China Natural Gas, Inc.
Form 10-Q
November 14, 2011

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended: September 30, 2011

or

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

For the transition period from to .

Commission File Number: 001-34373

CHINA NATURAL GAS, INC.
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Delaware<br>(State or other jurisdiction of incorporation or organization) | 98-0231607<br>(I.R.S. Employer Identification No.) |

19th Floor, Building B, Van Metropolis
35 Tang Yan Road, Hi-Tech Zone
Xi'an, 710065, Shaanxi Province, China
+86-29-8832-7391

(Address, including zip code, and telephone number, including area code, of registrant's principal executive offices)

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 þ No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§

232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes þ No ¨

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

| | | | |
|---|---|---|---|
| Large accelerated filer | ¨ | Accelerated filer | þ |
| Non-accelerated filer | ¨ | Smaller reporting company | ¨ |
| (Do not check if a smaller reporting company) | | | |

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

The number of shares outstanding of the registrant’s common stock as of Nov. 8, 2011 was 21,458,654.

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PART I — FINANCIAL INFORMATION

Item 1. Financial Statements

CHINA NATURAL GAS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)

| | September 30, 2011 | December 31, 2010 |
|---|---|---|
| ASSETS | | |
| CURRENT ASSETS: | | |
| Cash and cash equivalents | $ 11,213,236 | $ 10,046,249 |
| Accounts receivable, net | 2,023,046 | 1,821,595 |
| Other receivables | 539,521 | 188,364 |
| Employee advances | 287,279 | 302,532 |
| Inventories | 2,085,768 | 815,884 |
| Advances to suppliers | 6,928,676 | 8,434,995 |
| Prepaid expense and other current assets | 4,540,379 | 4,249,353 |
| Total current assets | 27,617,905 | 25,858,972 |
| | | |
| Investment in unconsolidated joint ventures | 1,565,000 | 1,517,000 |
| Property and equipment, net | 175,431,253 | 82,769,171 |
| Construction in progress | 39,965,531 | 116,569,871 |
| Deferred financing cost, net | 619,792 | 927,166 |
| Other assets | 30,750,525 | 19,806,375 |
| TOTAL ASSETS | $ 275,950,006 | $ 247,448,555 |
| | | |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| | | |
| CURRENT LIABILITIES: | | |
| Notes payable - current maturities | $ 7,529,330 | $ 2,551,306 |
| Long-term debt - current portion | 4,695,000 | - |
| Accounts payable and accrued liabilities | 7,563,468 | 5,428,669 |
| Other payable - related party | 782,500 | - |
| Short-term borrowing - related party | 2,319,945 | - |
| Unearned revenue | 5,671,402 | 2,376,563 |
| Accrued interest | 532,495 | 646,528 |
| Taxes payable | 2,921,975 | 2,377,765 |
| Total current liabilities | 32,016,115 | 13,380,831 |
| | | |
| LONG-TERM LIABILITIES: | | |
| Notes payable, net of current portion | 22,587,989 | 28,064,363 |
| Long-term debt | 14,085,000 | 18,204,000 |
| Derivative liabilities – warrants | 17,500,285 | 17,752,066 |
| Total long-term liabilities | 54,173,274 | 64,020,429 |
| Total liabilities | 86,189,389 | 77,401,260 |
| | | |
| COMMITMENTS AND CONTINGENCIES | | |

| | | |
|---|---|---|
| STOCKHOLDERS' EQUITY: | | |
| Preferred stock, par value $0.0001 per share, 50,000,000 authorized, none issued and outstanding | - | - |
| Common stock, par value $0.0001 per share, 45,000,000 authorized, 21,458,654 and 21,321,904 issued and outstanding at September 30, 2011 and December 31,2010, respectively | 2,145 | 2,132 |
| Additional paid-in capital | 82,761,447 | 81,611,763 |
| Accumulated other comprehensive income | 22,806,158 | 15,667,145 |
| Statutory reserves | 9,579,928 | 7,918,634 |
| Retained earnings | 74,610,939 | 64,847,621 |
| Total stockholders' equity | 189,760,617 | 170,047,296 |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | $ 275,950,006 | $ 247,448,555 |

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

CHINA NATURAL GAS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME
(Unaudited)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2011 | 2010 | 2011 | 2010 |
| Revenues | | | | |
| Natural gas | $32,225,481 | $17,836,178 | $74,859,041 | 49,540,810 |
| Gasoline | 1,508,657 | 1,904,357 | 4,790,207 | 5,407,013 |
| Installation and others | 3,163,237 | 2,585,939 | 8,669,404 | 7,881,073 |
| | 36,897,375 | 22,326,474 | 88,318,652 | 62,828,896 |
| | | | | |
| Cost of revenues | | | | |
| Natural gas | 19,893,643 | 9,904,265 | 44,863,543 | 26,126,909 |
| Gasoline | 1,461,302 | 1,798,825 | 4,588,735 | 5,076,397 |
| Installation and others | 1,363,506 | 1,234,189 | 3,736,054 | 3,525,895 |
| | 22,718,451 | 12,937,279 | 53,188,332 | 34,729,201 |
| | | | | |
| Gross profit | 14,178,924 | 9,389,195 | 35,130,320 | 28,099,695 |
| | | | | |
| Operating expenses | | | | |
| Selling | 4,667,132 | 3,663,654 | 12,288,465 | 9,610,436 |
| General and administrative | 2,513,296 | 1,732,058 | 7,276,052 | 5,463,580 |
| | 7,180,428 | 5,395,712 | 19,564,517 | 15,074,016 |
| | | | | |
| Income from operations | 6,998,496 | 3,993,483 | 15,565,803 | 13,025,679 |
| | | | | |
| Non-operating income (expense): | | | | |
| Interest income | 12,403 | 49,403 | 28,323 | 398,790 |
| Interest expense | (465,236) | - | (469,902) | - |
| Other (expense) income, net | (62,059) | (18,914) | 25,806 | 24,624 |
| Change in fair value of warrants | 11,971 | 449,820 | 251,781 | 1,508,003 |
| Foreign currency exchange loss | (421,031) | (54,167) | (428,079) | (96,942) |
| | (923,952) | 426,142 | (592,071) | 1,834,475 |
| | | | | |
| Income before income tax | 6,074,544 | 4,419,625 | 14,973,732 | 14,860,154 |
| | | | | |
| Provision for income tax | 1,529,451 | 834,783 | 3,549,122 | 2,719,539 |
| | | | | |
| Net income | 4,545,093 | 3,584,842 | 11,424,610 | 12,140,615 |
| | | | | |
| Other comprehensive income | | | | |
| Foreign currency translation gain | 2,696,721 | 3,302,747 | 7,139,013 | 4,061,751 |
| Comprehensive income | $7,241,814 | $6,887,589 | $18,563,623 | $16,202,366 |
| | | | | |
| Weighted average shares outstanding | | | | |
| Basic | 21,458,654 | 21,321,904 | 21,403,052 | 21,251,882 |

| | | | | |
|---|---|---|---|---|
| Diluted | 21,458,654 | 21,422,527 | 21,403,052 | 21,532,612 |
| | | | | |
| Earnings per share | | | | |
| Basic | $0.21 | $0.17 | $0.53 | 0.57 |
| Diluted | $0.21 | $0.17 | $0.53 | 0.56 |

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

CHINA NATURAL GAS, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

| | For the Nine Months Ended September 30, 2011 | 2010 |
|---|---|---|
| Net income | $11,424,610 | $12,140,615 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 6,271,846 | 4,798,446 |
| Provision for doubtful accounts | 6,759 | 129,167 |
| Gain on disposal of equipment | (3,366) | - |
| Stock-based compensation | 479,622 | 1,075,315 |
| Change in fair value of warrants | (251,781) | (1,508,003) |
| Change in assets and liabilities: | | |
| Accounts receivable | (148,404) | (200,764) |
| Other receivables | (339,992) | 561,238 |
| Employee advances | 24,019 | 40,640 |
| Inventories | (1,011,663) | (82,178) |
| Advances to suppliers | (5,863,429) | (1,993,592) |
| Prepaid expense and other current assets | (313,404) | (2,778,533) |
| Accounts payable and accrued liabilities | 1,953,199 | 1,708,603 |
| Unearned revenue | 3,171,096 | 363,203 |
| Accrued interest | (114,033) | (650,637) |
| Taxes payable | 461,903 | (69,060) |
| Net cash provided by operating activities | 15,746,982 | 13,534,460 |
| | | |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| | | |
| Payment for acquisition of property and equipment | (6,568,845) | (6,557,183) |
| Proceeds from sales of property and equipment | 16,896 | - |
| Loan to related party | - | (9,858,240) |
| Loans to third party | - | (4,401,000) |
| Repayment of loan receivable - related party | - | 9,858,240 |
| Repayment of loans receivable - third party | - | 4,695,200 |
| Additions to construction in progress | (7,884,773) | (22,433,455) |
| Prepayment on long-term assets | (805,522) | (8,323,603) |
| Payment for acquisition of business | - | (3,648,080) |
| Return of acquisition deposit | - | 1,618,100 |
| Payment for intangible assets | (189,327) | (4,882,939) |
| Payment for land use rights | - | (1,765,200) |
| | | |
| Net cash used in investing activities | (15,431,571) | (45,698,160) |
| | | |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Proceeds from exercise of stock options | 670,075 | 676,200 |
| Proceeds from short-term debt and other payable, related parties | 3,090,647 | 1,323,900 |
| Proceeds from long-term debt | - | 17,652,000 |

| | | |
|---|---|---|
| Repayment of senior notes | (3,333,334 ) | - |
| Net cash provided by financing activities | 427,388 | 19,652,100 |
| | | |
| Effect of exchange rate changes on cash and cash equivalents | 424,188 | 674,799 |
| | | |
| NET INCREASE (DECREASE) IN CASH & CASH EQUIVALENTS | 1,166,987 | (11,836,801) |
| | | |
| CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD | 10,046,249 | 48,177,794 |
| | | |
| CASH AND CASH EQUIVALENTS, END OF PERIOD | $11,213,236 | $36,340,993 |
| | | |
| SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION: | | |
| Interest paid, including capitalized interest | $3,004,095 | $2,629,926 |
| Income taxes paid | $3,142,069 | $3,012,334 |
| | | |
| Non-cash transactions for investing and financing activities: | | |
| Construction material transferred to construction in progress | $6,210,629 | $- |
| Construction in progress transferred to property and equipment | $93,297,528 | $4,143,807 |
| Construction in progress transferred to intangible assets | $11,611,672 | $- |
| Advances to suppliers transferred to construction in process | $7,609,906 | $- |
| Other assets transferred to construction in progress | $2,342,356 | $15,924,502 |
| Capitalized interest - amortization of discount of notes payable and issuance cost | $3,142,357 | $2,731,695 |

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

China Natural Gas, Inc. and Subsidiaries
Notes to Unaudited Condensed Consolidated Financial Statements

Note 1 - Organization

Organization and Line of Business

China Natural Gas, Inc. (the “Company,” “our,” “us” or “we”) was incorporated in the State of Delaware on March 31, 1999. The Company through its wholly owned subsidiaries and variable interest entity (“VIE”), Xi’an Xilan Natural Gas Co., Ltd. (“XXNGC”) and subsidiaries of its VIE, which are located in Hong Kong, Shaanxi Province, Henan Province and Hubei Province in the People’s Republic of China (“PRC”), engages in sales and distribution of natural gas and gasoline to commercial, industrial and residential customers through fueling stations, tankers and pipelines, construction of pipeline networks, installation of natural gas fittings and parts for end-users, and conversions of gasoline-fueled vehicles to hybrid (natural gas/gasoline) powered vehicles at automobile conversion sites. The condensed consolidated balance sheets as of September 30, 2011 and December 31, 2010, the condensed consolidated statements of income and comprehensive income for the three and nine months ended September 30, 2011 and 2010 and cash flows for the nine months ended September 30, 2011 and 2010 include the accounts of China Natural Gas, Inc. and subsidiaries and VIE. Our subsidiaries are: Xilan Energy Co. Ltd. (“XEC”), Shaanxi Xilan Natural Gas Equipment Co. Ltd (“SXNGE”), Hubei Xian Natural Gas Co., Ltd (“HBXNG”), Lingbao Yuxi Natural Gas Co. Ltd. (“LYNG”), Shaanxi Jingbian Liquefied Natural Gas Co. Ltd (“JBLNG”), Henan Xilan Natural Gas Co. Ltd (“HXNGC”), Xi’an Xilan Auto Body Shop Co, Ltd. (“XXABC”), Henan CNPC Kunlun Xilan Compressed Natural Gas Co., Ltd (“JV”) and Hanchuan Makou Yuntong Compressed Natural Gas Co., Ltd (“Makou”).

On July 16, 2011, our JBLNG plant successfully completed trial operation and commenced commercial production and sale.

On June 28, 2011, XXNGC entered into an Equity Transfer Agreement (the “Transfer Agreement”) with five individual shareholders of Xiantao City Jinhua Gas And Oil Co., Ltd. (“XTJH”). XTJH is in the business of retail sale of natural gas and gasoline, and it owns and operates a station selling natural gas and gasoline in Xiantao, Hubei Province. Pursuant to the Transfer Agreement, XXNGC will acquire a 58.5284% equity interest in XTJH for a total purchase price of approximately $1,909,000. The effectiveness of the Transfer Agreement is subject to the satisfaction of all the following conditions:

- the transferor, or the shareholders of XTJH, as applicable, must satisfy each of the items provided for in Article 2 of the Transfer Agreement, which includes providing relevant corporate certificates and documents of XTJH to XXNGC and providing approvals from government authorities for the construction of a building of XTJH’s;
- the Transfer Agreement must be approved at a General Meeting of Shareholders of XTJH;
- the Transfer Agreement must be notarized by the Notary Public Office of the City of Xiantao.

All terms above must be satisfied in order to complete the transaction. On October 19, 2011, the Company paid an installment of $688,600 (RMB 4,400,000) towards the purchase of the equity interest in XTJH.

Note 2 – Summary of Significant Accounting Policies

Basis of Presentation

The accompanying condensed consolidated financial statements have been prepared in conformity with the accounting principles generally accepted in the United States of America (“U.S. GAAP”).

The condensed consolidated financial statements include all adjustments, including all normal recurring adjustments, necessary to present fairly the condensed consolidated financial position, results of operations and cash flows of the Company for the periods presented. The results of operations for the three and nine months ended September 30, 2011 are not necessarily indicative of operating results expected for the full year or future interim periods. These unaudited condensed consolidated financial statements should be read in conjunction with the audited financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2010, as amended and filed on June 14, 2011.

Use of Estimates and Assumptions

The preparation of the condensed consolidated financial statements in conformity with U.S. GAAP 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. Significant accounting estimates reflected in the Company’s condensed consolidated financial statements include revenue recognition, allowance for doubtful accounts, inventory obsolescence, warrants liability and useful lives of property and equipment. Actual results could differ from those estimates.

Principles of Consolidation

The accompanying condensed consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries and its 100% VIE, XXNGC, and XXNGC’s wholly owned subsidiaries.  All inter-company accounts and transactions have been eliminated in consolidation.

Consolidation of Variable Interest Entity

In accordance with the accounting standard regarding consolidations, VIEs are 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. Any VIE with which the Company is involved must be evaluated to determine the primary beneficiary of the risks and rewards of the VIE. Management makes ongoing reassessments of whether the Company is the primary beneficiary of XXNGC.

Foreign Currency Translation

Our reporting currency is the U.S. dollar. The functional currency of XXNGC and the Company's and XXNGC's PRC subsidiaries is the Chinese Renminbi ("RMB"). The results of operations and financial position of XXNGC and the Company's and XXNGC's PRC subsidiaries are translated to U.S. dollars using the period end exchange rates as to assets and liabilities and weighted average exchange rates as to revenues, expenses and cash flows. Capital accounts are translated at their historical exchange rates when the capital transaction occurred. The resulting currency translation adjustments are recorded as a component of accumulated other comprehensive income (loss) within stockholders' equity.

The balance sheet amounts, with the exception of equity, were translated at the September 30, 2011 exchange rate of RMB 6.39 to $1.00 as compared to RMB 6.59 to $1.00 at December 31, 2010. The equity accounts were stated at their historical rate. The average translation rates applied to income and cash flow statement amounts for the nine months ended September 30, 2011 and 2010 were RMB 6.49 and RMB 6.80 to $1.00, respectively.

Accounts Receivable

Accounts receivable are presented net of an allowance for doubtful accounts.   Management periodically 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 the allowance.

Management considers accounts past due after three months. Delinquent account balances are allowed for when management has determined that the likelihood of collection is not probable. Uncollectible receivables are written off against the allowance for doubtful accounts when identified. We recorded allowances for doubtful accounts of $22,520 and $15,177 as of September 30, 2011 and December 31, 2010, respectively.

Inventories

Inventories are stated at the lower of cost or market, as determined on a first-in, first-out basis. Management compares the cost of inventories with the market value, and writes down the inventories to their market value, if lower than cost. Inventories consist of material used in the construction of pipelines and material used in repairing and modifying vehicles.  Inventories also consist of gasoline.

The following are the details of the inventories:

| | September 30, 2011 | December 31, 2010 |
|---|---|---|
| Materials and supplies | $ 1,915,362 | $ 524,934 |
| Finished goods | 170,406 | 290,950 |
| | $ 2,085,768 | $ 815,884 |

Investments in Unconsolidated Joint Ventures

Investee companies that are not required to be consolidated, but over which the Company exercises significant influence, are accounted for under the equity method of accounting. Whether or not the Company exercises significant influence with respect to an investee depends on an evaluation of several factors including, among others, representation on the investee company's board of directors and ownership level, which is generally a 20% to 50% interest in the voting securities of the investee company. Under the equity method of accounting, the Company's share of the earnings or losses of the investee company is reflected in the caption "other (expense) income, net" in the condensed consolidated statements of income and comprehensive income.

The Company's investment in unconsolidated joint ventures that are accounted for on the equity method of accounting represents the Company's 49% interest in the JV. The investment in the JV amounted to $1,565,000 and $1,517,000 at September 30, 2011 and December 31, 2010, respectively. The JV has not had any operations to date.

The financial position of the JV is summarized below:

| | September 30, 2011 | December 31, 2010 |
|---|---|---|
| Current assets | $ 3,193,878 | $ 3,095,918 |
| Total assets | $ 3,193,878 | $ 3,095,918 |
| Equity | $ 3,193,878 | $ 3,095,918 |
| Total liabilities and equity | $ 3,193,878 | $ 3,095,918 |

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. Depreciation of property and equipment is provided using the straight-line method for all assets with estimated lives as follows:

| | |
|---|---|
| Office equipment | 5 years |
| Operating equipment | 5-20 years |
| Vehicles | 5 years |
| Buildings and improvements | 5-30 years |

| | September 30, 2011 | December 31, 2010 |
|---|---|---|
| Office equipment | $ 737,771 | $ 580,688 |
| Operating equipment | 156,866,036 | 71,163,466 |
| Vehicles | 3,520,715 | 3,308,624 |
| Buildings and improvements | 41,252,891 | 27,861,655 |
| Property and equipment | 202,377,413 | 102,914,433 |
| Less accumulated depreciation | (26,946,160 ) | (20,145,262 ) |
| Property and equipment, net | $ 175,431,253 | $ 82,769,171 |

Depreciation expense for the three months ended September 30, 2011 and 2010 was $2,464,032 and $1,725,861, respectively. Depreciation expense for the nine months ended September 30, 2011 and 2010 was $6,106,122 and $4,792,833, respectively.

Construction in Progress

Construction in progress consists of (1) the costs for constructing compressed natural gas (“CNG”) fueling stations, the liquefied natural gas (“LNG”) project in Jingbian County, and the natural gas infrastructure project in Xi’an International Port District, and (2) other costs related to construction in progress projects, including technology licensing fees, equipment purchases, land use rights acquisition costs, capitalized interests and other construction fees. No depreciation is provided for construction in progress until such time as the assets are completed and placed into service. To the extent that the borrowings could have been avoided, should the construction in progress projects not be implemented, interest incurred on such borrowings during construction period is capitalized into construction in progress. All other interest is expensed as incurred.

As of September 30, 2011 and December 31, 2010, the Company had construction in progress in the amount of $39,965,531 and $116,569,871, respectively. On August 31, 2011, $81,860,675 was transferred from construction in progress to property and equipment, and $11,789,433 was transferred from construction in progress to intangible assets, related to the investment in construction of Phase I of the LNG plant. Interest cost (amortization of discount on notes payable and issuance costs) capitalized into construction in progress for the three months ended September 30, 2011 and 2010 amounted to $1,051,127 and $954,177, respectively. Interest cost (amortization of discount on notes payable and issuance costs) capitalized into construction in progress for the nine months ended September 30, 2011 and 2010, amounted to $3,142,357 and $2,731,695, respectively.

Construction in progress at September 30, 2011 and December 31, 2010 is set forth in the table below. The column of “estimated additional cost to complete” reflects the amounts currently estimated by management to be necessary to complete the relevant project. As of September 30, 2011, the Company was not contractually or legally obligated to expend the estimated additional cost to complete these projects, except to the extent reflected in Note 12 to the condensed consolidated financial statements.

| Project Description | Location | September 30, 2011 | Commencement date | Expected completion date | Estimated additional cost to complete |
|---|---|---|---|---|---|
| Phase I of LNG Project | Jingbian County, Shaanxi Province, PRC | $ 6,307,227 (1) | December 2006 | March 2012(2) | $ 325,697 (3) |
| Phases II and III of LNG Project | Jingbian County, Shaanxi Province, PRC | 8,355,419 (4) | December 2006 | December 2015 | 199,132,573 (5) |
| Fangzhi District | Fangzhi District, Xi'an, PRC | 16,352,207 | October 2010 | February 2012 | 9,141,643 |
| Sa Pu Mother Station | Henan Province, PRC | 1,033,714 | July 2008 | June 2013 | 6,300,000 |
| International Port(6) | International Port District, Xi'an, PRC | 5,334,195 | May 2009 | December 2020 | 299,400,000 |
| Other Construction in Progress Costs | PRC | 2,582,769 | Various | Various | 900,000 |
| | | $ 39,965,531 | | | $ 515,199,913 |

| Project Description | Location | December 31, 2010 | Commencement date | Expected completion date | Estimated additional cost to complete |
|---|---|---|---|---|---|
| Phase I of LNG Project | Jingbian County, Shaanxi Province, PRC | $ 65,309,335 | December 2006 | July 2011 | $ 1,760,278 |
| Phases II and III of LNG Project | Jingbian County, Shaanxi Province, PRC | 35,860,914 | December 2006 | December 2015 | 206,840,695 |
| Sa Pu Mother Station | Henan Province, PRC | 925,328 | July 2008 | Various | 6,300,000 |
| International port | International Port District, Xi'an, PRC | 5,440,515 | May 2009 | December 2020 | 299,400,000 |
| Other Construction in Progress Costs | PRC | 9,033,779 | Various | Various | 9,447,266 |
| | | $ 116,569,871 | | | $ 523,748,239 |

(1) Includes $4,499,780 of construction costs and $1,807,447of capitalized interest for Phase I of the LNG project.

(2) The Company completed most of the construction of Phase I of the LNG plant and initiated commercial production and sale on July 16, 2011. Phase I of the LNG plant has a processing capacity of 500,000 cubic meters of LNG per day, or approximately 150 million cubic meters of LNG per year. Construction of Phase I of the LNG plant experienced delays due to policy changes with respect to tariff exemptions for core equipments imported by the Company and the increased international shipment time for ordered equipments. As certain facilities, including the staff dormitory building are still under construction, the project hasn't been completely transferred from construction in progress to property and equipment, though a substantial amount of construction in progress has been transferred to property and equipment.

(3) Includes costs the Company expected to expend to complete test runs and make installment payments to contractors. The total expected cost of $68.7million for the construction of Phase I of the LNG project exceeded the amount originally anticipated by the Company. The increased costs were attributable to unforeseen cost overruns and escalations, including increased material and labor costs incurred to reinforce pilings based upon modified engineering analysis, and increased prices for land use rights, which the Company believes resulted from the energy resource exploration activities in nearby areas.

(4) Includes $5,961,026 of construction costs and $2,394,393 of capitalized interest for Phases II and III of the LNG project.

(5) This amount reflects the estimated costs of Phases II and III of the LNG project from September 30, 2011 to December 31, 2015, including an estimated $181 million of construction costs and $18 million of capitalized interest. Such costs should be able to finance the construction of a facility capable of processing 3 million cubic meters of LNG per day, or approximately 900 million cubic meters of LNG per year.

(6) Xi'an International Port District Committee, a local government agency in the PRC, pursuant to a conditional non-binding agreement, has appointed XXNGC to be the developer of natural gas infrastructure for Xi'an International Port District, a former agricultural area that has been zoned for urbanization. If XXNGC chooses to proceed with the project, it will be responsible for the construction and all costs related thereof a natural gas pipeline network that will service residential, commercial and industrial buildings and users, as well as fueling stations and related infrastructure. The estimated cost of $299,400,000 was based on a third-party feasibility study and management's estimate. The Company is the only natural gas provider in the surrounding area and expects that it would supply natural gas to the International Port District once construction is completed. If the Company decides not to proceed with this project, it expects to be able to obtain a refund from subcontractors of the $6,100,405 invested as of September 30, 2011 or sell the construction-in-progress assets to third parties.

Long-Lived Assets

We evaluate the carrying value of long-lived assets to be held and used whenever events or changes in circumstances indicate that the assets might be impaired. Impairment losses are 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 our review, no impairment indicators were noted at September 30, 2011.

Fair Value of Financial Instruments

The accounting standards regarding fair value of financial instruments and related fair value measurements define fair value, establish a three-level valuation hierarchy for disclosures of fair value measurement, and provide disclosure requirements for fair value measures. The carrying amounts reported in the condensed consolidated balance sheets for current receivables and payables qualify as financial instruments. Management concluded the carrying values 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, if applicable, their stated interest rate approximates current rates available. The three levels are defined as follows:

- 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 accounting standard regarding derivatives and hedging 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 to stockholders' equity in the statement of financial position would not be considered a derivative financial instrument. This Financial Accounting Standards Board's ("FASB") accounting standard also provides a 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 exception.

The fair value of the warrants was $285 and $252,066 as of September 30, 2011 and December 31, 2010, respectively. The Company recognized a gain of $11,971 and $449,820 for the three months ended September 30, 2011 and 2010, respectively, and a gain of $251,781 and $1,508,003 for the nine months ended September 30, 2011 and 2010, respectively, to reflect the change in fair value of the warrants.

These common stock purchase warrants do not trade in an active securities market and, as such, the Company estimates the fair value of these warrants using the Black-Scholes Option Pricing Model, using the following assumptions:

| | September 30, 2011 | | December 31, 2010 | |
|---|---|---|---|---|
| Annual dividend yield | - | | – | |
| Expected life (years) | 1.07 | | 1.59 | |
| Risk-free interest rate | 0.14 | % | 0.48 | % |
| Expected volatility | 63 | % | 90 | % |

The following table sets forth by level within the fair value hierarchy the Company's financial assets and liabilities that were accounted for at fair value on a recurring basis as of September 30, 2011.

| | Carrying Value at September 30, 2011 | Fair Value Measurement at September 30, 2011 | | |
|---|---|---|---|---|
| | | Level 1 | Level 2 | Level 3 |
| Senior notes | 30,117,319 | - | - | 30,117,319 |
| Redeemable liability – warrants | 17,500,000 | - | - | 17,500,000 |
| Derivative liability – warrants | 285 | - | 285 | - |
| | $47,617,604 | $- | $285 | $47,617,319 |

Other than the assets and liabilities set forth in the table above, the Company did not identify any other assets or liabilities that are required to be accounted for at fair value on the balance sheet. The carrying value of long-term debt with variable interest rate approximates its fair value.

The following is a reconciliation of the beginning and ending balance of warrants liability measured at fair value on a recurring basis using significant observable inputs (Level 2) as of September 30, 2011:

| | |
|---|---|
| Beginning balance | $252,066 |
| Change in fair value | (251,781) |
| Ending balance | $285 |

Revenue Recognition

Revenue is recognized when services are rendered to customers and 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. 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.

Income Taxes

FASB's accounting standard regarding income taxes 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 September 30, 2011 and December 31, 2010, there were no significant book to tax differences except for warrants liability and stock based compensation. An uncertain 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. Penalties and interest incurred related to underpayment of income tax are classified as income tax expense in the year incurred. No significant penalties or interest relating to income taxes have been incurred during the three and nine months ended September 30, 2011 and 2010. Income tax returns for the years prior to 2007 are no longer subject to examination by tax authorities.

XXNGC, the Company's PRC VIE, and XXNGC's subsidiaries operate in the PRC. Pursuant to the tax laws of PRC, general enterprises are subject to income tax at an effective rate of 25% as compared to 33% prior to 2008. However, under PRC income tax regulation, any company deemed to be engaged in the natural gas industry under such regulation enjoys a favorable income tax rate. Thus, XXNGC's income is subject to a reduced tax rate of 15%. All of XXNGC's subsidiaries are not deemed to be engaged in the natural gas industry under PRC income tax regulation and, accordingly, are subject to a 25% income tax rate.

The estimated tax savings as a result of the reduced tax rate enjoyed by XXNGC for the three months ended September 30, 2011 and 2010 amounted to approximately $565,315 and $445,812, respectively. The net effect on earnings per share, had the income tax been applied, would reduce basic and diluted earnings per share for the three months ended September 30, 2011 and 2010, from $0.21 to $0.19 and $0.17 to $0.15, respectively.

The estimated tax savings as a result of the reduced tax rate enjoyed by XXNGC for the nine months ended September 30, 2011 and 2010 amounted to approximately $1,691,566 and $1,472,254 respectively. The net effect on earnings per share, had the income tax been applied, would decrease basic earnings per share for the nine months ended September 30, 2011 and 2010, from $0.53 to $0.45 and $0.57 to $0.50, respectively. The net effect on earnings per share, had the income tax been applied, would decrease diluted earnings per share for the nine months ended September 30, 2011 and 2010, from $0.53 to $0.45 and $0.56 to $0.49, respectively.

China Natural Gas, Inc. was incorporated in the United States and has incurred net operating loss for income tax purposes for the period ended September 30, 2011. The estimated net operating loss carry-forwards for U.S. income tax purposes amounted to $9,014,196 as of September 30, 2011, which may be available to reduce future years' taxable income. These carry-forwards will expire, if not utilized through 2031. Management believes that the realization of the benefits arising from this loss appear to be uncertain due to Company's limited operating history and con