily in Renminbi ("RMB"), the currency of the People's Republic of China. There is no assurance that exchange rates between the RMB and the U.S. Dollar will remain stable. The Company does not engage in currency hedging. Inflation has not had a material impact on the Company's business.

Off-Balance Sheet Arrangements and Contractual Obligations

We entered into series of long term lease agreements with outside parties to lease land use right to the self-built natural gas fueling stations located in the PRC, and please refer to footnote "Commitments and Contingencies" to the financial statements for details. We have purchase agreements with several natural gas suppliers and please see footnote "Current Vulnerability Due to Certain Concentrations" for more explanations. We do not have any other off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that are material to our investors.

Foreign Currency Transactions and Comprehensive Income (Loss)

Accounting principles generally require that recognized revenue, expenses, gains and losses be included in net income. Certain statements, however, require entities to report specific changes in assets and liabilities, such as gain or loss on foreign currency translation, as a separate component of the equity section of the balance sheet. Such items, along with net income, are components of comprehensive income. Our transactions occur in Chinese Renminbi. The unit of Renminbi is in Yuan.

RECENT ACCOUNTING PRONOUNCEMENTS

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements". The objective of SFAS In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities—including an amendment of FASB Statement No. 115 ("FAS 159"). FAS 159 permits companies to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. The objective of FAS 159 is to provide opportunities to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply hedge accounting provisions. FAS 159 also establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. The Company adopted SFAS No. 159 on January 1, 2008. The Company chose not to elect the option to measure the fair value of eligible financial assets and liabilities.

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements - an amendment of Accounting Research Bulletin No. 51" ("SFAS 160"), which establishes accounting and reporting standards for ownership interests in subsidiaries held by parties other than the parent, the amount of consolidated net income attributable to the parent and to the noncontrolling interest, changes in a parent's ownership interest and the valuation of retained non-controlling equity investments when a subsidiary is deconsolidated. The Statement also establishes reporting requirements that provide sufficient disclosures that clearly identify and distinguish between the interests of the parent and the interests of the non-controlling owners. SFAS 160 is effective for fiscal years beginning after December 15, 2008. The Company has not determined the effect that the application of SFAS 160 will have on its consolidated financial statements.

In December 2007, Statement of Financial Accounting Standards No. 141(R), Business Combinations, was issued. SFAS No. 141R replaces SFAS No. 141, Business Combinations. SFAS 141R retains the fundamental requirements in SFAS 141 that the acquisition method of accounting (which SFAS 141 called the purchase method) be used for all business combinations and for an acquirer to be identified for each business combination. SFAS 141R requires an acquirer to recognize the assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at the acquisition date, measured at their fair values as of that date, with limited exceptions. This replaces SFAS 141's cost-allocation process, which required the cost of an acquisition to be allocated to the individual assets acquired and liabilities assumed based on their estimated fair values. SFAS 141R also requires the acquirer in a business combination achieved in stages (sometimes referred to as a step acquisition) to recognize the identifiable assets and

liabilities, as well as the noncontrolling interest in the acquiree, at the full amounts of their fair values (or other amounts determined in accordance with SFAS 141R). SFAS 141R applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. An entity may not apply it before that date. The Company is currently evaluating the impact that adopting SFAS No. 141R will have on its financial statements.

In February 2008, the FASB issued FASB Staff Position (FSP) No. FAS 140-3, "Accounting for Transfers of Financial Assets and Repurchase Financing Transactions." FSP No. FAS 140-3 requires an initial transfer of a financial asset and a repurchase financing that was entered into contemporaneously or in contemplation of the initial transfer to be evaluated as a linked transaction under SFAS No. 140 unless certain criteria are met, including that the transferred asset must be readily obtainable in the marketplace. FSP No. FAS 140-3 is effective for fiscal years beginning after November 15, 2008, and is applicable to new transactions entered into after the date of adoption. Early adoption is prohibited. The firm does not expect adoption of FSP No. FAS 140-3 to have a material effect on its financial condition and cash flows. Adoption of FSP No. FAS 140-3 will have no effect on the Company's results of operations.

In March 2008, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 161, "Disclosures about Derivative Instruments and Hedging Activities – An Amendment of SFAS No. 133" ("SFAS 161"). SFAS 161 seeks to improve financial reporting for derivative instruments and hedging activities by requiring enhanced disclosures regarding the impact on financial position, financial performance, and cash flows. To achieve this increased transparency, SFAS 161 requires (1) the disclosure of the fair value of derivative instruments and gains and losses in a tabular format; (2) the disclosure of derivative features that are credit risk-related; and (3) cross-referencing within the footnotes. SFAS 161 is effective on January 1, 2009. The Company is in the process of evaluating the new disclosure requirements under SFAS 161.

In May 2008, the FASB issued SFAS No. 162, "The Hierarchy of Generally Accepted Accounting Principles" ("FAS 162"). FAS 162 is intended to improve financial reporting by identifying a consistent framework, or hierarchy, for selecting accounting principles to be used in preparing financial statements that are presented in conformity with GAAP for nongovernmental entities. FAS 162 is effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board amendments to AU Section 411, "The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles." The Company is in the process of evaluating the impact of adoption of this statement on the results of operations, financial position or cash flows.

In June 2008, the FASB issued Emerging Issues Task Force Issue 07-5 "Determining whether an Instrument (or Embedded Feature) is indexed to an Entity's Own Stock" ("EITF No. 07-5"). This Issue is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Early application is not permitted. Paragraph 11(a) of Statement of Financial Accounting Standard No 133 "Accounting for Derivatives and Hedging Activities" ("SFAS 133") specifies that a contract that would otherwise meet the definition of a derivative but is both (a) indexed to the Company's own stock and (b) classified in stockholders' equity in the statement of financial position would not be considered a derivative financial instrument. EITF No.07-5 provides a new two-step model to be applied in determining whether a financial instrument or an embedded feature is indexed to an issuer's own stock and thus able to qualify for the SFAS 133 paragraph 11(a) scope exception. This standard will trigger liability accounting on all options and warrants exercisable at strike prices denominated in any currency other than the functional currency in China (Renminbi). The Company is currently evaluating the impact of adoption of EITF No. 07-5 on the Company's consolidated financial statements.

In June 2008, the FASB issued FSP No. EITF 03-6-1, "Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities." The FSP addresses whether instruments granted in share-based payment transactions are participating securities prior to vesting and therefore need to be included in the earnings allocation in calculating earnings per share under the two-class method described in SFAS No. 128, "Earnings per Share." The FSP requires companies to treat unvested share-based payment awards that have non-forfeitable rights to dividend or dividend equivalents as a separate class of securities in calculating earnings per share. The FSP is effective for fiscal years beginning after December 15, 2008; earlier application is not permitted. The Company does not expect adoption of FSP No. EITF 03-6-1 to have a material effect on its results of operations or earnings per share.

In September 2008, the FASB issued FASB Staff Positions FSP FAS 133-1 and FIN 45-4, Disclosures about Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45; and Clarification of the Effective Date of FASB Statement No. 161". This FSP amends FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, to require disclosures by sellers of credit derivatives, including credit derivatives embedded in a hybrid instrument. This FSP also amends FASB Interpretation No. 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, to require an additional disclosure about the current status of the payment/performance risk of a guarantee. Further, this FSP clarifies the Board's intent about the effective date of FASB Statement No. 161, Disclosures about Derivative Instruments and Hedging Activities. The provisions of this FSP that amend Statement 133 and Interpretation 45 shall be effective for reporting periods (annual or interim) ending after November 15, 2008. The Company is in the process of evaluating the new disclosure requirements under this FSP.

In October 2008, the FASB issued FSP No. FAS 157-3, "Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active." FSP No. FAS 157-3 clarifies the application of SFAS No. 157 in an inactive market, without changing its existing principles. The FSP was effective immediately upon issuance. The adoption of FSP No. FAS 157-3 did not have an effect on the Company's financial condition, results of operations or cash flows.

In January 2009, the FASB issued FSP EITF 99-20-1, "Amendments to the Impairment Guidance of EITF Issue No. 99-20, "Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets". FSP EITF 99-20-1 changes the impairment model included within EITF 99-20 to be more consistent with the impairment model of SFAS No. 115. FSP EITF 99-20-1 achieves this by amending the impairment model in EITF 99-20 to remove its exclusive reliance on "market participant" estimates of future cash flows used in determining fair value. Changing the cash flows used to analyze other-than-temporary impairment from the "market participant" view to a holder's estimate of whether there has been a "probable" adverse change in estimated cash flows allows companies to apply reasonable judgment in assessing whether an other-than-temporary impairment has occurred. The adoption of FSP EITF 99-20-1 did not have a material impact on our consolidated financial statements because all of our investments in debt securities are classified as trading securities.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Natural Gas Price Risk

Our major market risk exposure continues to be the pricing applicable to our purchases and value-added reselling of condensed natural gas (CNG). Our revenues and profitability depend substantially upon the applicable prices of natural gas, which in China are regulated and fixed by central and local governments and doesn't fluctuate much at all. Such a price involatility situation is expected to continue for operations in China. We currently don't have any hedge positions in place to reduce our exposure to changes in natural gas whole sale and retail prices.

Interest Rate Risk

We are subject to interest rate risk on our long-term fixed-interest rate debt. Fixed rate debt, where the interest rate is fixed over the life of the instrument, exposes us to changes in market interest rates reflected in the fair value of the debt and to the risk that we may need to refinance maturing debt with new debt at a higher rate. All other things being equal, the fair value of our fixed rate debt will increase or decrease as interest rates change. We had long-term debt outstanding of \$40 million at December 31, 2008, all of which bears interest at fixed rates. The \$40 million of fixed-rate debt is due on 2014. We currently have no interest rate hedge positions in place to reduce our exposure to changes in interest rates.

Foreign Currency Exchange Rates Risk

We operate in China local currency and the effects of foreign currency fluctuations are largely mitigated because local expenses in China are also denominated in the same currency.

Our assets and liabilities of which the functional currency is the China local currency are translated into U.S. dollars using the exchange rates in effect at the balance sheet date, resulting in translation adjustments that are reflected as Cumulative Translation Adjustment in the shareholders' equity section on our Consolidated Balance Sheets. A portion of our net assets are impacted by changes in foreign currencies in relation to the U.S. dollar. We recorded a \$5,184,035 adjustment to increase our equity account for the year ended December 31, 2008 to reflect the net impact of the strengthening of Chinese currency against the U.S. dollar.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The Consolidated Financial Statements of the Company and its subsidiaries including the notes thereto, together with the report of Moore Stephens Wurth Frazer and Torbet, LLP is presented beginning on page F-1 of this report.

| Year Ended December 31 | First Quarter | Second Quarter | Third Quarter | Fourth Quarter | Full Year |
|---------------------------|------------------|-------------------|------------------|-------------------|---------------|
| 2008 | | | | | |
| Net operating revenues | \$ 14,025,674 | \$ 16,890,486 | \$ 18,401,200 | \$ 18,403,299 | \$ 67,720,659 |
| Gross profit | 6,088,476 | 7,665,763 | 9,492,367 | 9,492,416 | 32,739,022 |
| Net income | 2,808,571 | 3,512,892 | 5,136,590 | 3,732,315 | 15,190,368 |
| Basic EPS | 0.10 | 0.12 | 0.18 | 0.13 | 0.52 |
| Diluted EPS | 0.10 | 0.12 | 0.18 | 0.13 | 0.52 |
| 2007 | | | | | |
| Net operating revenues | \$ 6,743,576 | \$ 8,273,309 | \$ 9,078,089 | \$ 11,297,079 | \$ 35,392,053 |
| Gross profit | 3,517,359 | 4,143,110 | 4,319,839 | 5,386,670 | 17,366,978 |
| Net income | 2,110,326 | 2,745,009 | 1,961,662 | 2,299,073 | 9,116,070 |
| Basic EPS | \$ 0.09 | \$ 0.11 | \$ 0.07 | \$ 0.08 | \$ 0.35 |
| Diluted EPS | \$ 0.09 | \$ 0.11 | \$ 0.07 | \$ 0.08 | \$ 0.35 |

The Company's fiscal year 2008 operating result was impacted by the following non-operating items:

Interest expense of \$2,228,244 related to the Company's \$40 million senior notes due 2014, net of capitalized interest. This charge includes \$995,578 in interest expense, \$1,004,677 in amortization of discount on our senior notes, and \$227,989 in amortization of deferred offering costs. The Company capitalized \$1,932,931 of interest expense and amortization into construction in progress for fiscal year 2008.

Foreign currency exchange loss of \$397,299 due to the decrease in value of the Company's dollar deposits as a result of depreciating US dollar against Chinese yuan.

These two non-operating charges have a combined effect of \$2,126,183 on our net income, assuming effective tax rate of 19.02%. The capitalized interest increases the cost of our long term assets and is depreciated or amortized over the useful life of these assets.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

Effective as of May 21, 2007, the Company dismissed Kabani & Company, Inc. ("Kabani"), the Company's independent registered public accounting firm. The decision to change accountants was recommended by the Company's Audit Committee and approved by the Company's Board of Directors.

Kabani reported on the Company's consolidated financial statements for the years ending December 31, 2006 and 2005 and reviewed the Company's consolidated financial statements for the period ending March 31, 2007. For these periods and up to May 21, 2007, there were no disagreements with Kabani on any matter of accounting principle or practices, financial statement disclosure, or auditing scope or procedure, which disagreement(s), if not resolved to the satisfaction of Kabani, would have caused it to make reference thereto in its report on the financial statements for such years.

The reports of Kabani on the financial statements of the Company for the fiscal years ended December 31, 2006 and 2005 did not contain any adverse opinion or disclaimer of opinion and were not qualified or modified as to uncertainty, audit scope or accounting principles.

ITEM 9A(T). CONTROLS AND PROCEDURES

(a) Evaluation of Disclosure Controls and Procedures

The Company's management has evaluated, under the supervision and with the participation of the Company's Chief Executive Officer and Chief Financial Officer, the effectiveness of the design and operations of the Company's disclosure controls and procedures (as defined in Securities Exchange Act Rule 13a-15(e)), as of the end of the period covered by this annual report. Based on that evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that the evaluation of the effectiveness of our disclosure controls and procedures was completed; our disclosure controls and procedures were not effective.

(b) Management's Annual Report on Internal Control over Financial Reporting

The Company's management is responsible for establishing and maintaining an adequate system of internal control over financial reporting. Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, a system of internal control over financial reporting can provide only reasonable assurance and may not prevent or detect misstatements. Therefore, even those systems determined to be effective can

provide only reasonable assurance with respect to financial statement preparation and presentation. Further, because of changes in conditions, effectiveness of internal control over financial reporting may vary over time.

A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the company's ability to initiate, authorize, record, process, or report external financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the company's annual or interim financial statements that is more than inconsequential will not be prevented or detected. An internal control material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

We have evaluated the effectiveness of our internal control over financial reporting as of December 31, 2008. This evaluation was performed using the Internal Control – Evaluation Framework developed by the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”). Based on such evaluation, management identified deficiencies that were determined to be a material weakness.

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis. Because of the material weakness described below, management concluded that our internal control over financial reporting was not effective as of December 31, 2008.

The specific material weakness and significant deficiency identified by the Company's management as of December 31, 2008 is described as follows:

Material Weakness

Inadequate US GAAP expertise - The current staff in the accounting department is inexperienced and they were primarily engaged in ensuring compliance with PRC accounting and reporting requirement for our operating subsidiaries and was not required to meet or apply U.S. GAAP requirements. They need substantial training to meet the higher demands of being a U.S. public company. The accounting skills and understanding necessary to fulfill the requirements of US GAAP-based reporting, including the skills of subsidiary financial statements consolidation, are inadequate.

The Company did not have sufficient and skilled accounting personnel with an appropriate level of technical accounting knowledge and experience in the application of generally accepted accounting principles accepted in the United States of America commensurate with the Company's financial reporting requirements, which resulted in a number of internal control deficiencies that were identified as being significant. The Company's management believes that the number and nature of these significant deficiencies, when aggregated, was determined to be a material weakness.

Significant Deficiency

The Company is lacking qualified resources to perform the internal audit functions properly. In addition, the scope and effectiveness of the Company's internal audit function are yet to be developed. We are committed to establishing the internal audit functions but due to limited qualified resources in the region, we were not able to hire sufficient internal audit resources before the end of 2008. However, internally we established a central management center to recruit more senior qualified people in order to improve our internal control procedures. Externally, we engaged Ernst & Young to assist the Company in improving the Company's internal control system based on COSO Framework. We also will increase our efforts to hire the qualified resources.

Remediation Initiative

Prior to December 31, 2008, we engaged an independent CPA consultant in CA to serve as our accountant. She is mainly engaged to perform our financial statements consolidation and to prepare our financial statements. In addition, we are seeking accountants experienced in several key areas of accounting, including persons with experience in Chinese and U.S. GAAP, U.S. GAAP consolidation requirements, and SEC financial reporting requirements. In addition, we plan to allocate additional resources to train our existing accounting staff and continue this effort in the future.

Meanwhile, the Company has also engaged Earnest & Young to consult on our internal audit function as well as other internal control practices. Most of the policies, procedures and practices are already in place for full implementation.

Conclusion

Despite of the material weakness and deficiencies reported above, the Company's management believes that its consolidated financial statements included in this report fairly present in all material respects the Company's financial condition, results of operations and cash flows for the periods presented and that this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report.

(c) Changes in Internal Control over Financial Reporting

Except as described above, there were no changes in its internal controls over financial reporting in connection with its fourth quarter evaluation that would materially affected, or are reasonably likely to materially affect, its internal control over financial reporting.

(d) Independent Registered Public Accounting Firm's Attestation Report

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of

China Natural Gas, Inc.

We have audited China Natural Gas, Inc. and subsidiaries' (the "Company") internal control over financial reporting as of December 31, 2008, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying "Management's Report on Internal Control Over Financial Reporting." Our responsibility is to express an opinion on the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of effectiveness of the internal control over financial reporting to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

A material weakness is a control deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the Company's annual or interim financial statements will not be prevented or detected on a timely basis. The following material weakness has been identified and included in management's assessment:

The Company did not maintain a sufficient complement of personnel with an appropriate level of accounting knowledge, experience and training in the application of generally accepted accounting principles commensurate with the Company's financial reporting requirements, and did not implement adequate supervisory review to ensure the

financial statements were prepared in conformity with generally accepted accounting principles in the United States of America. Additionally, we identified numerous internal control deficiencies that were identified as being significant. The number and nature of these significant deficiencies, when aggregated, was determined to be a material weakness. In the aggregate, these significant deficiencies could result in a misstatement of the Company's account balances or disclosures which could cause a material misstatement of the consolidated financial statements that would not be prevented or detected. This material weakness was considered in determining the nature, timing, and extent of audit tests applied in our audit of the 2008 financial statements, and this report does not affect our report dated March 13, 2009 on those financial statements.

In our opinion, because of the effect of the material weakness described above on the achievement of the objectives of the control criteria, the Company has not maintained effective internal control over financial reporting as of December 31, 2008, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets and the related statements of income and other comprehensive income, stockholders' equity, and cash flows of the Company, and our report dated March 13, 2009 expressed an unqualified opinion.

/s/ Moore Stephens Wurth Frazer and Torbet, LLP

Walnut, California
March 13, 2009

ITEM 9B. OTHER INFORMATION

None.

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS, AND CORPORATE GOVERNANCE.

Below are the names and certain information regarding our executive officers and directors:

| Name | Age | Position | Held Position Since |
|-------------------|-----|---|---------------------|
| Qinan Ji | 51 | Chief Executive Officer and Chairman of the Board | 2005 |
| Richard P. Wu | 44 | Chief Financial Officer | 2008 |
| Zhiqiang Wang | 68 | Director | 2006 |
| Donald Yang | 42 | Director | 2008 |
| Carl Yeung | 29 | Director | 2008 |
| Lawrence Leighton | 74 | Director | 2008 |

Officers are elected annually by the Board of Directors, at our annual meeting, to hold such office until an officer's successor has been duly appointed and qualified, unless an officer sooner dies, resigns or is removed by the Board.

Background of Executive Officers and Directors

Qinan Ji, Chairman of the Board of Directors - Mr. Ji joined Xilan as the Chairman of the Board of Directors in 2005. In 1996, he founded the Anxian Hotel in Weinan City in Shaanxi Province. In 2001, he formed the Xi'an Sunway Technology and Industry Co., Ltd. He has more than 20 years experience in the energy and petroleum industries in operational, administrative, management and government relation roles. He received a Bachelors of Economic Management from Northwestern University (Shaanxi).

Richard P. Wu, Chief Financial Officer – Mr. Wu joined the Company as the Chief Financial Officer in 2008. Prior joining the Company he served as COO and Interim CFO of China Operation at Tejari World FZ LLC, one of the largest online e-procurement service providers and B2B portal operators in the Middle East. In this capacity, he designed and constructed the China Operation's financial and accounting infrastructure and systems to support the company's growth in China. Mr. Wu served as CFO and Corporate SVP of The Alliancepharm US LLC from 2003 to 2007, where he assumed full financial and accounting responsibility for the multi-million-dollar sourcing and contract manufacturing businesses in the area of active pharmaceutical ingredients. Prior to that, he was CFO and Corporate EVP of Meetchina.com Inc., a pioneering online cross-border e-commerce portal in China. Earlier in his financial career, Mr. Wu was Senior Finance Director at Motorola Inc., and investment banking associate at Lehman Brothers Holdings, Inc. Mr. Wu received his Master of Business Administration in Finance from The Wharton School, University of Pennsylvania, and a Master of Justice Administration from Indiana University. He also holds a Master of Law from China University of Political Science & Law. He is a licensed lawyer of the People's Republic of China and practiced law in Beijing, China for 5 years.

Zhiqiang Wang, Vice Chairman of the Board of Directors - Mr. Wang was the former head of energy industry regulations from 1992 to 2002 as well as the Vice Mayor of the city of Xi'An, China's largest western city with a population of 8 million, in which position he was in charge of regulating and licensing the city's energy and natural gas businesses. From 2002 until his retirement in 2004, Mr. Wang was the Chief Executive Officer of Xi'An Municipal Government Construction Company where he was in charge of the city's major construction projects. Since

2004, Mr. Wang has been an independent advisor to the Company. Mr. Wang graduated from the Northwestern University of Politics and Law in China in 1962.

Donald Yang, Director - Mr. Yang is a founding partner and president of Abax Global Capital (“AGC”), a leading Hong Kong based investment firm focused on Pan-Asian public and private investments especially in Greater China and Southeast Asia. He was a Managing Director responsible for Merrill Lynch’s Hong Kong and China Debt Capital Markets division from 2000 to 2007. Mr. Yang also serves as a director for Sinoenergy Corporation (Ticker “SNEH”), a NASDAQ listed company. Mr. Yang holds a MBA degree from Wharton School of Business and a BA degree from Nankai University in China. Abax Lotus Ltd. (“Abax”), an affiliate of AGC, is the sole investor in the Company’s \$40 million note financing which closed in January 2008. Pursuant to an investor rights agreement, Abax has the right to appoint one member of the Company’s Board of Directors.

Carl Yeung, Director - Mr. Yeung is the Chief Financial Officer of ATA Inc, a China based, leading provider of computer-based testing and education services in China listed on the NASDAQ Global Market. Prior to that, Mr. Yeung worked as an associate and analyst at Merrill Lynch (Asia Pacific) Limited from 2002 to 2006. Mr. Yeung holds a bachelor’s degree in economics with concentrations in finance and operations management from Wharton School, University of Pennsylvania, and a bachelor’s degree in applied science with concentration in systems engineering from School of Engineering and Applied Sciences, University of Pennsylvania.

Lawrence Leighton, Director - Mr. Leighton has had an extensive 40-year international investment banking career. Beginning at what is now Lehman Brothers, he advised on financing for the Mexican Government and leading Mexican corporations. As Director of Strategic Planning for the consumer products company, Norton Simon Inc, he initiated and executed the acquisition of Avis Rent-a-car. Subsequently, he was a Limited Partner of Bear Stearns & Co., a Managing Director of the investment bank of Chase Manhattan Bank and then President and Chief Executive Officer of the U.S. investment bank of Credit Agricole, the major French Bank. Among his transactions have been advising Pernod Ricard, the major European beverage company, on its acquisitions in the United States; and advising Verizon, the major U. S. telecom company, on its dispositions of certain European operations. Mr. Leighton received his BSE degree in engineering from Princeton University and an MBA degree from Harvard Business School. He holds a commercial pilot’s license with instrument rating.

Board of Directors.

Our Directors are elected by the vote of a plurality in interest of the holders of our voting stock and hold office for a term of one year or until a successor has been elected and qualified.

A majority of the authorized number of directors constitutes a quorum of the Board for the transaction of business. The directors must be present at the meeting to constitute a quorum. However, any action required or permitted to be taken by the Board may be taken without a meeting if all members of the Board individually or collectively consent in writing to the action.

There are no family relationships, or other arrangements or understandings between or among any of the directors, executive officers or other person pursuant to which such person was selected to serve as a director or officer.

Our directors, executive officers and control persons have not been involved in any of the following events during the past five years:

1. any bankruptcy petition filed by or against any business of which such person was a general partner or executive officer either at the time of the bankruptcy or within two years prior to that time;

2. any conviction in a criminal proceeding or being subject to a pending criminal proceeding (excluding traffic violations and other minor offenses);
3. being subject to any order, judgment, or decree, not subsequently reversed, suspended or vacated, of any court of competent jurisdiction, permanently or temporarily enjoining, barring, suspending or otherwise limiting his involvement in any type of business, securities or banking activities; or
4. being found by a court of competent jurisdiction (in a civil action), the Commission or the Commodity Futures Trading Commission to have violated a federal or state securities or commodities law, and the judgment has not been reversed, suspended, or vacated.

Committees of the Board of Directors

The Board of Directors has the following standing committees: Audit, Compensation and Nominating. The Board of Directors has adopted written charters for each of these committees, copies of which can be found on our website at www.naturalgaschina.com. Mr. Yeung, and Leighton are independent directors within the meaning set forth in the rules of NASDAQ, as currently in effect.

Audit Committee

The Audit Committee consists of Mr. Leighton and Yeung and Wang with Mr. Yeung serving as the chair. The Audit Committee adopted a charter which provides that the Committee, (i) oversees our accounting, financial reporting and audit process; (ii) appoints, determines the compensation of, and oversees, the independent auditors; (iii) pre-approves audit and non-audit services provided by the independent auditors; (iv) reviews of the results and scope of audit and other services provided by the independent auditors; (v) reviews the accounting principles and practices and procedures used in preparing our financial statements; and (vi) reviews of internal controls.

The Audit Committee works closely with management and our independent auditors. The Audit Committee also meets with our independent auditors on a quarterly basis, following our auditors' quarterly reviews and annual audit and prior to our earnings announcements, to review the results of their work. The Audit Committee also meets with our independent auditors to approve the annual scope and fees for the audit services to be performed.

Compensation Committee

The Compensation Committee consists of Mr. Leighton and Yeung and Wang with Mr. Leighton serving as the chair. The Compensation Committee adopted a charter which provides that the Committee, (i) review and approves corporate goals and objectives relevant to the CEO's compensation, evaluation of the CEO's performance relative to goals and objectives and sets the CEO's compensation annually and (ii) makes recommendations annually to the Board of Directors with respect to non-CEO compensation.

Compensation Committee Interlocks and Insider Participation

No member of the Compensation Committee served or previously served as an officer or employee of the Company. In addition, no member of the Compensation Committee has any relationship with the Company requiring disclosure by the Company under the Exchange Act of 1934, as currently in effect.

Nominating Committee

The Nominating Committee consists of Mr. Leighton and Yeung and Wang with Mr. Wang serving as the chair. The Compensation Committee adopted a charter which provides that the Committee, (i) identify and review candidates for the Board and recommend to the full Board candidates for election to the Board and (ii) review from time to time the appropriate skills and characteristics required of Board members in the context of current composition of the Board.

Code of Ethics

On June 14, 2006, the Company adopted a Code of Ethics that applies to all officers, directors and employees of the Company. A copy of our Code of Ethics is available to you at no charge upon written request. The written request should be address to our corporate office at 19th Floor, Building B, Van Metropolis, No. 35 Tangyan Road, High Tech Zone, Xi'an 710065, Shaanxi Province, the People's Republic of China.

COMPLIANCE WITH SECTION 16(a) OF THE SECURITIES EXCHANGE ACT OF 1934

Section 16(a) of the Securities Exchange Act of 1934, as amended, requires our executive officers and directors and persons who own more than 10% of a registered class of our equity securities to file with the Securities and Exchange Commission initial statements of beneficial ownership, reports of changes in ownership and annual reports concerning their ownership of our common stock and other equity securities, on Forms 3, 4 and 5 respectively. Executive officers, directors and greater than 10% shareholders are required by the Securities and Exchange Commission regulations to furnish our Company with copies of all Section 16(a) reports they file.

To the Company's knowledge, based solely on a review of the copies of the reports furnished to the Company, all executive officers, directors and greater than 10% shareholders filed the required reports in a timely manner, except for Zhiqiang Wang who did not timely file a Form 3 when he was appointed to the Company's Board of Directors.

ITEM 11. EXECUTIVE COMPENSATION

EXECUTIVE COMPENSATION

The following table sets forth all cash compensation paid by us to our principal executive officer for fiscal year 2008.

Summary Compensation Table

In December 2007, our CEO Mr. Qinan Ji signed a one-year employment contract with the Company with the following key terms:

- ◆ Salary for 2008 will be \$15,000
- ◆ All fringes and benefits were included in the above-mentioned salary
- ◆ Contract was renewed in December 2008

In December 2007, our ex-CFO Ms. Lihong Guo signed a one-year employment contract with the Company with the following key terms:

- ◆ Salary for 2008 will be \$48,000
- ◆ All fringes and benefits were included in the above-mentioned salary

In October 2008, our CFO Mr. Richard Peidong Wu signed a one-year employment contract with the Company with the following key terms:

- ◆ Salary for the 12-month period will be \$250,000
- ◆ The Company will prvide additional \$10,000 insurance allowance per year
- ◆ Eligible for up to 1.5% stock option of the Company's shares outstanding, pending on the Company's employee stock option plan
- ◆ All fringes and benefits were included in the above-mentioned salary

◆ Contract will be renewed on a yearly basis

| Name and Principal Position | Year | Salary (\$) | Bonus (\$) | Option Awards (\$) | All Other Compensation (\$) | Total (\$) |
|---|------|-------------|------------|--------------------|-----------------------------|------------|
| Qinan Ji, Chief Executive Officer and Chairman of the Board | 2008 | 15,000 | - | - | - | 15,000 |
| | 2007 | 15,000 | - | - | - | 15,000 |
| | 2006 | 15,000 | - | - | - | 15,000 |
| Richard P. Wu, Chief Financial Officer(1) | 2008 | 62,499 | | | | 62,499 |
| Lihong Guo, Chief Financial Officer(2) | 2008 | 40,000 | | | | 40,000 |
| | 2007 | 4,000 | | | | 4,000 |

(1)Mr. Wu was appointed as our CFO on October 23, 2008.

(2)Ms. Guo was appointed as our CFO on December 10, 2007 and resigned from that position on October 23, 2008.

Stock-Based Compensation

None of our officers or other employees have been granted stock options or stock appreciation rights, or paid any other stock-based compensation, by our company or any of our subsidiaries.

Director Compensation

The following Director Compensation Table summarizes the compensation of our directors for services rendered to the Company during the year ended December 31, 2008.

| Name | Fees Earned or Paid in Cash (\$) | Stock Awards (\$) | Option Awards (\$) | All Other Compensation (\$) | Total (\$) |
|-------------------|----------------------------------|-------------------|--------------------|-----------------------------|------------|
| James Garner(1) | 36,000 | - | - | - | 36,000 |
| Qinan Ji(2) | - | - | - | - | - |
| Zhiqiang Wang(3) | - | - | - | - | - |
| Donald Yang | 36,000 | - | - | - | 36,000 |
| Carl Yeung | 36,000 | | | | 36,000 |
| Lawrence Leighton | 36,000 | | | | 36,000 |

(1)Removed from the Board of Directors on August 3, 2008.

(2)Ji Qinan, our Chief Executive Officer, does not receive any compensation for his service as a director.

(3)Zhiqiang Wang was appointed as a director in September 2006; he receives no compensation for his service as a director.

The Company did not pay any other compensation to these directors in 2008.

Employment Agreements

The Company signs employment agreements with all of its employees. Our employment agreement is in full compliance with the current Labor Contract Law of the People's Republic of China. Our employment agreement is typically valid for one year and is renewable afterwards. All the employment-related matters are either clearly stipulated in the agreement or in reference to the standard provisions of China's Labor Law.

Outstanding Equity Awards at Fiscal Year End

There has been no outstanding equity awards at fiscal year ended December 31, 2008.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER

The following table sets forth certain information, as of March 10, 2009 with respect to the beneficial ownership of the outstanding common stock by (i) any holder of more than five (5%) percent; (ii) each of our executive officers and directors; and (iii) our directors and executive officers as a group. Except as otherwise indicated, each of the stockholders listed below has sole voting and investment power over the shares beneficially owned.

| Name of Beneficial Owner (1) | Number of Common Stock Beneficially Owned | Percentage Of Common Stock Outstanding(2) |
|--|---|--|
| Executive Officers and Directors | | |
| Qinan Ji | 5,931,596(3) | 20.3% |
| All officers and directors as a group (1 person) | 5,931,596(3) | 20.3% |
| 5% holders | | |
| Yangling Bodisen Biotech Development co, Ltd. c/o New York Global Group, Inc. 14 Wall Street, 12th Floor, New York, NY 10005 | 2,063,768(4) | 7.1% |
| Xiang Ji | 1,456,232 | 5.0% |
| Robert Moses | 2,000,000(5) | 6.9% |
| Heartland Value Fund | 1,725,000(6) | 5.9% |
| Xi'an Sunway Technology & Industry Co., Ltd | 2,875,364(3) | 9.8% |
| Abax Lotus Ltd. | 2,900,000(7) | 9.9% |

(1) Except as otherwise indicated, the address of each beneficial owner is c/o Xi'an Xilan Natural Gas Co., Ltd., 19th Floor, Building B, Van Metropolis, Tangyan Road, Hi-Tech Zone, Xi'an, Shaanxi Province, China.

(2) Applicable percentage ownership is based on 29,200,304 shares of common stock outstanding as of March 13, 2008, together with securities exercisable or convertible into shares of common stock within 60 days of March 13, 2008 for each stockholder. Beneficial ownership is determined in accordance with the rules of the Securities and Exchange Commission and generally includes voting or investment power with respect to securities. Shares of common stock that are currently exercisable or exercisable within 60 days of March 13, 2008 are deemed to be beneficially owned by the person holding such securities for the purpose of computing the percentage of ownership of such person, but are not treated as outstanding for the purpose of computing the percentage ownership of any other person.

(3) Of which 2,875,364 shares are owned by Xi'an Sunway Technology & Industry Co., Ltd. Qinan Ji owns 42.1% of Xi'an Sunway and may be deemed to beneficially own such shares.

(4) As set forth in the Schedule 13D filed with the SEC on December 23, 2005.

(5) As set forth in the Schedule 13G filed with the SEC on September 7, 2007.

(6) William J. Nasgovitz has shared voting and dispositive power with respect to such shares as reported in the Schedule 13G filed with the SEC on February 8, 2008 and as amended on February 11, 2009.

(7) As set forth in Schedule 13D filed with the SEC on February 6, 2008.

No Director, executive officer, affiliate or any owner of record or beneficial owner of more than 5% of any class of voting securities of the Company is a party adverse to the Company or has a material interest adverse to the Company.

Securities Authorized for Issuance under Equity Compensation Plans

The Company had no equity compensation plans as of the fiscal year ended December 31, 2008.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE.

Transactions with related persons

None

Director Independence

The Board has determined that all Board members, excluding Qinan Ji and Donald Yang, are independent under the applicable NASDAQ rules. The Board has also determined the members of each committee of the Board are independent under the listing standards of the NASDAQ Global Select Market. In making these determinations, the Board considered, among other things, the types and amounts of the commercial dealings between the Company and the companies and organizations with which the directors are affiliated.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

All the service agreements related with auditors and lawyers need to be approved and signed by the Company's Audit Committee. 100% of those services provided were approved by the Committee.

The following table shows the fees paid or accrued for the audit and other services provided by our independent auditors for 2007 and 2008.

| Audit fees | 2007 | 2008 |
|---|------------|------------|
| Moore Stephens Wurth Frazer and Torbet, LLP* | \$ 150,000 | \$ 260,000 |
| Kabani & Company, Inc. | \$ 35,000 | \$ 7,500 |
| Audit-related fees | \$ 9,000 | |
| Tax fees** | | \$ 10,000 |
| All other fees | | - |
| Total fees paid or accrued to our principal accountants | \$ 150,000 | \$ 270,000 |

*The fees billed for professional services rendered for the audit of the Company's internal control over financial reporting, audit of the consolidated annual financial statements and review of the interim consolidated financial statements included in quarterly reports and services that are normally provided by our auditors in connection with statutory and regulatory filings or engagements.

**The fee billed for professional services rendered for the preparation of the Company's corporate and state tax return.

ITEM 15. EXHIBITS

Exhibits:

| Exhibit Number | Description of Exhibit |
|-------------------|---|
| 2.1 | Form of Equity Ownership Transfer Agreement (incorporated by reference to same exhibit filed with the Company's Form 8-K filed on December 31, 2008). |
| 3.1 | Articles of Incorporation (incorporated by reference to same exhibit filed with the Company's Form 10SB Registration Statement filed September 15, 2000, SEC file no. 000-31539). |
| 3.2 | Registrant's Amended and Restated By-Laws (incorporated by reference to exhibit 3.1 filed with the Registrant's Form 8K filed June 16, 2006, SEC file no. 000-31539). |
| 10.1 | Share Purchase Agreement made as of December 6, 2005 among Coventure International Inc., Xi'an Xilan Natural Gas Co., Ltd. and each of Xilan's shareholders. (incorporated by reference to the exhibits to Registrant's Form 8-K filed on December 9, 2005). |
| 10.2 | Return to Treasury Agreement between Coventure International Inc. and John Hromyk, dated December 6, 2005. (incorporated by reference to the exhibits to Registrant's Form 8-K filed on December 9, 2005). |
| 10.3 | Purchase Agreement made as of December 19, 2005 between China Natural Gas, Inc. and John Hromyk (incorporated by reference to the exhibits to Registrant's Form 8-K filed on December 23, 2005). |
| 10.4 | Form of Securities Purchase Agreement (incorporated by reference to the exhibits to Registrant's Form 8-K filed on January 12, 2006). |
| 10.5 | Form of Common Stock Purchase Agreement (incorporated by reference to the exhibits to Registrant's Form 8-K filed on January 12, 2006). |
| 10.6 | Form of Registration Rights Agreement (incorporated by reference to the exhibits to Registrant's Form 8-K filed on January 12, 2006). |
| 10.7 | CNG Product Purchase and Sale Agreement between Xi'an Xilan Natural Gas Co., Ltd. and Zhengzhou Zhongyou Hengran Petroleum Gas Co., Ltd. made as of July 20, 2006, (translated from the original Mandarin) (incorporated by reference to the exhibits to Registrant's Form 10-KSB filed on April 17, 2007). |
| 10.8 | Securities Purchase Agreement dated August 2, 2007 between the Company and the Investors named therein (incorporated by reference to the exhibits to Registrant's Form 8-K filed on August 8, 2007). |
| 10.9 | |

Registration Rights Agreement dated August 2, 2007 between the Company and the Investors named therein (incorporated by reference to the exhibits to Registrant's Form 8-K filed on August 8, 2007).

- 10.10 Consulting Services Agreement dated August 17, 2007 between Shaanxi Xilan Natural Gas Equipment Co., Ltd. and Xi'an Xilan Natural Gas Co., Ltd. (incorporated by reference to the exhibits to Registrant's Form 10-QSB filed on August 20, 2007).
- 10.11 Operating Agreement dated August 17, 2007 between Shaanxi Xilan Natural Gas Equipment Co., Ltd. and Xi'an Xilan Natural Gas Co., Ltd. (incorporated by reference to the exhibits to Registrant's Form 10-QSB filed on August 20, 2007).
- 10.12 Equity Pledge Agreement dated August 17, 2007 between Shaanxi Xilan Natural Gas Equipment Co., Ltd. and Xi'an Xilan Natural Gas Co., Ltd. (incorporated by reference to the exhibits to Registrant's Form 10-QSB filed on August 20, 2007).
- 10.13 Option Agreement dated August 17, 2007 between Shaanxi Xilan Natural Gas Equipment Co., Ltd. and Xi'an Xilan Natural Gas Co., Ltd. (incorporated by reference to the exhibits to Registrant's Form 10-QSB filed on August 20, 2007).
- 10.14 Proxy Agreement dated August 17, 2007 between Shaanxi Xilan Natural Gas Equipment Co., Ltd. and Xi'an Xilan Natural Gas Co., Ltd. (incorporated by reference to the exhibits to Registrant's Form 10-QSB filed on August 20, 2007).
- 10.15 Securities Purchase Agreement dated December 30, 2007 between the Company and Abax Lotus Ltd. (incorporated by reference to the exhibits to Registrant's Form 8-K filed on January 31, 2008).
- 10.16 Amendment to Securities Purchase Agreement dated January 29, 2008 between the Company and Abax Lotus Ltd. (incorporated by reference to the exhibits to Registrant's Form 8-K filed on January 31, 2008).
- 10.17 Indenture, dated January 29, 2008, by and among the Company and DB Trustees (Hong Kong) Limited, as trustee, relating to the 5.00% Guaranteed Senior Notes due 2014 (incorporated by reference to the exhibits to Registrant's Form 8-K filed on January 31, 2008).
- 10.18 Warrant Agreement, dated January 29, 2008, by and among the Company, Mr. Qinan Ji, Deutsche Bank AG, Hong Kong Branch as Warrant Agent and Deutsche Bank Luxembourg S.A. as Warrant Agent (incorporated by reference to the exhibits to Registrant's Form 8-K filed on January 31, 2008).
- 10.19 Equity Registration Rights Agreement, dated January 29, 2008, by and between the Company and Abax Lotus Ltd. (incorporated by reference to the exhibits to Registrant's Form 8-K filed on January 31, 2008).
- 10.20 Investor Rights Agreement, dated January 29, 2008, by and among the Company, its subsidiaries, Mr. Qinan Ji, and Abax Lotus Ltd. (incorporated by reference to the exhibits to Registrant's Form 8-K filed on January 31, 2008).
- 10.21 Information Rights Agreement, dated January 29, 2008, between the Company and Abax Lotus Ltd. (incorporated by reference to the exhibits to Registrant's Form 8-K filed on January 31, 2008).

- 10.22 Onshore Share Pledge Agreement, dated January 29, 2008, between the Company and DB Trustees (Hong Kong) Limited, as security agent (incorporated by reference to the exhibits to Registrant's Form 8-K filed on January 31, 2008).
- 10.23 Account Pledge and Security Agreement, dated January 29, 2008, by and between the Company and DB Trustees (Hong Kong) Limited as Security Agent (incorporated by reference to the exhibits to Registrant's Form 8-K filed on January 31, 2008).
- 14.1 Code of Ethics adopted by the Company on June 14, 2006 (incorporated by reference to the exhibits to Registrant's Form 8-K filed on June 16, 2006).
- 21.1 List of Subsidiaries. (incorporated by reference to the exhibits to Registrant's Form 10-KSB filed on April 17, 2007).
- 31.1* Certification of Principal Executive Officer pursuant to Rule 13a-14 and Rule 15d-14(a), promulgated under the Securities and Exchange Act of 1934, as amended
- 31.2* Certification of Principal Financial Officer pursuant to Rule 13a-14 and Rule 15d 14(a), promulgated under the Securities and Exchange Act of 1934, as amended
- 32.1* Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (Chief Executive Officer)
- 32.2* Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (Chief Financial Officer)

* Filed herewith

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: March 13, 2009

CHINA NATURAL GAS, INC.

/s/ Qinan Ji

Name: Qinan Ji

Title: Chief Executive Officer
(Principal Executive Officer)

/s/ Richard Peidong Wu

Name: Richard Peidong Wu

Title: Chief Financial Officer
(Principal Financial and Accounting
Officer)

Pursuant to the requirements of Section 13 or 15(d) of the Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf of the registrant and in the capacities and on the dates indicated.

| | | |
|--|--|----------------|
| /s/ Qinan Ji Qinan Ji | President and Chief Executive Officer and Director (Principal Executive Officer) | March 13, 2009 |
| /s/ Zhiqiang Wang Zhiqiang Wang | Director | March 13, 2009 |
| /s/ Donald Yang Donald Yang | Director | March 13, 2009 |
| /s/ Richard Peidong Wu Richard Peidong Wu | Chief Financial Officer (Principal Accounting Officer) | March 13, 2009 |
| /s/ Carl Yeung Carl Yeung | Director | March 14, 2009 |
| /s/ Lawrence Leighton Lawrence Leighton | Director | March 13, 2009 |

CHINA NATURAL GAS, INC.
AND SUBSIDIARIES

CONSOLIDATED FINANCIAL STATEMENTS
AS OF DECEMBER 31, 2008 AND 2007

CONTENTS

| | Pages |
|---|-------|
| Reports of Independent Registered Public Accounting Firms | F-2 |
| Consolidated Balance Sheets as of December 31, 2008 and 2007 | F-3 |
| Consolidated Statements of Income and Other Comprehensive income for the years ended December 31, 2008 and 2007 | F-4 |
| Consolidated Statements of Stockholders' Equity | F-5 |
| Consolidated Statements of Cash Flows for the years ended December 31, 2008 and 2007 | F-6 |
| Notes to Consolidated Financial Statements | F-7 |

F-1

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of
China Natural Gas, Inc.

We have audited the accompanying consolidated balance sheets of China Natural Gas, Inc. and subsidiaries as of December 31, 2008 and 2007, and the related consolidated statements of income and other comprehensive income, stockholders' equity, and cash flows for each of the years in the two-year period ended December 31, 2008. China Natural Gas, Inc.'s management is responsible for these consolidated financial statements. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of China Natural Gas, Inc. and Subsidiaries as of December 31, 2008 and 2007, and the results of its operations and its cash flows for each of the years in the two-year period ended December 31, 2008 in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), China Natural Gas, Inc. and subsidiaries' internal control over financial reporting as of December 31, 2008, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 13, 2009 expressed an adverse opinion.

/s/ Moore Stephens Wurth Frazer and Torbet, LLP

Walnut, California
March 13, 2009

CHINA NATURAL GAS, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS
AS OF DECEMBER 31, 2008 and 2007

| | 2008 | 2007 |
|--|-----------------------|----------------------|
| ASSETS | | |
| CURRENT ASSETS: | | |
| Cash & cash equivalents | \$ 5,854,383 | \$ 13,291,729 |
| Short-term investments | - | 238,554 |
| Accounts receivable | 906,042 | 306,179 |
| Other receivable | 60,784 | 292,320 |
| Other receivable - employee advances | 332,263 | 257,500 |
| Inventories | 519,739 | 231,339 |
| Advances to suppliers | 837,592 | 663,041 |
| Prepaid expense and other current assets | 777,510 | 109,722 |
| Loan receivable | 293,400 | 274,200 |
| Total current assets | 9,581,713 | 15,664,584 |
| PROPERTY AND EQUIPMENT, net | 76,028,272 | 32,291,995 |
| CONSTRUCTION IN PROGRESS | 22,061,414 | 2,210,367 |
| DEFERRED FINANCING COSTS | 1,746,830 | - |
| OTHER ASSETS | 8,844,062 | 3,123,052 |
| TOTAL ASSETS | \$ 118,262,291 | \$ 53,289,998 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| CURRENT LIABILITIES: | | |
| Accounts payable and accrued liabilities | \$ 800,013 | \$ 487,710 |
| Other payables | 124,151 | 55,979 |
| Unearned revenue | 944,402 | 327,220 |
| Accrued interest | 861,114 | - |
| Taxes payable | 1,862,585 | 1,211,775 |
| Total current liabilities | 4,592,265 | 2,082,684 |
| LONG TERM LIABILITIES: | | |
| Notes payable, net of \$15,478,395 discount | 24,521,605 | - |
| Derivative liabilities - warrants | 17,500,000 | - |
| Total long term liabilities | 42,021,605 | - |
| COMMITMENTS AND CONTINGENCIES | | - |
| STOCKHOLDERS' EQUITY: | | |
| Preferred stock, \$0.0001 per share; 5,000,000 shares authorized; none issued | - | - |
| Common stock, \$0.0001 per share; 45,000,000 shares authorized, 29,200,304 shares issued and outstanding at December 31, 2008 and 2007 | 2,920 | 2,920 |
| Additional paid-in capital | 32,113,583 | 32,046,879 |
| Cumulative translation adjustment | 8,661,060 | 3,477,025 |

Edgar Filing: China Natural Gas, Inc. - Form 10-K

| | | |
|---|-----------------------|----------------------|
| Statutory reserves | 3,730,083 | 1,802,735 |
| Retained earnings | 27,140,775 | 13,877,755 |
| Total stockholders' equity | 71,648,421 | 51,207,314 |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | \$ 118,262,291 | \$ 53,289,998 |

The accompanying notes are an integral part of these statements.
See report of independent registered public accounting firm.

F-3

CHINA NATURAL GAS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME AND OTHER COMPREHENSIVE INCOME
FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007

| | Years Ended December 31, | |
|--|--------------------------|----------------------|
| | 2008 | 2007 |
| Revenue | | |
| Natural gas revenue | \$ 55,746,893 | \$ 28,278,033 |
| Gasoline revenue | 4,616,052 | 38,486 |
| Installation and other | 7,357,714 | 7,075,534 |
| Total revenue | 67,720,659 | 35,392,053 |
| Cost of revenue | | |
| Natural gas cost | 27,234,508 | 14,838,997 |
| Gasoline cost | 4,277,458 | 34,747 |
| Installation and other | 3,469,671 | 3,151,331 |
| Total cost of revenue | 34,981,637 | 18,025,075 |
| Gross profit | 32,739,022 | 17,366,978 |
| Operating expenses | | |
| Selling expenses | 7,651,948 | 3,451,161 |
| General and administrative expenses | 4,024,882 | 2,837,768 |
| Total operating expenses | 11,676,830 | 6,288,929 |
| Income from operations | 21,062,192 | 11,078,049 |
| Non-operating income (expense): | | |
| Interest income | 209,502 | 70,697 |
| Interest expense | (2,228,244) | - |
| Other income, net | 111,859 | 31,976 |
| Foreign currency exchange loss | (397,299) | (150,729) |
| Total non-operating expense | (2,304,182) | (48,056) |
| Income before income tax | 18,758,010 | 11,029,993 |
| Provision for income tax | 3,567,642 | 1,913,923 |
| Net income | 15,190,368 | 9,116,070 |
| Other comprehensive income | | |
| Foreign currency translation gain | 5,184,035 | 2,637,573 |
| Comprehensive income | \$ 20,374,403 | \$ 11,753,643 |
| Weighted average shares outstanding | | |
| Basic | 29,200,304 | 26,200,679 |
| Diluted | 29,290,139 | 26,301,802 |
| Earnings per share | | |
| Basic | \$ 0.52 | \$ 0.35 |
| Diluted | \$ 0.52 | \$ 0.35 |

The accompanying notes are an integral part of these statements.
See report of independent registered public accounting firm.

F-4

CHINA NATURAL GAS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

| | Common Stock Shares | Amount | Additional Paid-in Capital | Accumulative Other Comprehensive Gain | Retained Earnings Statutory Reserve | Unrestricted | Total Stockholders' Equity |
|--|------------------------|----------|-------------------------------|---|---|---------------|----------------------------------|
| Balance January 01, 2007 | 24,210,183 | \$ 2,421 | \$ 18,223,911 | \$ 839,452 | \$ 750,886 | \$ 5,813,534 | \$ 25,630,204 |
| Shares issued for cash, at \$3.25 | 4,615,385 | 462 | 14,999,538 | | | | 15,000,000 |
| Offering costs | | | (1,176,533) | | | | (1,176,533) |
| Cashless exercise of warrants | 374,736 | 37 | (37) | | | | - |
| Cumulative translation adjustment | | | | 2,637,573 | | | 2,637,573 |
| Net Income | | | | | | 9,116,070 | 9,116,070 |
| Transfer to statutory reserve | | | | | 1,051,849 | (1,051,849) | - |
| Balance December 31, 2007 | 29,200,304 | \$ 2,920 | \$ 32,046,879 | \$ 3,477,025 | \$ 1,802,735 | \$ 13,877,755 | \$ 51,207,314 |
| Options issued for services | | | 66,704 | | | | 66,704 |
| Cumulative translation adjustment | | | | 5,184,035 | | | 5,184,035 |
| Net Income | | | | | | 15,190,368 | 15,190,368 |
| Transfer to statutory reserve | | | | | 1,927,348 | (1,927,348) | - |
| Balance December 31, 2008 | 29,200,304 | \$ 2,920 | \$ 32,113,583 | \$ 8,661,060 | \$ 3,730,083 | \$ 27,140,775 | \$ 71,648,421 |

The accompanying notes are an integral part of these statements.
See report of independent registered public accounting firm.

CHINA NATURAL GAS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007

| | Year Ended December 31, | |
|---|-------------------------|------------------|
| | 2008 | 2007 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | \$ 15,190,368 | \$ 9,116,070 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 3,474,905 | 1,639,685 |
| Loss on disposal of building improvements and equipment | 24,806 | - |
| Amortization of discount on senior notes | 1,004,677 | - |
| Amortization of financing costs | 227,989 | - |
| Stock based compensation | 66,704 | - |
| Change in assets and liabilities: | | |
| Accounts receivable | (568,370) | 290,660 |
| Other receivable | 247,349 | 36,929 |
| Other receivable - employee advances | (55,747) | - |
| Inventories | (267,470) | 71,226 |
| Advances to suppliers | (125,896) | 245,514 |
| Prepaid expense and other current assets | (642,857) | (11,113) |
| Accounts payable and accrued liabilities | 275,929 | 28,531 |
| Other payables | 63,239 | (208,669) |
| Unearned revenue | 583,940 | 22,425 |
| Accrued interest | 861,114 | - |
| Taxes payable | 556,121 | (754,817) |
| Net cash provided by operating activities | 20,916,801 | 10,476,441 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Purchase of property and equipment | (43,225,673) | (14,180,053) |
| Proceeds from sales of equipment | 194,891 | - |
| Proceeds from (purchases of) short term investments | 250,821 | (229,106) |
| Additions to construction in progress | (19,012,750) | (519,309) |
| Prepayment on long term assets | (5,729,833) | (1,914,343) |
| Payment for intangible assets | (53,826) | - |
| Payment for land use rights | (30,354) | (42,529) |
| Net cash used in investing activities | (67,606,724) | (16,885,340) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Stock issued for cash | - | 15,000,000 |
| Proceeds from senior notes | 40,000,000 | - |
| Payment for offering costs | (2,122,509) | (1,176,533) |
| Net cash provided by financing activities | 37,877,491 | 13,823,467 |
| Effect of exchange rate changes on cash and cash equivalents | 1,375,086 | 582,948 |
| NET (DECREASE) INCREASE IN CASH & CASH EQUIVALENTS | (7,437,346) | 7,997,516 |
| CASH & CASH EQUIVALENTS, BEGINNING OF YEAR | 13,291,729 | 5,294,213 |

| | | |
|--------------------------------------|--------------|---------------|
| CASH & CASH EQUIVALENTS, END OF YEAR | \$ 5,854,383 | \$ 13,291,729 |
|--------------------------------------|--------------|---------------|

SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:

| | | |
|--|--------------|--------------|
| Interest paid, net of capitalized interest | \$ 902,777 | \$ - |
| Income taxes paid | \$ 2,998,627 | \$ 2,387,487 |

Non-cash transactions for investing and financing activities:

| | | |
|--|------------|------|
| Construction in progress transferred to property and equipment | \$ 823,464 | \$ - |
| Prepayment on long term assets transferred to property and equipment | \$ 405,630 | \$ - |

The accompanying notes are an integral part of these statements.
See report of independent registered public accounting firm.

F-6

China Natural Gas, Inc. and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2008

Note 1 - Organization

Organization and Line of Business

China Natural Gas, Inc. (the "Company") was incorporated in the state of Delaware on March 31, 1999. The Company through its wholly-owned subsidiaries and variable interest entities engages in sales and distribution of natural gas and gasoline to commercial, industrial and residential customers, construction of pipeline networks, installation of natural gas fittings and parts for end-users.

On May 15, 2007, the Company's variable interest entity, through Xi'an Xilan Natural Gas Co., Ltd. ("XXNGC") established Xi'an Xilan Auto Bodyshop Co., Ltd ("XXABC") with registered capital of \$519,200 in Shaanxi province, People's Republic of China ("PRC"). XXABC was established for the purpose of providing modification services to different types of automobiles to be able to use natural gas. XXABC is 100% owned by Xi'an Xilan Natural Gas Co., Ltd.

On March 18, 2008, Xilan Natural Gas Equipment Co., Ltd ("XNGE") increased its registered capital from \$30,000,000 to \$53,929,260. The additional \$14,429,260 of registered capital was contributed by China Natural Gas, Inc on April 17, 2008 and \$9,500,000 of registered capital was contributed by China Natural Gas, Inc. as a payment to Chemtex International Inc on January 31, 2008, for the purchase of license, know-how, and design of constructing the Liquefied Natural Gas ("LNG") processing plant.

On April 22, 2008, Shaanxi Jingbian Liquefied Natural Gas Co., Ltd. ("SJLNG") increased its registered capital by \$2,862,000. SJLNG is 100% owned by Xi'an Xilan Natural Gas Co., Ltd.

On April 30, 2008, the Industrial and Commercial Administration Bureau approved XXNGC to increase registered capital from \$8,336,856 to \$43,443,640 as an additional contribution by the shareholders of XXNGC under PRC Law. \$15,513,526 was approved by the Industrial and Commercial Administration Bureau to be transferred out from the surplus reserve and retained earnings as an increase of registered capital. Another \$19,593,258 was contributed by XNGE cumulatively prior to April 30, 2008, which was previously classified as an intercompany payable in XXNGC and was eliminated in the consolidated financial statements. The increase in registered capital in XXNGC was in compliance with the Addendum to Option Agreement entered by the Company through XXGE and XXNGC, Mr. Qinan Ji, chairman and shareholder of XXNGC, and each of the shareholders of XXNGC (hereafter collectively referred to as the "Transferor") on August 8, 2008, and made retroactive to June 30, 2008. See "Consolidation of Variable Interest Entity" section for further detail on the Addendum to Option Agreement.

On July 3, 2008, XXNGC formed Henan Xilan Natural Gas Co., Ltd. ("HXNGC") as a wholly owned limited liability company, with registered capital of \$4,383,000 in Henan province, PRC. HXNGC was established for the purpose of natural gas city gasification engineering design, construction and technical advisory work services in Henan, PRC.

On October 2, 2008, China Natural Gas, Inc. (the "Company") through its wholly-owned subsidiary, XXNGC, entered into an Equity Ownership Transfer Agreement (the "Acquisition Agreement") with Lingbao Yuxi Natural Gas Co., Ltd. ("LBNGC") and the shareholders of LBNGC, Zhihe Zhang and Lingjun Hu (the "Sellers"). Pursuant to the term of the Acquisition Agreement, XXNGC acquired for cash consideration of approximately \$19,604,200 (RMB 134 million), 100% of all outstanding registered equity interest in LBNGC and all assets held by LBNGC, including the land use right to 0.44 acres and all of LBNGC's local business' exclusive operating right. LBNGC owns the exclusive rights to operate CNG fueling stations and pipelines in Lingbao City. In conjunction with this acquisition, XXNGC has also

secured abundant supply of natural gas to support its future expansion in the Henan province. The Acquisition Agreement was fully executed in November, 2008.

See report of independent registered public accounting firm.

F-7

China Natural Gas, Inc. and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2008

Note 2 – Summary of Significant Accounting Policies

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of China Natural Gas, Inc. and its wholly owned subsidiary, Xilan Natural Gas Equipment Co., Ltd and its 100% variable interest entities (“VIE”), Xi’an Xilan Natural Gas Co. Ltd., Shaanxi Jingbian Liquefied Natural Gas Co., Ltd., Xian Xilan Auto Bodyshop Co., Ltd., Henan Xilan Natural Gas Co., Ltd., and Lingbao Yuxi Natural Gas Co., Ltd. All inter-company accounts and transactions have been eliminated in the consolidation.

Consolidation of Variable Interest Entity

In accordance with Financial Interpretation No. 46R, Consolidation of Variable Interest Entities (“FIN 46R”), VIEs are generally entities that lack sufficient equity to finance their activities without additional financial support from other parties or whose equity holders lack adequate decision making ability. All VIEs with which the Company is involved must be evaluated to determine the primary beneficiary of the risks and rewards of the VIE. The primary beneficiary is required to consolidate the VIE for financial reporting purposes.

On February 21, 2006, we formed Xilan Natural Gas Equipment Co., Ltd as a wholly-owned foreign enterprise (WFOE). We then, through XNGE, entered into exclusive arrangements with Xian Xilan Natural Gas and its shareholders that give us the ability to substantially influence Xian Xilan Natural Gas’ daily operations and financial affairs, appoint its senior executives and approve all matters requiring shareholder approval. We memorialized these arrangements on August 17, 2007 and made retroactive to March 8, 2006. As a result, the Company consolidates the financial results of Xian Xilan Natural Gas as variable interest entity pursuant to Financial Interpretation No. 46R, “Consolidation of Variable Interest Entities.” The arrangements consist of the following agreements:

- a. Xian Xilan Natural Gas holds the licenses and approvals necessary to operate its natural gas business in China.
- b. XNGE provides exclusive technology consulting and other general business operation services to Xian Xilan Natural Gas in return for a consulting services fee which is equal to Xian Xilan Natural Gas’s revenue.
- c. Xian Xilan Natural Gas’s shareholders have pledged their equity interests in Xian Xilan Natural Gas to the Company.
- d. Irrevocably granted the Company an exclusive option to purchase, to the extent permitted under PRC law, all or part of the equity interests in Xian Xilan Natural Gas and agreed to entrust all the rights to exercise their voting power to the person appointed by the Company.

On August 8, 2008, the Company through XNGE entered into an Addendum to Option Agreement with Mr. Qinan Ji, chairman and shareholder of XXNGC, and each of the shareholders of XXNGC (hereafter collectively referred to as the “Transferor”), and made retroactive to June 30, 2008. According to the agreement, the Chairman and the Shareholders of XXNGC irrevocably grants to XNGE an option to purchase each Transferors’ Purchased Equity Interest at \$1.00 or the lowest price permissible under the applicable laws at the time that XNGE exercise the Option. The Agreement limits the XXNGC and the transferors’ right to make all equity interest related decisions.

Basis of Presentation

The accompanying consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America. The Company's functional currency is the Chinese Renminbi ("RMB"); however, the Company's reporting currency is the United States Dollar ("USD"), therefore, the accompanying consolidated financial statements have been translated and presented in USD.

See report of independent registered public accounting firm.

F-8

China Natural Gas, Inc. and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2008

Foreign Currency Translation

As of December 31, 2008 and December 31, 2007, the accounts of the Company were maintained, and their consolidated financial statements were expressed in RMB. Such consolidated financial statements were translated into USD in accordance with Statement of Financial Accounts Standards ("SFAS") 52, "Foreign Currency Translation," with the RMB as the functional currency. According to SFAS 52, all assets and liabilities were translated at the exchange rate as of the balance sheet date, stockholder's equity are translated at the historical rates and statement of income and cash flow items are translated at the weighted average exchange rate for the year. The resulting translation adjustments are reported under other comprehensive income in accordance with SFAS 130, "Reporting Comprehensive Income." In accordance with SFAS 95, "Statement of Cash Flows," cash flows from the Company's operations is calculated based upon the local currencies and translated to USD at average translation rates for the period. As a result, translation adjustments amounts related to assets and liabilities reported on the statement of cash flows will not necessarily agree with changes in the corresponding balances on the balance sheet.

The balance sheet amounts with the exception of equity at December 31, 2008 were translated 6.82 RMB to \$1.00 as compared to 7.29 RMB at December 31, 2007. The equity accounts were stated at their historical rate. The average translation rates applied to income and cash flow statement amounts for the year ended December 31, 2008 and 2007 were 6.94 RMB and 7.59 RMB to \$1.00, respectively. Translation adjustments resulting from this process in the amount of \$8,661,060 and \$3,477,025 as of December 31, 2008 and 2007, respectively are classified as an item of other comprehensive income in the stockholders' equity section of the consolidated balance sheets. For the year ended December 31, 2008 and 2007, other comprehensive income in the consolidated statements of income and other comprehensive income included translation gains of \$5,184,035 and \$2,637,573, respectively.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash and Cash Equivalents

Cash and cash equivalents include cash on hand and demand deposits in accounts maintained with state-owned banks within the PRC and the United States. The Company considers all highly liquid investments with original maturities of three months or less at the time of purchase to be cash equivalents.

Certain financial instruments, which subject the Company to concentration of credit risk, consist of cash. The Company maintains balances at financial institutions which, from time to time, may exceed Federal Deposit Insurance Corporation insured limits for the banks located in the United States. Balances at financial institutions or state-owned banks within the PRC are not covered by insurance. As of December 31, 2008 and 2007, the Company had total deposits of \$5,604,383 and \$13,053,994, without insurance coverage. And as of December 31, 2008 and 2007, the Company has deposits in United States of \$1,273,639 and \$126,170 in excess of federally insured limits, respectively. The Company has not experienced any losses in such accounts and believes it is not exposed to any significant risks on its cash in bank accounts.

See report of independent registered public accounting firm.

F-9

China Natural Gas, Inc. and Subsidiaries
 Notes to Consolidated Financial Statements
 December 31, 2008

Short Term Investments

Short-term investments are securities classified as available for sale, held by a private investment trust company for investing activities. Gain or loss on securities is computed using cost basis of first-in, first-out (FIFO) basis. The fair value of securities at December 31, 2007 totaled \$238,554, which equaled the original costs, and was returned to the Company in March 2008.

Accounts Receivable

Accounts and other receivable are netted against an allowance for uncollectible accounts, as needed. The Company maintains reserves for potential credit losses on accounts receivable. Management reviews the composition of accounts receivable and analyzes historical bad debts, customer concentrations, customer credit worthiness, current economic trends and changes in customer payment patterns to evaluate the adequacy of these reserves. Reserves are recorded primarily on a specific identification basis in the period of the related sales. Delinquent account balances are written-off after management has determined that the likelihood of collection is not probable, known bad debts are written off against allowance for doubtful accounts when identified. The Company's management has determined that all receivables are collectible and there is no need for an allowance for uncollectible accounts as of December 31, 2008 and 2007.

Other Receivable – Employee Advances

From time to time, the Company advances predetermined amounts based upon internal Company policy to certain employees and internal units to ensure certain transactions are performed in a timely manner. The Company has full oversight and control over the advanced accounts. As of December 31, 2008 and 2007, no allowance for the uncollectible accounts was deemed necessary.

Inventory

Inventory is stated at the lower of cost, as determined on a first-in, first-out basis, or market. Management compares the cost of inventories with the market value, and allowance is made for writing down the inventories to their market value, if lower. Inventory consists of material used in the construction of pipelines and material used in repairing and modifying of vehicles. Inventory also consists of natural gas and gasoline.

The following are the details of the inventories:

| | December 31, 2008 | December 31, 2007 |
|--------------------------|-------------------|-------------------|
| Materials and supplies | \$ 318,069 | \$ 109,333 |
| Natural gas and gasoline | 201,670 | 122,006 |
| | \$ 519,739 | \$ 231,339 |

Advances to Suppliers

The Company advances to certain vendors for purchase of its material. The advances are interest free and unsecured.

Loan Receivable

Loan receivable consists of the following:

| | December 31, 2008 | December 31, 2007 |
|---|----------------------|----------------------|
| Shanxi Yuojin Mining Company, due on November 26, 2008, extended to November 30, 2009, annual interest at 6.57% | \$ 293,400 | \$ 274,200 |

See report of independent registered public accounting firm.

F-10

China Natural Gas, Inc. and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2008

Property and Equipment

Property and equipment are stated at cost. Expenditures for maintenance and repairs are charged to earnings as incurred while additions, renewals and betterments are capitalized. When property and equipment are retired or otherwise disposed of, the related cost and accumulated depreciation are removed from the respective accounts, and any gain or loss is included in operations. Depreciation of property and equipment is provided using the straight-line method for substantially all assets with estimated lives as follows:

| | |
|---|------------|
| Office equipment | 5 years |
| Operating equipment | 5-20 years |
| Vehicles | 5 years |
| B u i l d i n g s a n d improvements | 5-30 years |

The following are the details of the property and equipment:

| | December 31, 2008 | December 31, 2007 |
|-------------------------------|-------------------|-------------------|
| Office equipment | \$ 412,490 | \$ 163,432 |
| Operating equipment | 59,473,283 | 22,413,270 |
| Vehicles | 2,414,756 | 1,484,892 |
| Buildings and improvements | 21,190,599 | 11,943,006 |
| Total property and equipment | 83,491,128 | 36,004,600 |
| Less accumulated depreciation | (7,462,856) | (3,712,605) |
| Property and equipment, net | \$ 76,028,272 | \$ 32,291,995 |

Depreciation expense for the years ended December 31, 2008 and 2007 was \$3,473,429 and \$1,639,685, respectively.

Construction in Progress

Construction in progress consists of the cost of constructing property and equipment for the Company's gas stations and new project of processing, distribution and sale of LNG. The major cost of construction in progress relates to technology licensing fees, equipment purchase, land use rights requisition cost and other construction fees. The facility construction work is expected to be completed around June 2009, and processing equipment installation and testing will be finished by October 2009. As of December 31, 2008 and 2007, the company had construction in progress in the amount of \$22,061,414 and 2,210,367, respectively.

Interest cost capitalized into construction in progress for the years ended December 31, 2008 and 2007 amounted to \$1,932,931 and \$0, respectively.

Long-Lived Assets

The Company applies the provision of SFAS 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" to all long lived assets. SFAS 144 addresses accounting and reporting for impairment and disposal of long-lived assets. The Company periodically evaluates the carrying value of long-lived assets to be held and used in accordance with SFAS 144. SFAS 144 requires impairment losses to be recorded on long-lived assets used in operations when

indicators of impairment are present and the undiscounted cash flows estimated to be generated by those assets are less than the assets' carrying amounts. In that event, a loss is recognized based on the amount by which the carrying amount exceeds the fair market value of the long-lived assets. Loss on long-lived assets to be disposed of is determined in a similar manner, except that fair market values are reduced for the cost of disposal. Based on its review, the Company believes that, as of December 31, 2008, there were no significant impairments of its long-lived assets.

See report of independent registered public accounting firm.

F-11

China Natural Gas, Inc. and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2008

Fair Value of Financial Instruments

On January 1, 2008, the Company adopted SFAS 157, Fair Value Measurements. SFAS 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability (i.e., the “exit price”) in an orderly transaction between market participants at the measurement date. SFAS 157 establishes a three-level valuation hierarchy for disclosure of fair value measurement and enhances disclosures requirements for fair value measures. The carrying amounts reported in the balance sheets for receivables and current liabilities each qualify as financial instruments and are a reasonable estimate of fair value because of the short period of time between the origination of such instruments and their expected realization and their current market rate of interest. The three levels are defined as follow:

- Level 1 inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.
- Level 2 inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.
- Level 3 inputs to the valuation methodology are unobservable and significant to the fair value measurement.

The Company analyzes all financial instruments with features of both liabilities and equity under SFAS 150, “Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity,” SFAS 133, “Accounting for Derivative Instruments and Hedging Activities” and EITF 00-19, “Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company’s Own Stock.”

As required by SFAS 57, financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement. Depending on the product and the terms of the transaction, the fair value of our notes payable and derivative liabilities were modeled using a series of techniques, including closed-form analytic formula, such as the Black-Scholes option-pricing model, which does not entail material subjectivity because the methodology employed does not necessitate significant judgment, and the pricing inputs are observed from actively quoted markets.

The following table sets forth by level within the fair value hierarchy our financial assets and liabilities that were accounted for at fair value on a recurring basis as of December 31, 2008.

| | Carrying Value at December 31, 2008 | Fair Value Measurement at December 31, 2008 | | |
|---|---|--|----------------------|----------|
| | | Level 1 | Level 2 | Level 3 |
| Senior notes | \$ 24,521,605 | - | \$ 40,047,843 | - |
| Derivative liability - warrants | 17,500,000 | - | 5,282,256 | - |
| Total liability measured at fair value | \$ 42,021,605 | - | \$ 45,330,099 | - |

The Company did not identify any other non-recurring assets and liabilities that are required to be presented on the balance sheet at fair value in accordance with SFAS 157.

See report of independent registered public accounting firm.

F-12

China Natural Gas, Inc. and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2008

Revenue Recognition

The Company's revenue recognition policies are in accordance with Staff Accounting Bulletin (SAB) 104. Revenue is recognized when services are rendered to customers when a formal arrangement exists, the price is fixed or determinable, the delivery is completed, no other significant obligations of the Company exist and collectability is reasonably assured. Payments received before all of the relevant criteria for revenue recognition are satisfied are recorded as unearned revenue. Revenue from gas and gasoline sales is recognized when gas and gasoline is pumped through pipelines to the end users. Revenue from installation of pipelines is recorded when the contract is completed and accepted by the customers. The construction contracts are usually completed within one to two months. Revenue from repairing and modifying vehicles is recorded when services are rendered to and accepted by the customers.

Enterprise Wide Disclosure

The Company's chief operating decision-makers (i.e. chief executive officer and his direct reports) review financial information presented on a consolidated basis, accompanied by disaggregated information about revenues by business lines for purposes of allocating resources and evaluating financial performance. There are no segment managers who are held accountable for operations, operating results and plans for levels or components below the consolidated unit level. Based on qualitative and quantitative criteria established by SFAS 131, "Disclosures about Segments of an Enterprise and Related Information", the Company considers itself to be operating within one reportable segment.

Unearned Revenue

Unearned revenue represents prepayments by customers for gas purchases and advance payments on installation of pipeline contracts. The Company records such prepayment as unearned revenue when the payments are received.

Advertising Costs

The Company expenses the cost of advertising as incurred or, as appropriate, the first time the advertising takes place. Advertising costs for the years ended December 31, 2008 and 2007 were insignificant.

Stock-Based Compensation

The Company records and reports stock-based compensation pursuant to SFAS 123R "Accounting for Stock-Based Compensation", which defines a fair-value-based method of accounting for stock-based employee compensation and transactions in which an entity issues its equity instruments to acquire goods and services from non-employees. Stock compensation for stock granted to non-employees has been determined in accordance with SFAS 123R and the EITF 96-18, "Accounting for Equity Instruments that are issued to Other than Employees for Acquiring, or in Conjunction with Selling Goods or Services", as the fair value of the consideration received or the fair value of equity instruments issued, whichever is more reliably measured.

Income Taxes

The Company utilizes SFAS 109, "Accounting for Income Taxes," which requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements or tax returns. Under this method, deferred income taxes are recognized for the tax consequences in future

years of temporary differences between the tax bases of assets and liabilities and their financial reporting amounts at each period end based on enacted tax laws and statutory tax rates applicable to the periods in which the differences are expected to affect taxable income. Valuation allowances are established, when necessary, to reduce deferred tax assets to the amount expected to be realized. At December 31, 2008 and December 31, 2007, there was no significant book to tax differences. There is no difference between book depreciation and tax depreciation as the Company uses the same method for both book and tax. The Company adopted FASB Interpretation 48, "Accounting for Uncertainty in Income Taxes" ("FIN 48"), as of January 1, 2007. A tax position is recognized as a benefit only if it is "more likely than not" that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the "more likely than not" test, no tax benefit is recorded. The adoption had no affect on the Company's financial statements.

See report of independent registered public accounting firm.

F-13

China Natural Gas, Inc. and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2008

Local PRC Income Tax

The Company's subsidiary and VIE's operate in China. Starting January 1, 2008, pursuant to the tax laws of China, general enterprises are subject to income tax at an effective rate of 25% compared to 33% prior to 2008. The Company's VIE, XXNGC, is in the natural gas industry whose development is encouraged by the government. According to the income tax regulation, any company engaged in the natural gas industry enjoys a favorable tax rate. Accordingly, except for income from XNGE, SJLNG, XXABC, HXNGC and LBNGC which subjects to 25% PRC income tax rate, XXNGC's income is subject to a reduced tax rate of 15%. A reconciliation of tax at the United States federal statutory rate to the provision for income tax recorded in the financial statements is as follows:

| | For the years ended December 31, | |
|--|-------------------------------------|-------|
| | 2008 | 2007 |
| Tax provision (credit) at statutory rate | 34% | 34% |
| Foreign tax rate difference | (9)% | (1)% |
| Effect of favorable tax rate | (6)% | (15)% |
| Effective rate of income tax | 19% | 18% |

The estimated tax savings for the years ended December 31, 2008 and 2007 amounted to approximately \$2,195,871 and \$2,174,806, respectively. The net effect on earnings per share had the income tax been applied would decrease basic earnings per share for the years ended December 31, 2008 and 2007 from \$0.52 to \$0.43 and \$0.35 to \$0.26, respectively.

China Natural Gas, Inc. was incorporated in the United States and incurred a net operating loss for income tax purposes for 2008 and 2007. The net operating loss carry forwards for United States income tax purposes amounted to \$2,429,266 and \$948,865 for the years ended December 31, 2008 and 2007, respectively, which may be available to reduce future years' taxable income. These carry forwards will expire, if not utilized, beginning in 2027 through 2028. Management believes that the realization of the benefits arising from this loss appear to be uncertain due to Company's limited operating history and continuing losses for United States income tax purposes. Accordingly, the Company has provided a 100% valuation allowance at December 31, 2008. Management reviews this valuation allowance periodically and makes adjustments as warranted. The valuation allowance for the years ended December 31, 2008 and 2007 were as follow:.

| Valuation allowance | For the year ended December 31, | |
|----------------------------|---------------------------------|------------|
| | 2008 | 2007 |
| Balance of January 01, | \$ 322,614 | \$ - |
| Increase | 825,951 | 322,614 |
| Balance as of December 31, | \$ 1,148,565 | \$ 322,614 |

See report of independent registered public accounting firm.

China Natural Gas, Inc. and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2008

Value added tax

Sales revenue represents the invoiced value of goods, net of a value-added tax (“VAT”). All of the Company’s variable interest entity XXNGC’s products that are sold in the PRC are subject to a Chinese value-added tax at a rate of 13% of the gross sales price. This VAT may be offset by VAT paid by the XXNGC on raw materials and other materials included in the cost of producing their finished product. XXNGC recorded VAT payable and VAT receivable net of payments in the financial statements. The VAT tax return is filed offsetting the payables against the receivables.

All revenues from XXABC subject to a Chinese value-added tax at a rate of 6%. This VAT cannot offset with VAT paid for materials included in the cost of revenues.

Basic and Diluted Earning Per Share

Earning per share is calculated in accordance with the SFAS 128, “Earnings per share”. Basic net earnings per share is based upon the weighted average number of common shares outstanding. Diluted net earnings per share is based on the assumption that all dilutive convertible shares and stock options were converted or exercised. Dilution is computed by applying the treasury stock method. Under this method, options and warrants are assumed to be exercised at the beginning of the period (or at the time of issuance, if later), and as if funds obtained thereby were used to purchase common stock at the average market price during the period.

Reclassifications

Certain prior period amounts have been reclassified to conform to the current period’s presentation. These reclassifications had no material effect on net income or cash flows as previously reported.

Recent Pronouncements

In February 2007, the FASB issued SFAS 159, The Fair Value Option for Financial Assets and Financial Liabilities—including an amendment of FASB Statement No. 115. SFAS 159 permits companies to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. The objective of SFAS 159 is to provide opportunities to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply hedge accounting provisions. SFAS 159 also establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. The Company adopted SFAS 159 on January 1, 2008. The Company chose not to elect the option to measure the fair value of eligible financial assets and liabilities.

In December 2007, the FASB issued SFAS 160, “Noncontrolling Interests in Consolidated Financial Statements - an amendment of Accounting Research Bulletin No. 51,” which establishes accounting and reporting standards for ownership interests in subsidiaries held by parties other than the parent, the amount of consolidated net income attributable to the parent and to the noncontrolling interest, changes in a parent’s ownership interest and the valuation of retained non-controlling equity investments when a subsidiary is deconsolidated. The Statement also establishes reporting requirements that provide sufficient disclosures that clearly identify and distinguish between the interests of the parent and the interests of the non-controlling owners. SFAS 160 is effective for fiscal years beginning after December 15, 2008. The Company has not determined the effect that the application of SFAS 160 will have on its

consolidated financial statements.

See report of independent registered public accounting firm.

F-15

China Natural Gas, Inc. and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2008

In December 2007, SFAS 141(R), "Business Combinations," was issued. SFAS 141R replaces SFAS 141. SFAS 141R retains the fundamental requirements in SFAS 141 that the acquisition method of accounting (which SFAS 141 called the purchase method) be used for all business combinations and for an acquirer to be identified for each business combination. SFAS 141R requires an acquirer to recognize the assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at the acquisition date, measured at their fair values as of that date, with limited exceptions. This replaces SFAS 141's cost-allocation process, which required the cost of an acquisition to be allocated to the individual assets acquired and liabilities assumed based on their estimated fair values. SFAS 141R also requires the acquirer in a business combination achieved in stages (sometimes referred to as a step acquisition) to recognize the identifiable assets and liabilities, as well as the noncontrolling interest in the acquiree, at the full amounts of their fair values (or other amounts determined in accordance with SFAS 141R). SFAS 141R applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. An entity may not apply it before that date. The Company is currently evaluating the impact that adopting SFAS No. 141R will have on its financial statements.

In February 2008, the FASB issued FASB Staff Position (FSP) FAS 140-3, "Accounting for Transfers of Financial Assets and Repurchase Financing Transactions." FSP FAS 140-3 requires an initial transfer of a financial asset and a repurchase financing that was entered into contemporaneously or in contemplation of the initial transfer to be evaluated as a linked transaction under SFAS No. 140 unless certain criteria are met, including that the transferred asset must be readily obtainable in the marketplace. FSP FAS 140-3 is effective for fiscal years beginning after November 15, 2008, and is applicable to new transactions entered into after the date of adoption. Early adoption is prohibited. The Company does not expect adoption of FSP FAS 140-3 to have a material effect on its financial condition and cash flows. Adoption of FSP FAS 140-3 will have no effect on the Company's results of operations.

In March 2008, the FASB issued SFAS 161, "Disclosures about Derivative Instruments and Hedging Activities – An Amendment of SFAS No. 133". SFAS 161 seeks to improve financial reporting for derivative instruments and hedging activities by requiring enhanced disclosures regarding the impact on financial position, financial performance, and cash flows. To achieve this increased transparency, SFAS 161 requires (1) the disclosure of the fair value of derivative instruments and gains and losses in a tabular format; (2) the disclosure of derivative features that are credit risk-related; and (3) cross-referencing within the footnotes. SFAS 161 is effective on January 1, 2009. The Company is in the process of evaluating the new disclosure requirements under SFAS 161.

In May 2008, the FASB issued SFAS 162, "The Hierarchy of Generally Accepted Accounting Principles". SFAS 162 is intended to improve financial reporting by identifying a consistent framework, or hierarchy, for selecting accounting principles to be used in preparing financial statements that are presented in conformity with GAAP for nongovernmental entities. SFAS 162 is effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board amendments to AU Section 411, "The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles." The Company is in the process of evaluating the impact of adoption of this statement on the results of operations, financial position or cash flows.

In June 2008, the FASB issued EITF 07-5 "Determining whether an Instrument (or Embedded Feature) is indexed to an Entity's Own Stock". This Issue is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Early application is not permitted. Paragraph 11(a) of SFAS 133 specifies that a contract that would otherwise meet the definition of a derivative but is both (a) indexed to the Company's own stock and (b) classified in stockholders' equity in the statement of financial position would not be considered a derivative financial instrument. EITF No.07-5 provides a new two-step model to be applied in

determining whether a financial instrument or an embedded feature is indexed to an issuer's own stock and thus able to qualify for the SFAS 133 paragraph 11(a) scope exception. This standard will trigger liability accounting on all options and warrants exercisable at strike prices denominated in any currency other than the functional currency in China (Renminbi). The Company is currently evaluating the impact of adoption of EITF 07-5 on the Company's consolidated financial statements.

In June 2008, the FASB issued FSP EITF 03-6-1, "Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities." The FSP addresses whether instruments granted in share-based payment transactions are participating securities prior to vesting and therefore need to be included in the earnings allocation in calculating earnings per share under the two-class method described in SFAS 128, "Earnings per Share." The FSP requires companies to treat unvested share-based payment awards that have non-forfeitable rights to dividend or dividend equivalents as a separate class of securities in calculating earnings per share. The FSP is effective for fiscal years beginning after December 15, 2008; earlier application is not permitted. The Company does not expect adoption of FSP EITF 03-6-1 to have a material effect on its results of operations or earnings per share.

See report of independent registered public accounting firm.

China Natural Gas, Inc. and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2008

In September 2008, the FASB issued FSP FAS 133-1 and FIN 45-4, Disclosures about Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45; and Clarification of the Effective Date of FASB Statement No. 161". This FSP amends SFAS 133 to require disclosures by sellers of credit derivatives, including credit derivatives embedded in a hybrid instrument. This FSP also amends FIN 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others", to require an additional disclosure about the current status of the payment/performance risk of a guarantee. Further, this FSP clarifies the Board's intent about the effective date of SFAS 161. The provisions of this FSP that amend SFAS 133 and FIN 45 shall be effective for reporting periods (annual or interim) ending after November 15, 2008. The Company is in the process of evaluating the new disclosure requirements under this FSP.

In October 2008, the FASB issued FSP FAS 157-3, "Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active." FSP FAS 157-3 clarifies the application of SFAS 157 in an inactive market, without changing its existing principles. The FSP was effective immediately upon issuance. The adoption of FSP FAS 157-3 did not have an effect on the Company's financial condition, results of operations or cash flows.

In January 2009, the FASB issued FSP EITF 99-20-1, "Amendments to the Impairment Guidance of EITF Issue No. 99-20, "Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets". FSP EITF 99-20-1 changes the impairment model included within EITF 99-20 to be more consistent with the impairment model of SFAS No. 115. FSP EITF 99-20-1 achieves this by amending the impairment model in EITF 99-20 to remove its exclusive reliance on "market participant" estimates of future cash flows used in determining fair value. Changing the cash flows used to analyze other-than-temporary impairment from the "market participant" view to a holder's estimate of whether there has been a "probable" adverse change in estimated cash flows allows companies to apply reasonable judgment in assessing whether an other-than-temporary impairment has occurred. The adoption of FSP EITF 99-20-1 did not have a material impact on our consolidated financial statements because all of our investments in debt securities are classified as trading securities.

Note 3 – Other Assets

Other assets at December 31, 2008 and 2007 consisted of the following,

| | December 31, 2008 | December 31, 2007 |
|---|----------------------|----------------------|
| Prepaid rent – natural gas stations | \$ 272,635 | \$ 225,924 |
| Prepayment for acquiring land use right | 1,060,675 | 993,975 |
| Advances on purchasing equipment and construction in progress | 6,427,974 | 1,501,443 |
| Refundable security deposits | 981,083 | 356,460 |
| Others | 101,695 | 45,250 |
| Total | \$ 8,844,062 | \$ 3,123,052 |

All land in the People's Republic of China is government owned. However, the government grants users land use rights. As of December 31, 2008 and 2007, the Company prepaid \$1,060,675 and \$993,975, respectively, to the PRC local government to purchase land use rights. The Company is in the process of negotiating the final purchase price with the local government and the land use rights have not been granted to the Company. Therefore, the Company did not amortize the prepaid land use rights.

Advances on the purchase of equipment and construction in progress are monies deposited or advanced to outside vendors/subcontractors for the purchase of operating equipment or for services to be provided for constructions in progress.

See report of independent registered public accounting firm.

F-17

China Natural Gas, Inc. and Subsidiaries
 Notes to Consolidated Financial Statements
 December 31, 2008

Refundable security deposits are monies deposited with one of the Company's major vendors and gas station landlord. These amounts will be returned to the Company if they terminate the business relationship or at the end of the lease.

Note 4 – Senior Notes Payable

On December 30, 2007, the Company entered into a Securities Purchase Agreement with Abax Lotus Ltd. (the "Investor"). The Purchase Agreement was subsequently amended on January 29, 2008, pursuant to which the Company (i) agreed to issue 5.00% Guaranteed Senior Notes due 2014 (the "Senior Notes") of approximately \$20,000,000, (ii) agreed to issue to the Investor Senior Notes in aggregate principal amount of approximately \$20,000,000 on or before March 3, 2008 subject to the Company meeting certain closing conditions, (iii) granted the Investor an option to purchase up to approximately \$10,000,000 in principal amount of its Senior Notes and (iv) agreed to issue to the Investor seven-year warrants exercisable for up to 2,900,000 shares of the Company's common stock (the "Warrants") at an initial exercise price equal to \$7.3652 per share, subject to certain adjustments. On January 29, 2008, the Company issued \$20,000,000 Senior Notes and 2,900,000 warrants pursuant to the Purchase Agreement. On March 3, 2008, the Investor exercised its first option for an additional \$20,000,000 of Senior Notes. On March 10, 2008, the Company issued \$20,000,000 in additional Senior Notes resulting in total Senior Notes of \$40,000,000.

At the closing, the Company entered into:

- An indenture for the 5.00% Guaranteed Senior Notes due 2014;
- An investor rights agreement;
- A registration rights agreement covering the shares of common stock issuable upon exercise of the warrants;
- An information rights agreement that grants to the Investor, subject to applicable law, the right to receive certain information regarding the Company, and
- A share-pledge agreement whereby the Company granted to the Collateral Agent (on behalf of the holders of the Senior Notes) a pledge on 65% of the Company's equity interest in Shaanxi Xilan Natural Gas Equipment Co., Ltd., a PRC corporation and wholly-owned subsidiary of the Company.
 - An account pledge and security agreement whereby the Company granted to the Collateral Agent a security interest in the account where the proceeds from the Senior Notes are deposited.

In addition, Qinan Ji, Chief Executive Officer and Chairman of the Board of the Company, executed a non-compete agreement for the benefit of the Investor.

The Senior Notes were issued pursuant to an indenture between the Company and DB Trustees (Hong Kong) Limited, as trustee, at the closing. The Senior Notes will mature on January 30, 2014 and will initially bear interest at the stated interest rate of 5.00% per annum, subject to increase in the event of certain circumstances. The Company is required to make mandatory prepayments on the Senior Notes on the following dates and in the following amounts, expressed as a percentage of the aggregate principal amount of Notes that will be outstanding on the first such payment date:

| Date | Prepayment Percentage |
|------------------|-----------------------|
| July 30, 2011 | 8.3333% |
| January 30, 2012 | 8.3333% |
| July 30, 2012 | 16.6667% |
| January 30, 2013 | 16.6667% |

July 30, 2013

25.0000%

See report of independent registered public accounting firm.

F-18

China Natural Gas, Inc. and Subsidiaries
 Notes to Consolidated Financial Statements
 December 31, 2008

During the twelve month period commencing January 30 of the years set forth below, the Company may redeem the Senior Notes at the following principal amount:

| Year | Principal |
|---------------------|------------|
| 2009 | 43,200,000 |
| 2010 | 42,400,000 |
| 2011 | 41,600,000 |
| 2012 | 40,800,000 |
| 2013 and thereafter | 40,000,000 |

Upon the occurrence of certain events defined in the indenture, the Company must offer the holders of the Senior Notes the right to require the Company to purchase the Senior Notes in an amount equal to 105% of the aggregate principal amount purchased plus accrued and unpaid interest on the Senior Notes purchased.

The indenture requires the Company to pay additional interest at the rate of 3.0% per annum of the Senior Notes if the Company has not obtained a listing of its common stock on the Nasdaq Global Market, the Nasdaq Capital Market or the New York Stock Exchange by January 29, 2009 and maintained such listing continuously thereafter as long as the Senior Notes are outstanding. As of January 29, 2009, the Company has not obtained a listing of its common stock on the market stated in the agreement. However, the Company does get a three-month waiver from Abax for the additional interest payment. The waiver gives the Company three more months until April 28th to achieve the uplisting status. By the end of the extended period, if the Company cannot get its stock uplisted, the Company would try to get another waiver or the Company will have to pay an additional interest at the rate of 3.0% starting April 28th, 2009. Pursuant to the registration rights agreement (described herein), the Company has agreed to pay additional interest at the rate of 1.0% per annum of the Senior Notes principal amount outstanding for each 90-day period in which the Company has failed to comply with the registration obligations under the registration rights agreement.

The indenture limits the Company's ability to incur debt and liens, make dividend payments and stock repurchases, make investments, reinvest proceeds from asset sales and enter into transactions with affiliates, among other things. The indenture also requires the Company to maintain certain financial ratios.

The Company also entered into an investor rights agreement, pursuant to which, as long as an investor holds at least 10% of the aggregate principal amount of the Senior Notes issued and outstanding or at least 3% of the Company's issued and outstanding common stock pursuant to the warrants on an as-exercised basis ("Minimum Holding"), the Company has agreed not to undertake certain corporate actions without prior Investor approval. In addition, so long as an Investor owns the Minimum Holding, such Investor shall have a right of first refusal for future debt securities offerings by the Company and the Company is subject to certain transfer restrictions on its securities and certain other properties.

From the Closing Date and as long as the Investor continues to hold more than 10% of the outstanding shares of common stock on an as-converted, fully-diluted basis, the Investor shall be entitled to appoint one of the Company's board of directors (the "Investor Director"). The Investor Director shall be entitled to serve on each committee of the board, except that, the Investor Director shall not serve on the audit committee unless it is an independent director. Mr. Ji has agreed to vote his shares for the election of the Investor Director.

The Company was required to prepare and file a registration statement covering the sales of all of the shares of common stock issuable upon exercise of the warrants or incur additional interest of 1% on the Notes. The Company's registration statement was declared effective on May 6, 2008; therefore, no penalties were incurred.

See report of independent registered public accounting firm.

F-19

China Natural Gas, Inc. and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2008

On March 3, 2008, the Investor exercised its option to purchase an additional \$20,000,000 of Senior Notes. On March 10, 2008, the Company issued the additional \$20,000,000 in Senior Notes resulting in total Senior Notes of \$40,000,000.

In connection with the issuance of the Securities Purchase Agreement, the Company paid \$2,122,509 in debt issuance costs which is being amortized over the life of the Senior Notes. For the year ended December 31, 2008, the Company amortized \$227,989 of the aforesaid issuance costs, net of capitalized of interest.

In connection with the Securities Purchase Agreement, the Company agreed to issue to the Investor seven-year warrants exercisable for up to 2,900,000 shares of the Company's common stock at an initial exercise price equal to \$7.3652 per share, subject to certain adjustments. The exercise price of the Warrants is adjusted on the first anniversary of issuance and thereafter, at every six month anniversary beginning in the fiscal year 2009 if the volume weighted average price, or VWAP, (as defined therein) for the 15 trading days prior to the applicable reset date is less than the then applicable exercise price, in which case the exercise price shall be adjusted downward to the then current VWAP; provided, however, that in no event shall the exercise price be adjusted below \$3.6826 per share. . The latest reset date was January 29, 2009 and the exercise price for the warrants was adjusted to \$3.6826. The Company is in the process of filing this information with SEC.

If the Company's consolidated net profit after tax for financial statements purpose does not reach the stated level for 2007 or 2008, the exercise price of the warrants shall be adjusted by multiplying the current exercise price by a fraction, the numerator of which is the sum of (i) the number of shares of the Company's common stock outstanding immediately prior to such adjustment and (ii) 87,000, and the denominator of which is the number of shares of the Company's common stock outstanding immediately prior to such adjustment. Pursuant to the terms of the warrant agreement, a holder cannot exercise the Warrants to the extent that the number of shares of Common Stock beneficially owned by the holder would, following such exercise, exceed 9.9% of the outstanding shares of common stock at the time of exercise.

The warrants granted to the Investor on January 29, 2008 are considered derivative instruments that need to be bifurcated from the original security. If the Warrants have not been exercised within the seven year period, then the Investor can have the Company purchase the Warrants for \$17,500,000. This amount is shown as a debt discount and is being amortized over the term of the Senior Notes. For the year ended December 31, 2008, the Company amortized \$1,004,677 of the aforesaid discounts, net of capitalized of interest.

In connection with the Securities Purchase Agreement, the Company agreed to issue to the Investor seven-year warrants exercisable for up to 2,900,000 shares of the Company's common stock at an initial exercise price equal to \$7.3652 per share, adjusted to \$3.6826 on January 29, 2009. The warrants have been determined to be derivative liabilities instruments because there is a required redemption requirement if the holder does not exercise the Warrants. However, the warrants are not required to be value at fair value, rather, to be at its undiscounted redemption amount of \$17.5 million according to FAS 150.

Note 5 – Stockholders' Equity

Common stock

On August 2, 2007, the Company entered into a Securities Purchase Agreement with investors to sell 4,615,385 shares of the Company's common stock and attached warrants to purchase up to 692,308 shares of Common stock ("Investor warrants") for \$3.25 per share (or an aggregate purchase price of \$15,000,000) and for total net proceeds of \$13,823,467. Warrants are exercisable for a period of five years with exercise price of \$7.79 per share.

In connection with the above-mentioned offering, the Company entered into a finance representation agreement ("Agreement") with a placement agent ("Agent"). Pursuant to the agreement, the Company agreed to pay the Agent \$10,000 and issued a warrant ("Placement Agent Warrants") to acquire 75,000 shares of the Company's common stock. In addition, the Company paid \$1,050,000 fee (7% of the gross proceeds).

See report of independent registered public accounting firm.

China Natural Gas, Inc. and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2008

Warrants associated with the above-mentioned issuance of common stock were issued in October 2007 upon the effective filing of its certificate of Amendment of Articles of Incorporation to increase the authorized number of shares of common stock from 30,000,000 to 45,000,000.

Both Investor Warrants and Placement Agent Warrants meet the conditions for equity classification pursuant to FAS 133 and EITF 00-19. Therefore, these warrants were classified as equity and accounted as common stock issuance cost.

Following is a summary of the warrant activity:

| | Warrants Outstanding | Weighted Average Exercise Price | Aggregate Intrinsic Value |
|--------------------------------|-------------------------|---------------------------------------|---------------------------------|
| Outstanding, January 01, 2007 | 1,140,286 | \$ 3.60 | - |
| Granted | 767,308 | \$ 7.79 | - |
| Forfeited | - | - | - |
| Exercised | (819,110) | \$ 3.60 | - |
| Outstanding, December 31, 2007 | 1,088,484 | \$ 6.55 | \$ 376,977 |
| Granted | 2,900,000 | \$ 7.37 | - |
| Forfeited | - | - | - |
| Exercised | - | - | - |
| Outstanding, December 31, 2008 | 3,988,484 | \$ 7.14 | - |

Following is a summary of the status of warrants outstanding at December 31, 2008:

| Outstanding Warrants | | | Exercisable Warrants | | |
|----------------------|-----------|---|------------------------------|-----------|--|
| Exercise Price | Number | Average Remaining Contractual Life | Average Exercise Price | Number | |
| \$3.60 | 321,176 | 0.03 | \$ 3.60 | 321,176 | |
| \$7.37 | 2,900,000 | 6.08 | \$ 7.37 | 2,900,000 | |
| \$7.79 | 767,308 | 3.59 | \$ 7.79 | 767,308 | |
| \$7.14 | 3,988,484 | 3.00 | \$ 7.14 | 3,988,484 | |

Note 6 – Defined Contribution Plan

The Company is required to participate in a defined contribution plan operated by the local municipal government in accordance with Chinese law and regulations. The Company makes annual contributions of 14% of all employees' salaries to the plan. Starting from 2008, no minimum contribution is required but the maximum contribution cannot be more than 14 % of the current salary expense. The total contribution for the above plan was \$112,233 and \$122,677 for the years ended December 31, 2008 and 2007, respectively.

Note 7 – Statutory Reserve

As stipulated by the Company Law of the People's Republic of China (PRC) as applicable to Chinese companies with foreign ownership, net income after taxation can only be distributed as dividends after appropriation has been made for the following:

See report of independent registered public accounting firm.

F-21

China Natural Gas, Inc. and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2008

- i. Making up cumulative prior years' losses, if any;
- ii. Allocations to the "Statutory surplus reserve" of at least 10% of income after tax, as determined under PRC accounting rules and regulations, until the fund amounts to 50% of the Company's registered capital;
- iii. Allocations to the discretionary surplus reserve, if approved in the shareholders' general meeting.

The Company has appropriated \$1,927,348 and \$1,051,849 as reserve for the statutory surplus reserve for the years ended December 31, 2008 and 2007.

Note 8 – Accounting for stock-based compensation

On September 22, 2007, Mr. Qinan Ji, chairman and shareholder of the Company, transferred 100,000 of his personally-owned options to the Company's attorney to cover certain Company legal expenses. 30% of the options vested on September 22, 2008, 30% vest on September 22, 2009, and the remaining 40% vest on September 22, 2010. Upon termination of service to the Company, the attorney is required to return all unvested options. These options expire June 1, 2012.

The Company used the Black-Sholes model to value the options at the time they were issued, based on the stock price on its grant date, the stated exercise prices and expiration dates of the instruments and using a risk-free rate of 4.10%. The estimated life is based on one half of the sum of the vesting period and the contractual life of the option. This is the same as assuming that the options are exercised at the mid-point between the vesting date and expiration date. \$66,704 of compensation expense was recorded during the year ended December 31, 2008.

As of December 31, 2008, approximately \$132,559 of estimated expense with respect to non-vested stock-based compensation has yet to be recognized and will be recognized in expense over the optionee's remaining weighted average service period of approximately 1.75 years.

Note 9 – Earnings Per Share

Earnings per share for the periods ended December 31, 2008 and 2007 is determined by dividing net income for the periods by the weighted average number of both basic and diluted shares of common stock and common stock equivalents outstanding. The following is an analysis of the differences between basic and diluted earnings per common share in accordance with Statement of Financial Accounting Standards No. 128, "Earnings Per Share."

The following demonstrates the calculation for earnings per share for the years ended December 31, 2008 and 2007:

| | For the years ended December 31, | |
|-----------------------------------|-------------------------------------|--------------|
| | 2008 | 2007 |
| Basic earning per share | | |
| Net income | \$ 15,190,368 | \$ 9,116,070 |
| Weighted shares outstanding-Basic | 29,200,304 | 26,200,679 |

Edgar Filing: China Natural Gas, Inc. - Form 10-K

| | | | | |
|---------------------------------------|----|------------|----|------------|
| Earnings per share-Basic | \$ | 0.52 | \$ | 0.35 |
| Diluted earning per share | | | | |
| Net income | \$ | 15,190,368 | \$ | 9,116,070 |
| Weighted shares outstanding-Basic | | 29,200,304 | | 26,200,679 |
| Effect of diluted securities-Warrants | | 89,835 | | 101,123 |
| Weighted shares outstanding-Diluted | | 29,290,139 | | 26,301,802 |
| Earnings per share –Diluted | \$ | 0.52 | \$ | 0.35 |

See report of independent registered public accounting firm.

F-22

China Natural Gas, Inc. and Subsidiaries
 Notes to Consolidated Financial Statements
 December 31, 2008

At December 31, 2008 and 2007, the Company had outstanding warrants of 3,988,484 and 1,088,484, respectively. For the year ended December 31, 2008, the average stock price was greater than the exercise prices of the 321,176 warrants which resulted in additional weighted average common stock equivalents of 89,835; 3,667,308 outstanding warrants were excluded from the diluted earnings per share calculation as they are anti-dilutive.

Note 10 – Current Vulnerability Due to Certain Concentrations

Concentration of natural gas vendors:

| | For the years ended December 31, | |
|---|----------------------------------|-------|
| | 2008 | 2007 |
| Numbers of natural gas vendors | 4 | 3 |
| Percentage of total natural gas purchases | 96.0% | 88.4% |

As of December 31, 2008 and 2007, the Company has \$206,811 and \$0 payable due to Shanxin Natural Gas Company, one of its major natural gas vendors.

The Company has long-term natural gas minimum purchase agreements with one of its vendors. For the years ended December 31, 2008 and 2007, the minimum purchase requirements were 25.58 million cubic meters and 12.93 million cubic meters, respectively. Contracts are renewed on an annual basis. The Company's management reports that it does not expect any issues or difficulty in continuing to renew the supply contracts with these vendors going forward. Price points for natural gas are strictly controlled by the government and have remained stable over the past three years.

The Company's operations are carried out in the People's Republic of China. Accordingly, the Company's business, financial condition and results of operations may be influenced by the political, economic and legal environments in the People's Republic of China, by the general state of the People's Republic of China's economy. The Company's business may be influenced by changes in governmental policies with respect to laws and regulations, anti-inflationary measures, currency conversion and remittance abroad, and rates and methods of taxation, among other things.

Note 11 – Commitments and Contingencies

(a) Lease Commitments

The Company recognizes lease expense on a straight line basis over the term of the lease in accordance to SFAS 13, "Accounting for leases." The Company entered into a series of long term lease agreements with outside parties to lease land use rights to the self-built Natural Gas filling stations located in the PRC. The agreements have terms ranging from 10 to 30 years. The Company makes annual prepayments for most lease agreements. The Company also entered into two office leases in Xian, PRC and New York, NY. The minimum future payment for leasing land use rights and offices is as follows:

| | |
|-------------------------------|--------------|
| Year ending December 31, 2009 | \$ 1,213,744 |
| Year ending December 31, 2010 | 1,208,556 |
| Year ending December 31, 2011 | 1,204,212 |
| Year ending December 31, 2012 | 1,131,931 |

Edgar Filing: China Natural Gas, Inc. - Form 10-K

| | |
|-------------------------------|---------------|
| Year ending December 31, 2013 | 1,052,520 |
| Thereafter | 6,936,959 |
| Total | \$ 12,747,922 |

See report of independent registered public accounting firm.

F-23

China Natural Gas, Inc. and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2008

For the years ended December 31, 2008 and 2007, the land use right and office lease expenses were \$1,127,558 and \$433,755, respectively.

(b) Property and Equipment

In January 2008, the Company entered into a contract with Chemtex International Inc. to purchase equipment supply for LNG plant and LNG storage tank located in Jingbian county, Shannxi Province China, in the total amount of \$13,700,000. On May 16, 2008, SJLNG entered into an agreement with Hebei Tongchan Import and Export Co. Ltd. (Hebei) and agreed that Hebei will act as the trade agency for SJLNG. On June 16, 2008, the Company entered into an equipment supply contract with Chemtex International Inc. to supply imported equipment for a LNG plant and a storage tank to be built by Jingbian Xilan LNG Co. Ltd. As of December 31, 2008, the Company advanced \$6,106,589 to the trade agency and the future commitment for equipment is \$7,593,411.

(c) Natural Gas Purchase Commitments

The Company has existing long-term natural gas purchase agreements with its major suppliers. However, none of those agreements stipulate any specific purchase amount or quota each year, thus giving the Company enough flexibility to constantly look for lower-cost sources of supply. Therefore, the Company is not legally bound in purchase commitments by those agreements.

(d) Legal Proceedings

A former member of the board of directors filed a lawsuit against the Company in New York State Supreme Court, Nassau County, in which he has sought, among other things; to recover a portion of his monthly compensation plus 20,000 options that he alleges are due to him pursuant to a written agreement. After the plaintiff rejected an offer by the Company that included the options that plaintiff alleged were due to him, the Company moved to dismiss the complaint. The judge ordered the Company to issue the 20,000 options to the plaintiff subject to any restrictions required by applicable securities laws, which was essentially what the Company had previously offered, and dismissed all of the plaintiff's remaining claims against the Company. The current board of directors has complied with the court's decision by tendering an options agreement to the plaintiff consistent with the court's decision, but the plaintiff has refused to execute the agreement, and instead has filed an appeal. Regardless of the outcome of the appeal, the Company believes that any liability it would incur will not have a materially adverse effect on its financial condition or its results of operations, and, accordingly, this matter has not been reflected on the Company's financial statements.

See report of independent registered public accounting firm.

China Natural Gas, Inc. and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 2008

Note 12 – Subsequent Events

(a) Reverse Split

On January 15, 2009, our board of directors adopted resolutions by written consent to effect a 1 for 2 reverse split for our common stock to potentially enable the Company to list on the NASDAQ stock market. On January 30 2009, pursuant section 228 of Delaware General Corporation Law, the majority shareholders of our Company adopted resolutions by written consent and waiving all notice of and holding of any stockholder meeting to act upon such resolutions, to effect a 1for 2 reverse split of our common stock to potentially enable the Company to list on the NASDAQ stock market. The Company has filed a Pre14C information statement with SEC and waiting for comments from regulatory authorities before the Company can file the Certificate of Amendment. Because the stock split is not effect until at least the Certificate of Amendment is filed and our board of directors can authorize the Company to suspend or withdraw the filing of Certificate of Amendment before it is effective, the Company did not consider the stock split is effective. The following table disclosed the pro forma information on EPS to give effect to the 1 for 2 reverse stock split

| | For the years ended December 31, | |
|-------------------------------------|-------------------------------------|--------------|
| | 2008 | 2007 |
| Basic earning per share | | |
| Net income | \$ 15,190,368 | \$ 9,116,070 |
| Weighted shares outstanding-Basic | 14,600,152 | 13,100,339 |
| Earnings per share-Basic | \$ 1.04 | \$ 0.70 |
| Diluted earning per share | | |
| Weighted shares outstanding-Diluted | 14,645,069 | 13,150,901 |
| Earnings per share-Diluted | \$ 1.04 | \$ 0.69 |

(b) Adoption of Stock Option Plan

On March 11, 2009, our board of directors approved by written consent the Company's stock option plan for its employees, directors and consultants. Pursuant to the plan, the total stock option pool will equal to 10% of the Company's total shares outstanding as of March 11, 2009. Among the option pool approved, 5% shall be awarded in 2009 and another 5% shall be awarded in 2010. For the 2009 stock option award, the CEO and CFO will be granted total options of 1% and 0.6% of our common shares outstanding respectively, 50% as Non-qualified Stock Options (NSO) and 50% as Incentive Stock Awards (ISA), for a vesting period of four years. 10,000 option shares per year will be granted to each non-executive board member and 12,000 option shares per year granted to Audit Committee Chairman. Other senior management and employees will be granted total options of 2.26% of our common shares. The strike price for the options is \$2.45 per share. It is the mutual understanding of the board and the optionee that the 2009 stock option plan shall be effective January 1, 2009.

See report of independent registered public accounting firm.

F-25
