

China Natural Gas, Inc.  
Form 10QSB  
August 20, 2007

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

**FORM 10-QSB**

(Mark One)

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

For the quarterly period ended June 30, 2007

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

000-31539  
(Commission file number)

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

Delaware  
(State or other jurisdiction of  
incorporation or organization)

98-0231607  
(IRS Employer of  
Identification No.)

Tang Xing Shu Ma Building, Suite 418  
Tang Xing Road  
Xian High Tech Area  
Xian, Shaanxi Province, China  
(Address of principal executive offices)

86-29-88323325  
(Issuer's telephone number)

N/A  
(Former name, former address and former fiscal year, if changed since last report)

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Number of shares of Common Stock outstanding as of August 10, 2007: 28,888,655

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

Transitional Small Business Disclosure Format (check one): Yes  No

(Mark One)

---

**China Natural Gas, Inc.**  
**Index**

PART I.	FINANCIAL INFORMATION	2
Item 1.	Financial Statements	2
	Consolidated Balance Sheet as of June 30, 2007 (unaudited)	2
	Consolidated Statements of Operations for the three and six months ended June 30, 2007 and 2006 (unaudited)	3
	Consolidated Statements of Cash Flows for the six months ended June 30, 2007 and 2006 (unaudited)	4
	Notes to Consolidated Financial Statements (unaudited)	5
Item 2.	Management's Discussion and Analysis or Plan of Operations	18
Item 3.	Controls and Procedures	36
PART II.	OTHER INFORMATION	37
Item 1.	Legal Proceedings	37
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	37
Item 3.	Defaults Upon Senior Securities	37
Item 4.	Submission of Matters to a Vote of Security Holders	37
Item 5.	Other Information	37
Item 6.	Exhibits	37
SIGNATURES		38

## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

CHINA NATURAL GAS INC. AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEET  
AS OF JUNE 30, 2007

ASSETS

	June 30, 2007 (Unaudited)
<b>CURRENT ASSETS:</b>	
Cash & cash equivalents	\$ 7,601,358
Accounts receivable, trade	709,328
Other receivables	1,433,695
Inventories	133,962
Advances to suppliers	1,493,755
Prepaid expense and other current assets	111,477
<b>Total current assets</b>	<b>11,483,575</b>
<b>PLANT AND EQUIPMENT, net</b>	<b>20,164,004</b>
<b>CONSTRUCTION IN PROGRESS</b>	<b>2,396,447</b>
<b>Total assets</b>	<b>\$ 34,044,026</b>

LIABILITIES AND SHAREHOLDERS' EQUITY

<b>CURRENT LIABILITIES:</b>	
Accounts payable and accrued expense	\$ 795,359
Other payables	107,741
Unearned revenue	350,672
Taxes payable	1,568,003
<b>Total current liabilities</b>	<b>2,821,775</b>

**SHAREHOLDERS' EQUITY:**

Preferred stock, \$0.0001 par value, 5,000,000 shares authorized, none outstanding as of June 30, 2007	-
Common stock, \$0.0001 par value, 30,000,000 shares authorized,	2,421

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

24,210,183 shares issued and outstanding as of June 30, 2007	
Additional paid in capital	18,223,911
Statutory reserves	1,245,269
Retained earnings	10,174,486
Accumulated other comprehensive income	1,576,164
Total shareholders' equity	31,222,251
Total liabilities and shareholders' equity	\$ 34,044,026

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

CHINA NATURAL GAS INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF INCOME AND  
OTHER COMPREHENSIVE INCOME  
FOR THE THREE MONTHS AND SIX MONTHS ENDED JUNE 30, 2007 AND 2006  
(UNAUDITED)

	Three Months Ended June 30		Six months Ended June 30	
	2007	2006	2007	2006
<b>REVENUES</b>				
Natural gas revenue	\$ 6,765,265	\$ 2,504,449	\$ 11,688,837	\$ 3,369,402
Construction/installation revenue	1,508,044	1,219,734	3,328,048	2,141,995
Total revenue	8,273,309	3,724,183	15,016,885	5,511,397
<b>COST OF GOODS SOLD</b>				
Natural gas revenue	3,463,242	1,603,745	5,955,893	2,109,608
Construction/installation revenue	666,957	505,884	1,400,523	842,533
Total Cost goods sold	4,130,199	2,109,629	7,356,416	2,952,141
<b>GROSS PROFIT</b>	4,143,110	1,614,554	7,660,469	2,559,256
<b>OPERATING EXPENSE</b>				
Selling expenses	682,423	312,610	1,276,552	557,344
General and administrative expenses	260,883	203,408	682,262	423,110
Total operating expense	943,306	516,018	1,958,814	980,454
<b>INCOME FROM OPERATIONS</b>	3,199,804	1,098,536	5,701,655	1,578,802
<b>OTHER INCOME (EXPENSE)</b>				
Interest income	8,330	2,033	17,739	4,777
Other income(expense)	7,973	(5,977)	8,356	(5,951)
Total other income (expense)	16,303	(3,944)	26,095	(1,174)
<b>INCOME BEFORE INCOME TAXES</b>	3,216,107	1,094,592	5,727,750	1,577,628
<b>PROVISION FOR INCOME TAXES</b>	471,098	167,323	872,415	239,779
<b>NET INCOME</b>	2,745,009	927,269	4,855,335	1,337,849
<b>OTHER COMPREHENSIVE INCOME</b>				
Foreign currency translation gain (loss)	455,308	(29,439)	736,712	33,217

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

COMPREHENSIVE INCOME	\$	3,200,317	\$	897,830	\$	5,592,047	\$	1,371,066
NET INCOME PER SHARE-BASIC	\$	0.11	\$	0.04	\$	0.20	\$	0.06
BASIC WEIGHTED AVERAGE NUMBER OF SHARES		24,210,183		23,918,956		24,210,183		23,776,062
NET INCOME PER SHARE-DILUTED	\$	0.11	\$	0.04	\$	0.20	\$	0.06
DILUTED WEIGHTED AVERAGE NUMBER OF SHARES		24,210,183		23,918,956		24,210,183		23,776,062

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

CHINA NATURAL GAS INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
FOR THE SIX MONTHS ENDED JUNE 30, 2007 AND 2006

	2007 (Unaudited)	2006 (Unaudited)
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$ 4,855,335	\$ 1,337,849
Adjustments to reconcile net income to cash provided by (used in) operating activities:		
Depreciation and amortization	726,256	312,407
Exchange gains		(102,032)
Change in operating assets and liabilities:		
(Increase) decrease in assets:		
Accounts receivable	(123,663)	(317,954)
Other receivables	(608,070)	(634,763)
Inventories	156,897	(82,697)
Advance to suppliers	207,903	(430,503)
Prepaid expense	199,307	(263,019)
Increase (decrease) in liabilities:		
Accounts payable	358,550	15,914
Other payables	(161,022)	(292,443)
Taxes payables	(343,379)	215,267
Unearned revenue	58,409	(55,975)
Net cash provided by operating activities	5,326,523	(297,947)
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchase of property and equipment	(3,203,009)	(2,113,842)
Net cash used in investing activities	(3,203,009)	(2,113,842)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Issuance of common stock	-	10,400,000
Payment of offering costs	-	(1,557,147)
Net cash provided by financing activities	-	8,842,853
<b>EFFECT OF EXCHANGE RATE ON CASH</b>	<b>183,631</b>	<b>36,164</b>
<b>INCREASE IN CASH</b>	<b>2,307,145</b>	<b>6,467,228</b>
CASH, beginning of period	5,294,213	675,624



CASH, end of period	\$ 7,601,358	\$ 7,142,852
---------------------	--------------	--------------

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

**China Natural Gas, Inc. and Subsidiaries**  
**Notes to Consolidated Financial Statements**  
**For the Six Months Ended June 30, 2007 and 2006**  
**(unaudited)**

**Note 1 - Organization and Basis of Presentation**

The unaudited consolidated financial statements have been prepared by China Natural Gas, Inc. (the “Company”), pursuant to the rules and regulations of the Securities and Exchange Commission. The information furnished herein reflects all adjustments (consisting of normal recurring accruals and adjustments) which are, in the opinion of management, necessary to fairly present the operating results for the respective periods. Certain information and footnote disclosures normally present in annual consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been omitted pursuant to such rules and regulations. These consolidated financial statements should be read in conjunction with the audited consolidated financial statements and footnotes for the year ended December 31, 2006 included in the Company’s Annual Report on Form 10-KSB. The results of the six months ended June 30, 2007 are not necessarily indicative of the results to be expected for the full year ending December 31, 2007.

Organization and Line of Business

China Natural Gas, Inc. (formerly Coventure International, Inc.) was incorporated in Delaware on March 31, 1999 as Bullet Environmental Systems, Inc. and on May 25, 2000 the Company changed its name to Liquidpure Corp. On February 14, 2002, the Company changed its name to Coventure International, Inc.

Xi’an Xilan Natural Gas Co, Ltd. (“XXNGC”) was incorporated on January 8, 2000 in Xi’an city in the Shaanxi province, China. The core business of XXNGC is distribution of natural gas to commercial, industrial and residential customers, construction of pipeline networks, and installation of natural gas fittings and parts for end-users. XXNGC has an exclusive permit to provide gas utility service in Lantian County, Lintong and Baqiao District of Xi’an city, China.

On December 6, 2005, XXNGC entered into and closed a share purchase agreement with Coventure International, Inc. (“Coventure”), a public shell in the United States of America. Pursuant to the purchase agreement, Coventure acquired all of the issued and outstanding capital stock of XXNGC in exchange for 16,000,000 (post-split) shares of Coventure’s common stock.

Concurrently with the closing of the purchase agreement and as a condition thereof, Coventure entered into an agreement with John Hromyk, its President and Chief Financial Officer, pursuant to which Mr. Hromyk returned 23,884,712 (post-split) shares of Coventure's common stock for cancellation. Upon completion of the foregoing transactions, Coventure had an aggregate of 20,204,088 (post-split) shares of common stock issued and outstanding.

As a result of the merger, XXNGC’s stockholders own approximately 80% of the combined company and the directors and executive officers of XXNGC became the directors and executive officers of the Coventure. Accordingly, the transaction has been accounted for as a reverse acquisition of Coventure by XXNGC resulting in a recapitalization of XXNGC rather than as a business combination. XXNGC is deemed to be the purchaser and surviving company for accounting purposes. Accordingly, its assets and liabilities are included in the balance sheet at their historical book values and the results of operations of XXNGC have been presented for the comparative prior period. The historical cost of the net liabilities of Coventure that were acquired was \$3,378. In addition, Coventure changed its name to China Natural Gas, Inc. (hereafter referred to as the “Company”) and the stockholders approved a stock dividend of three shares for each share held, which has been accounted for as a four to one forward stock split.

However, this merger acquisition was not able to be approved under the certain laws of the People's Republic of China ("PRC"). PRC law currently has limits on foreign ownership of companies in certain industries. To comply with these foreign ownership restrictions, the Company established its wholly owned subsidiary, Xilan Natural Gas Equipment Ltd., (XNGE) a limited liability company organized under the PRC law on February 21, 2006. The Company through XNGE entered into exclusive arrangements with XXNGC. Through these arrangements, the Company has the ability to substantially influence XXNGC's daily operations and financial affairs, appoint its senior executives and approve all matters requiring shareholder approval. These arrangements were formalized on August 17, 2007, and made retroactive to March 8, 2006. As a result, XXNGC became a VIE effective on March 8, 2006.

**China Natural Gas, Inc. and Subsidiaries**  
**Notes to Consolidated Financial Statements**  
**For the Six Months Ended June 30, 2007 and 2006**  
**(unaudited)**

**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 subsidiaries, Shaanxi Natural Gas Equipment Co., Ltd (incorporated in February 2006) and its 100% variable interest entity ("VIE") Xi'an Xilan Natural Gas Co. Ltd. Shaanxi Jingbian Liquefied Natural Gas Co., Ltd (incorporated in October 2006) and Xian Xilan Auto Bodyshop (incorporated in May, 2007). All inter-company accounts and transactions have been eliminated in 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 August 17, 2007 and made retroactive to March 8, 2006, the Company through XNGE entered into exclusive arrangements with XXNGC. These arrangements obligate the Company to absorb a majority of the risk of loss from XXNGC's activities and enable the Company to receive a majority of XXNGC's expected residual returns. As a result, the Company accounts for XXNGC as a VIE under FASB Interpretation No. 46R ("FIN 46R"), "Consolidation of Variable Interest Entities." The arrangements consist of the following agreements:

- a. XXNGC 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 XXNGC in return for a consulting services fee which is equal to XXNGC's revenue.
- c. XXNGC's shareholders have pledged their equity interests in XXNGC 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 XXNGC and agreed to entrust all the rights to exercise their voting power to the person appointed by the Company

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; however the accompanying consolidated financial statements have been translated and presented in United States Dollars (\$).

Reclassifications

Certain prior period amounts have been reclassified to conform to current period's presentation. This reclassification had no material effect on operations or cash flows

Foreign Currency Translation

As of June 30, 2007 and 2006, the accounts of the Company were maintained, and their consolidated financial statements were expressed in the Chinese Yuan Renminbi (CNY). Such consolidated financial statements were translated into U.S. Dollars (USD) in accordance with Statement of Financial Accounts Standards ("SFAS") No. 52, "Foreign Currency Translation," with the CNY as the functional currency. According to the Statement, all assets and liabilities were translated at the exchange rate on the balance sheet date, stockholder's equity are translated at the historical rates and statement of operations 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 No. 130, "Reporting Comprehensive Income."

Translation adjustments resulting from this process amounted to \$1,576,164 and \$839,452 as of June 30, 2007 and December 31, 2006, respectively. The balance sheet amounts with the exception of equity at June 30, 2007 were translated 7.60 RMB to \$1.00 USD as compared to 7.80 RMB at December 31, 2006. The equity accounts were stated at their historical rate. The average translation rates applied to income statement accounts for the periods ended June 30, 2007 and 2006 were 7.73 RMB and 8.04 RMB to \$1.00 USD, respectively.

**China Natural Gas, Inc. and Subsidiaries**  
**Notes to Consolidated Financial Statements**  
**For the Six Months Ended June 30, 2007 and 2006**  
**(unaudited)**

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 cash in bank.

Accounts and Other Receivable

Accounts and other receivable 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 June 30, 2007.

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 natural gas.

Advances

The Company advances to certain vendors (for purchase of its material and equipment) and a consultant. The advances are interest free and unsecured.

Property and Equipment

Property and equipment are stated at cost. Expenditures for maintenance and repairs are charged to earnings as incurred; 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:

**China Natural Gas, Inc. and Subsidiaries**  
**Notes to Consolidated Financial Statements**  
**For the Six Months Ended June 30, 2007 and 2006**  
**(unaudited)**

Office equipment	5 years
Operating equipment	5-20 years
Vehicles	5 years
Buildings	30 years

At June 30, 2007, the following are the details of the property and equipment:

Office equipment	\$ 83,972
Operating equipment	15,397,856
Vehicles	1,238,366
Buildings	6,056,252
	22,776,446
Less accumulated depreciation	2,612,442
	\$ 20,164,004

Depreciation expense for the six months ended June 30, 2007 and 2006 was \$726,139 and \$312,295, respectively.

#### Long-Lived Assets

Effective January 1, 2002, the Company adopted Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS 144"), which addresses financial accounting and reporting for the impairment or disposal of long-lived assets and supersedes SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of," and the accounting and reporting provisions of APB Opinion No. 30, "Reporting the Results of Operations for a Disposal of a Segment of a Business." 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 June 30, 2007, there were no significant impairments of its long-lived assets.

#### Construction In Progress

Construction in progress consists of the cost of constructing fixed assets for the Company's use. The major cost of construction in progress relates to material, labor and overhead.

**China Natural Gas, Inc. and Subsidiaries**  
**Notes to Consolidated Financial Statements**  
**For the Six Months Ended June 30, 2007 and 2006**  
**(unaudited)**

Contracts In Progress

Contracts in progress consist of the cost of constructing pipelines for customers. The major cost of construction relates to material, labor and overhead. Revenue from construction and 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 time. As of June 30, 2007, the Company has no contracts in progress.

Fair Value of Financial Instruments

Statement of financial accounting standard No. 107, Disclosures about fair value of financial instruments, requires that the Company disclose estimated fair values of financial instruments. The carrying amounts reported in the statements of financial position for current assets and current liabilities qualifying as financial instruments are a reasonable estimate of fair value.

Revenue Recognition

The Company's revenue recognition policies are in compliance 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 collectibility is reasonably assured. Payments received before all of the relevant criteria for revenue recognition are satisfied are recorded as unearned revenue. Revenue from gas sales is recognized when gas is pumped through pipelines to the end users. Revenue from construction and 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 time.

Unearned Revenue

Unearned revenue represents prepayments by customers for gas purchases and advance payments on construction and 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 six months ended June 30, 2007 and 2006 were insignificant.

Stock-Based Compensation

The Company accounts for its stock-based compensation in accordance with Statement of Financial Accounting Standards ("SFAS") No. 123R, "Share-Based Payment, an Amendment of Financial Accounting Standards Board ("FASB") Statement No. 123." The Company recognizes in the statement of operations the grant-date fair value of stock options and other equity-based compensation issued to employees and non-employees. The Company did not grant any options and no options were cancelled or exercised during the six months ended June 30, 2007 and 2006. As of June 30, 2007, there were no options outstanding.





**China Natural Gas, Inc. and Subsidiaries**  
**Notes to Consolidated Financial Statements**  
**For the Six Months Ended June 30, 2007 and 2006**  
**(unaudited)**

Income Taxes

The Company utilizes SFAS No. 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 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 June 30, 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 effect on the Company's financial statements.

Local PRC Income Tax

Pursuant to the tax laws of China, general enterprises are subject to income tax at an effective rate of 33%. The Company 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, the Company's income is subject to a reduced tax rate of 15%.

A reconciliation of tax at United States federal statutory rate to provision for income tax recorded in the financial statements is as follows:

	For the Six Months Ended June 30,	
	2007	2006
Tax provision (credit) at statutory rate	34%	34%
Foreign tax rate difference	(19%)	(19%)
	15%	15%

**China Natural Gas, Inc. and Subsidiaries**  
**Notes to Consolidated Financial Statements**  
**For the Six Months Ended June 30, 2007 and 2006**  
**(unaudited)**

The estimated tax savings for the six months ended June 30, 2007 amounted to \$1,042,675. The net effect on earnings per share had the income tax been applied would decrease basic and diluted earnings per share from \$0.20 to \$0.16.

Beginning January 1, 2008, the new Chinese Enterprise Income Tax ("EIT") law will replace the existing laws for Domestic Enterprises ("DES") and Foreign Invested Enterprises ("FIEs"). The new standard EIT rate of 25% will replace the 33% rate currently applicable to both DES and FIEs. The two years tax exemption, three years 50% tax reduction tax holiday for production-oriented FIEs will be eliminated.

Basic and Diluted Earning Per Share

Earning per share is calculated in accordance with the Statement of Financial Accounting Standards No. 128 ("SFAS No. 128"), "Earnings per share". SFAS No. 128 superseded Accounting Principles Board Opinion No.15 (APB 15). Net earning per share for all periods presented has been restated to reflect the adoption of SFAS No. 128. Basic net earning per share is based upon the weighted average number of common shares outstanding. Diluted net earning per share is based on the assumption that all dilutive convertible shares and stock options were converted or exercised. At June 30, 2007, the Company had outstanding 1,140,286 warrants. The average stock price for the six months ended June 30, 2007 was less than the exercise price of the warrants; therefore, the warrants are not factored into the diluted earning per share calculation as they are anti-dilutive.

Statement of Cash Flows

In accordance with Statement of Financial Accounting Standards No. 95, "Statement of Cash Flows," cash flows from the Company's operations is calculated based upon the local currencies. As a result, 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

Segment Reporting

Statement of Financial Accounting Standards No. 131 ("SFAS 131"), "Disclosure About Segments of an Enterprise and Related Information" requires use of the "management approach" model for segment reporting. The management approach model is based on the way a company's management organizes segments within the company for making operating decisions and assessing performance. Reportable segments are based on products and services, geography, legal structure, management structure, or any other manner in which management disaggregates a company. SFAS 131 has no effect on the Company's consolidated financial statements as the Company consists of one reportable business segment. All revenue is from customers in People's Republic of China. All of the Company's assets are located in People's Republic of China.

**China Natural Gas, Inc. and Subsidiaries**  
**Notes to Consolidated Financial Statements**  
**For the Six Months Ended June 30, 2007 and 2006**  
**(unaudited)**

Recent Pronouncements

In September 2006, FASB issued SFAS 157 'Fair Value Measurements'. This Statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. This Statement applies under other accounting pronouncements that require or permit fair value measurements, the Board having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, this Statement does not require any new fair value measurements. However, for some entities, the application of this Statement will change current practice. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The management is currently evaluating the effect of this pronouncement on financial statements.

In September 2006, FASB issued SFAS 158 'Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)' This Statement improves financial reporting by requiring an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income of a business entity or changes in unrestricted net assets of a not-for-profit organization. This Statement also improves financial reporting by requiring an employer to measure the funded status of a plan as of the date of its year-end statement of financial position, with limited exceptions. An employer with publicly traded equity securities is required to initially recognize the funded status of a defined benefit postretirement plan and to provide the required disclosures as of the end of the fiscal year ending after December 15, 2006. An employer without publicly traded equity securities is required to recognize the funded status of a defined benefit postretirement plan and to provide the required disclosures as of the end of the fiscal year ending after June 15, 2007. However, an employer without publicly traded equity securities is required to disclose the following information in the notes to financial statements for a fiscal year ending after December 15, 2006, but before June 16, 2007, unless it has applied the recognition provisions of this Statement in preparing those financial statements. The requirement to measure plan assets and benefit obligations as of the date of the employer's fiscal year-end statement of financial position is effective for fiscal years ending after December 15, 2008. The management is currently evaluating the effect of this pronouncement on financial statements.

In February of 2007 the FASB issued SFAS 159, "The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115." The statement permits entities to choose to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. The statement is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. The company is analyzing the potential accounting treatment.

**China Natural Gas, Inc. and Subsidiaries**  
**Notes to Consolidated Financial Statements**  
**For the Six Months Ended June 30, 2007 and 2006**  
**(unaudited)**

FASB Interpretation 48 prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Benefits from tax positions should be recognized in the financial statements only when it is more likely than not that the tax position will be sustained upon examination by the appropriate taxing authority that would have full knowledge of all relevant information. The amount of tax benefits to be recognized for a tax position that meets the more-likely-than-not recognition threshold is measured as the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. Tax benefits relating to tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent financial reporting period in which that threshold is met or certain other events have occurred. Previously recognized tax benefits relating to tax positions that no longer meet the more-likely-than-not recognition threshold should be derecognized in the first subsequent financial reporting period in which that threshold is no longer met. Interpretation 48 also provides guidance on the accounting for and disclosure of tax reserves for unrecognized tax benefits, interest and penalties and accounting in interim periods. Interpretation 48 is effective for fiscal years beginning after December 15, 2006. The change in net assets as a result of applying this pronouncement will be a change in accounting principle with the cumulative effect of the change required to be treated as an adjustment to the opening balance of retained earnings on January 1, 2007, except in certain cases involving uncertainties relating to income taxes in purchase business combinations. In such instances, the impact of the adoption of Interpretation 48 will result in an adjustment to goodwill. The adoption of this standard had no material impact on the Company's consolidated financial statements.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements," ("SAB 108"), which provides interpretive guidance on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. The Company adopted SAB 108 in the fourth quarter of 2006 with no impact on its consolidated financial statements.

**Note 3 - Stockholders' Equity**

Warrants

Following is a summary of the warrant activity:

	Warrants outstanding	Weighted Average Exercise Price	Aggregate Intrinsic Value
Outstanding, December 31, 2006	1,140,286	\$ 3.60	\$ 0
Granted	-	-	-
Forfeited	-	-	-
Exercised	-	-	-
Outstanding, June 30, 2007	1,140,286	\$ 3.60	\$ 0

**China Natural Gas, Inc. and Subsidiaries**  
**Notes to Consolidated Financial Statements**  
**For the Six Months Ended June 30, 2007 and 2006**  
**(unaudited)**

Following is a summary of the status of warrants outstanding at June 30, 2007:

Outstanding Warrants			Exercisable Warrants	
Exercise Price	Number	Average Remaining Contractual Life	Average Exercise Price	Number
\$3.60	1,140,286	1.53	\$3.60	1,140,286

**Note 4 - Employee Welfare Plan**

The Company has established its own employee welfare plan in accordance with Chinese law and regulations. The Company makes annual contributions of 14% of all employees' salaries to employee welfare plan. The total expense for the above plan was \$54,992 and \$22,774 for the six months and \$10,981 and \$4,881 for the three months ended June 30, 2007 and 2006, respectively.

**Note 5 - Statutory Common Welfare Fund**

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:

- 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 of 5-10% of income after tax, as determined under PRC accounting rules and regulations, to the Company's "Statutory common welfare fund", which is established for the purpose of providing employee facilities and other collective benefits to the Company's employees; and
- iv. Allocations to the discretionary surplus reserve, if approved in the shareholders' general meeting.

The Company has appropriated \$494,383 and \$203,812 as reserve for the statutory surplus reserve and welfare fund for the six months ended June 30, 2007 and 2006, respectively.

**China Natural Gas, Inc. and Subsidiaries**  
**Notes to Consolidated Financial Statements**  
**For the Six Months Ended June 30, 2007 and 2006**  
**(unaudited)**

**Note 7 - Supplemental disclosure of cash flow information**

Income taxes paid amounted to \$1,473,635 and \$128,908 for the six months ended June 30 2007 and 2006 and for the three months ended June 30, 2007 and 2006 amounted to \$384,794 and \$25,753, respectively.

**Note 8 - Earnings Per Share**

Earnings (loss) per share for the six months ended June 30, 2007 and 2006 is determined by dividing net income (loss) 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 six months and three months ended June 30, 2007 and 2006:

	Six months ended June 30	
	2007 (Unaudited)	2006 (Unaudited)
Net income for basic earnings per share	\$ 4,855,335	\$ 1,337,849
Weighted average shares used in basic computation	24,210,183	23,918,956
Diluted effect of warrants	-	104,158
Weighted average shares used in diluted computation	24,210,183	23,776,062
<b>Earnings per share</b>		
Basic	\$ 0.20	\$ 0.06
Diluted	\$ 0.20	\$ 0.06

  

	Three months ended June 30	
	2007 (Unaudited)	2006 (Unaudited)
Net income for basic earnings per share	\$ 2,745,009	\$ 927,269
Weighted average shares used in basic computation	24,210,183	23,918,956
Diluted effect of warrants	-	-
Weighted average shares used in diluted computation	24,210,183	23,918,956
<b>Earnings per share</b>		
Basic	\$ 0.11	\$ 0.04
Diluted	\$ 0.11	\$ 0.04

**China Natural Gas, Inc. and Subsidiaries**  
**Notes to Consolidated Financial Statements**  
**For the Six Months Ended June 30, 2007 and 2006**  
**(unaudited)**

**Note 9 - Current Vulnerability Due to Certain Concentrations**

For the six months ended June 30, 2007 and 2006, the Company purchased all of the natural gas for resale from three vendors, PetroChina Changqing Oilfield Company, Shaanxi Natural Gas Co Ltd, and Jingcheng city Mingshi Coal Bed Methane Exploitation Ltd. No amount was owing to these vendors at June 30, 2007. Except for Shaanxi Natural Gas Co Ltd, the other two vendors have long-term agreements with the Company without minimum purchases requirement. The Company has had annual agreements with Shaanxi Natural Gas Co Ltd that require the Company to purchase a minimum amount of natural gas. For the years ended December 31, 2006 and 2005 the minimum purchases were 2.36 million and 1.60 million cubic meters, respectively. In the past, contracts were renewed on an annual basis. However, as the volume of usage has increased, Shaanxi Natural Gas has revised their policies, and contract terms are now six months and subject to review prior to renewal. 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 3 years.

For the six months ended June 30, 2007, two suppliers account for 23.97% and 14.28% of the total equipment purchased by the Company and for the six months ended June 30, 2006, two suppliers account for 48.2% and 24.1% of the total equipment purchased by the Company. Payables to those two suppliers accounted for 17% of the total account payables at June 30, 2007.

Four customers accounted for 46%, 28%, 7% and 1% of the Company's installation revenue for the six months ended June 30, 2007 and one customer accounted for 32% of the Company's construction revenue for the six months ended June 30, 2006. Receivables from one customer accounted for 51% of the total account receivables at June 30, 2007.

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 10 - Commitments and Contingencies**

The Company is obligated to contribute \$10,000,000 as registered capital of Xilan Natural Gas Equipment Company, a 100% subsidiary of CHNG incorporated under the laws of PRC in February, 2006. The Company has already made a capital contribution of \$6,480,000 and the Company remains obligated to contribute the additional \$3,520,000 by February 2008.



**China Natural Gas, Inc. and Subsidiaries**  
**Notes to Consolidated Financial Statements**  
**For the Six Months Ended June 30, 2007 and 2006**  
**(unaudited)**

**Note 11 - Subsequent event**

On August 2, 2007, the Company entered into a Securities Purchase Agreement with investors named therein (the "Investors") to sell in a private placement to the Investors 4,615,385 shares of the Company's common stock, par value \$0.0001 per share (the "Common Stock") for \$3.25 per share (the "Shares") and warrants to purchase up to 692,308 shares of Common Stock exercisable for a period of five years at an exercise price of \$7.79 per share (the "Investor Warrants"), for an aggregate purchase price of \$15,000,000. The Company issued the Shares on the same day and will issue the Investor Warrants upon the effective filing of the Certificate of Amendment of Articles of Incorporation with the Secretary of State of the State of Delaware to increase its total authorized Common Stock.

The Company also entered into a Registration Rights Agreement with the Investors, pursuant to which the Company is obligated to file a registration statement registering the resale of the Shares and Common Stock issuable upon the exercise of the Investor Warrants.

Brean Murray, Carret & Co., LLC acted as the sole placement agent in the transaction, and received a fee of \$1,049,999.97 (7% of the gross proceeds) and will receive a warrant to purchase 75,000 shares of Common Stock (the "Placement Agent Warrant"). The Placement Agent Warrant is identical to the Investor Warrants.

## Item 2. Management's Discussion and Analysis or Plan of Operations

### CAUTIONARY STATEMENT

The following discussion and analysis should be read in conjunction with the Company's Consolidated Financial Statements and the Notes thereto included in this Report. Unless otherwise noted, all amounts are expressed in U.S. dollars. The following discussion regarding the Company and its business and operations contains forward-looking statements that consist of any statement other than a recitation of historical fact and can be identified by the use of forward-looking terminology such as "may," "expect," "anticipate," "estimate" or "continue" or the negative thereof or other variations thereon or comparable terminology. In particular, these include statements relating to our expectation that we will continue to have adequate liquidity from cash flow from operations the other risks and uncertainties, which are described above under "RISK FACTORS." The reader is cautioned that all forward-looking statements are necessarily speculative and there are certain risks and uncertainties that could cause actual events or results to differ materially from those referred to in such forward-looking statements, including the risk factors discussed in this Report. The Company does not have a policy of updating or revising forward-looking statements and thus it should not be assumed that silence by management of the Company over time means that actual events are bearing out as estimated in such forward-looking statements.

### 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 closed a Share Purchase Agreement with Xian Xilan Natural Gas Co., Ltd., a corporation formed under the laws of the People's Republic of China on January 8, 2000, and the shareholders of Xian Xilan Natural Gas Co., Ltd. Pursuant to the Share Purchase Agreement, we acquired all of the issued and outstanding capital stock of Xian Xilan Natural Gas Co., Ltd. from the shareholders of Xian Xilan Natural Gas Co., Ltd. On December 19, 2005, we changed our name to China Natural Gas, Inc.

However, this merger acquisition was not able to be approved under the certain laws of the People's Republic of China ("PRC"). PRC law currently has limits on foreign ownership of companies in certain industries. To comply with these foreign ownership restrictions, the Company established its wholly owned subsidiary, Xilan Natural Gas Equipment Ltd., (XNGE) a limited liability company organized under the PRC law on February 21, 2006. The Company through XNGE entered into exclusive arrangements with XXNGC. Through these arrangements, the Company has the ability to substantially influence XXNGC's daily operations and financial affairs, appoint its senior executives and approve all matters requiring shareholder approval. These arrangements were formalized on August 17, 2007, and made retroactive to March 8, 2006. As a result, XXNGC became a VIE effective on March 8, 2006.

We transport, distribute and sell natural gas to commercial, industrial and residential customers in the Xian 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"). Shaanxi Province is located in central China and has a population of approximately 36 million in an area of over 200,000 square kilometers (about 77,225 square miles). Xian, the capital of Shaanxi Province, is located in the southern part of Shaanxi Province and has a population of approximately 8 million people, with about 5 million people living within the urban area.

We operate three primary business lines:

- Distribution and sale of compressed natural gas (CNG) through Company-owned CNG filling stations for hybrid (natural gas/gasoline) powered vehicles (17 stations in service as of June 30, 2007 and we expect to add three additional stations by the end of third quarter of 2007);

·Distribution and sale of CNG to third party-owned CNG filling stations for hybrid (natural gas/gasoline) powered vehicles; and

18

---

Distribution and sale of natural gas to residential, commercial and industrial customers through Company-owned pipelines. As of June 30, 2007, the Company distributed and sold natural gas to approximately 78,216 pipeline customers.

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.

## CONSOLIDATED RESULTS OF OPERATIONS

### Comparing Three Months Ended June 30, 2007 and 2006:

The following table presents certain consolidated statement of operations information. Financial information is presented for the three months ended June 30, 2007 and 2006.

	June 30, 2007	June 30, 2006
Revenues	\$ 8,273,309	\$ 3,724,183
Cost of Revenues	4,130,199	2,109,629
Operating Expenses	943,306	516,018
Income from Operations	3,199,804	1,098,536
Net Income	\$ 2,745,009	\$ 927,269

*Revenues:* We generated approximately 83% of our revenues in the three months ended June 30, 2007 from the sale of natural gas and approximately 17% of our revenues from construction and installation fees charged to connect end-user customers to our natural gas distribution system. Sales of natural gas at the Company-owned filling stations accounted for approximately 77.53% of our total revenues in the three months ended June 30, 2007, or approximately \$6,413,970, 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 22.21% of our total revenues in the three months ended June 30, 2007, or approximately \$1,837,502, including both natural gas sales and construction and installation fees. Sales of natural gas to third party-owned filling stations accounted for approximately 0.26% of our total revenues in the three months ended June 30, 2007, or approximately \$21,511. The Company expects installation revenues to increase on both an actual basis and as a percentage of revenue in 2007.

As of June 30, 2007, the Company had approximately 78,216 pipeline customers, an increase of approximately 15,661 customers over the same period in 2006, and had constructed 17 filling stations, an increase of 13 stations over the same period in 2006 with additional two filling stations under construction with expected completion by the end of the third quarter of 2007. In the third quarter of 2007, the Company expects to add up to 5,000 pipeline customers and 3 additional filling stations, which the Company estimates will increase sales of natural gas by 2 million cubic meters.

We had total revenues of \$8,273,309 for the three months ended June 30, 2007, an increase of \$4,549,126 or 122%, compared to \$3,724,183 for the three months ended June 30, 2006. The increase in revenues was due primarily to contributions from Company-owned CNG filling stations completed after the second quarter of 2006 as well as an increase in the number of residential, commercial and industrial pipeline customers from approximately 62,555 in the three months ended June 30, 2006 to approximately 78,216 in the three months ended June 30, 2007.

New pipeline customers pay approximately 60% of the construction costs to connect to our pipeline system up front and the balance is payable as part of their monthly natural gas bill. During the three months ended June 30, 2007, our installation revenues increased approximately 23.6% over the same period in 2006 and our sales of natural gas increased approximately 170% over the previous year. Four customers accounted for approximately 61%, 1.57%, 1.17% and 0.01% of the Company's installation revenue for the three months ended June 30, 2007.

*Cost of Revenues:* Our cost of revenues consists of both the cost of natural gas and the cost of construction and installation. Cost of natural gas consists primarily of the cost that we pay for natural gas purchased from our supplier, together with transportation costs and depreciation of equipment. Cost of connection includes certain construction costs related to connecting customers to our pipeline system that are generally expensed when incurred.

Cost of revenues in the three months ended June 30, 2007 was \$4,130,199, an increase of \$2,020,570 or approximately 96% over the same period in 2006. Cost of natural gas increased by approximately 116% to \$3,463,242 in the three months ended June 30, 2007, as compared with \$1,603,745 for the same period in 2006. The increase in our cost of revenues was primarily related to a material increase in the amount of gas sold. In addition, our construction and installation costs increased in the three months ended June 30, 2007 by approximately 32% to \$666,957, as compared with \$505,884 in the same period in 2006 as a result of the addition of new pipeline customers. The price that we paid for gas in the three months ended June 30, 2007 remained relatively constant compared to 2006.

*Gross profit:* The Company earned a gross profit of \$4,143,110 for the three months ended June 30, 2007, an increase of \$2,528,556 or approximately 157%, compared to \$1,614,554 for the three months ended June 30, 2006. The increase in gross profit is due to a material increase in gas sales and installation revenues in this quarter, partially offset by an increase in cost of sales.

*Gross margin:* Gross margin, as a percentage of revenues, increased to approximately 50% for the three months ended June 30, 2007, from approximately 43% for the three months ended June 30, 2006. The increase in gross margin is primarily due to increased portion of the total gross profit represented by CNG filling stations as compared to the same period in 2006.

*Operating expenses:* The Company incurred operating expenses of \$943,306 for the three months ended June 30, 2007, an increase of \$432,688 or approximately 83%, compared to \$516,018 for the three months ended June 30, 2006. Our operating expenses increased primarily as a result of expenses related to the construction and operation of three new filling stations in this quarter, as well as continuing expenses related to the identification of possible locations for additional filling stations and the governmental licensing and approval process. In addition, sales and marketing costs increased in the three months ended June 30, 2007 as we increased our efforts to obtain new residential and commercial customers and attract customers to our filling stations.

The Company purchases all of the natural gas for resale from three vendors, PetroChina Changqing Oilfield Company, Shaanxi Natural Gas Co Ltd, and Jingcheng city Mingshi Coal Bed Methane Exploitation Ltd. Except for Shaanxi Natural Gas Co Ltd, the other two vendors have long-term agreements with the Company without minimum purchases requirement. The Company has had annual agreements with Shaanxi Natural Gas Co Ltd that require the Company to purchase a minimum amount of natural gas. For the years ended December 31, 2006 and 2005 the minimum purchases were 2.36 million and 1.60 million cubic meters, respectively. In the past, contracts were renewed on an annual basis. However, as the volume of usage has increased, Shaanxi Natural Gas has revised their policies, and contract terms are now six months and subject to review prior to renewal. 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. 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. As China shifts from a centrally planned economy to a market economy, we believe that it is in the government's best interest to keep prices, stable, as they been for the past 3 years, and maintain a stable flow of supply. The government has undertaken programs to promote the growth of the region in which we are located. Therefore, we expect supply and price to continue to be stable in the future.

For the three months ended June 30, 2007, two suppliers accounted for 40% and 27% 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 two vendors would not have a material adverse effect on our operations.

Income tax was \$471,098 for the three months ended June 30, 2007, as compared to \$167,323 for the three months ended June 30, 2006. The increase in income tax was attributed to the growth of construction and installation fees and the sale of natural gas.

*Net Income:* Net income increased to \$2,745,009 for the three months ended June 30, 2007, an increase of \$1,817,740 or approximately 196% from \$927,269 for the three months ended June 30, 2006. Increase in net income is attributed to our significant increase in revenues, partially offset by a higher increase in cost of sales and operating expenses. The Company expects installation revenues to increase on both an actual basis and as a percentage of revenue. In the third quarter of 2007, the Company expects to add up to 5,000 pipeline customers and add additional 3 filling stations, which the Company estimates will increase sales of natural gas by 2 million cubic meters.

#### **Comparing six Months Ended June 30, 2007 and 2006:**

The following table presents certain consolidated statement of operations information. Financial information is presented for the six months ended June 30, 2007 and 2006.

	June 30, 2007		June 30, 2006	
Revenues	\$	15,016,885	\$	5,551,397
Cost of Revenues		7,356,416		2,952,141
Operating Expenses		1,958,814		980,454
Income from Operations		5,701,655		1,578,802
Net Income	\$	4,855,335	\$	1,337,849

*Revenues:* We generated approximately 78% of our revenues in the six months ended June 30, 2007 from the sale of natural gas and approximately 22% of our revenues from construction and installation fees charged to connect end-user customers to our natural gas distribution system. Sales of natural gas at the Company-owned filling stations accounted for approximately 72.95% of our total revenues in the six months ended June 30, 2007, or approximately

\$10,954,818, 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 26.69% of our total revenues in the six months ended June 30, 2007, or approximately \$4,008,007, including both natural gas sales and construction and installation fees. Sales of natural gas to third party-owned filling stations accounted for approximately 0.36% of our total revenues in the six months ended June 30, 2007, or approximately \$54,061. The Company expects installation revenues to increase on both an actual basis and as a percentage of revenue in 2007.

As of June 30, 2007, the Company had approximately 78,216 pipeline customers, an increase of approximately 15,661 customers over the same period in 2006, and had constructed 17 filling stations, an increase of 13 stations over the same period in 2006 with additional two filling stations under construction with expected completion by the end of the third quarter of 2007. In the third quarter of 2007, the Company expects to add up to 5,000 pipeline customers and add additional 3 filling stations, which the Company estimates will increase sales of natural gas by 2 million cubic meters.

We had total revenues of \$15,016,885 for the six months ended June 30, 2007, an increase of \$9,505,488 or approximately 172%, compared to \$5,511,397 for the six months ended June 30, 2006. The increase in revenues was due primarily to contributions from Company-owned CNG filling stations completed after the second quarter of 2006 as well as an increase in the number of residential, commercial and industrial pipeline customers from approximately 62,555 in the six months ended June 30, 2006 to approximately 78,216 in the six months ended June 30, 2007.

New pipeline customers pay approximately 60% of the construction costs to connect to our pipeline system up front and the balance is payable as part of their monthly natural gas bill. During the six months ended June 30, 2007, our installation revenues increased approximately 55% over the same period in 2006 and our sales of natural gas increased approximately 247% over the previous year. Four customers accounted for approximately 46%, 28%, 7% and 1% of the Company's installation revenue for the six months ended June 30, 2007.

*Cost of Revenues:* Our cost of revenues consists of both the cost of natural gas and the cost of construction and installation. Cost of natural gas consists primarily of the cost that we pay for natural gas purchased from our supplier, together with transportation costs and depreciation of equipment. Cost of connection includes certain construction costs related to connecting customers to our pipeline system that are generally expensed when incurred.

Cost of revenues in the six months ended June 30, 2007 was \$7,356,416, an increase of \$4,404,275 or approximately 149% over the same period in 2006. Cost of natural gas increased by approximately 182% to \$5,955,893 in the six months ended June 30, 2007, as compared with \$2,109,608 for the same period in 2006. The increase in our cost of revenues was primarily related to a material increase in the amount of gas sold. In addition, our construction and installation costs increased in the six months ended June 30, 2007 by approximately 66% to \$1,400,523, as compared with \$842,533 in the same period in 2006 as a result of the addition of new pipeline customers. The price that we paid for gas in the six months ended June 30, 2007 remained relatively constant compared to 2006.

*Gross profit:* The Company earned a gross profit of \$7,660,469 for the six months ended June 30, 2007, an increase of \$5,101,213 or approximately 199%, compared to \$2,559,256 for the six months ended June 30, 2006. The increase in gross profit is due to a material increase in gas sales and installation revenues in this quarter, partially offset by an increase in cost of sales.



*Gross margin:* Gross margin, as a percentage of revenues, increased to approximately 51% for the six months ended June 30, 2007, from approximately 46% for the six months ended June 30, 2006. The increase in gross margin is primarily due to increased portion of the total gross profit represented by CNG filling stations as compared to the same period in 2006.

*Operating expenses:* The Company incurred operating expenses of \$1,958,814 for the six months ended June 30, 2007, an increase of \$978,360 or approximately 100%, compared to \$980,454 for the six months ended June 30, 2006. Our operating expenses increased primarily as a result of expenses related to the construction and operation of 13 new filling stations in this quarter, as well as continuing expenses related to the identification of possible locations for additional filling stations and the governmental licensing and approval process. In addition, sales and marketing costs increased in the six months ended June 30, 2007 as we increased our efforts to obtain new residential and commercial customers and attract customers to our filling stations.

We purchase all of our natural gas for resale from three vendors, PetroChina Changqing Oilfield Company, Shaanxi Natural Gas Co Ltd, and Jingcheng city Mingshi Coal Bed Methane Exploitage Ltd. 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. As China shifts from a centrally planned economy to a market economy, we believe that it is in the government's best interest to keep prices stable, as they have been for the last 3 years, and maintain a stable flow of supply. The government has undertaken programs to promote the growth of the region in which we are located. Therefore, we expect supply and price to continue to be stable in the future.

For the six months ended June 30, 2007, two suppliers accounted for 23.97% and 14.28% 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 two vendors would not have a material adverse effect on our operations.

Income tax was \$872,415 for the six months ended June 30, 2007, as compared to \$239,779 for the six months ended June 30, 2006. The increase in income tax was attributed to the growth of construction and installation fees and the sale of natural gas.

*Net Income:* Net income increased to \$4,855,335 for the six months ended June 30, 2007, an increase of \$3,517,486 or approximately 263% from \$1,337,849 for the six months ended June 30, 2006. Increase in net income is attributed to our material increase in revenues, partially offset by a higher increase in cost of sales and operating expenses. The Company expects installation revenues to increase on both an actual basis and as a percentage of revenue. In the third quarter of 2007, the Company expects to add up to 5,000 pipeline customers and add additional 3 filling stations, which the Company estimates will increase sales of natural gas by 2 million cubic meters.

## **Liquidity and Capital Resources**

As of June 30, 2007, the Company had \$7,601,358 of cash and cash equivalents on hand compared to \$7,142,852 of cash and cash equivalents as of June 30, 2006.

The primary source of cash in the six months ended June 30, 2007 was income from operations. The Company had net cash flows provided by operations of \$5,326,523 for the six months ended June 30, 2007 as compared to net cash used in operations of \$297,948 in the corresponding period last year.

Cash outflows for investing activities increased from \$2,113,842 in the six months ended June 30, 2006 to \$3,203,009 for the same period in 2007 primarily because the Company purchased more equipment in 2007 in anticipation of its business growth.

The Company expects to add 3 additional CNG filling stations by the end of third quarter of 2007. The Company expects the funds for these investing activities will primarily come from the Company's operating and financing cash flows.

The Company is obligated to contribute \$10 million of registered capital to its wholly-owned subsidiary, Xilan Natural Gas Equipment Co. As of June 30, 2007, the Company had contributed \$6,480,000 of this capital commitment and is obligated to contribute the remaining \$3,520,000 by February 2008.

The Company expects to require financing of \$40 million to \$80 million in order to complete its proposed LNG Project.

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 acquisition of other filling stations) 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 RMB, the currency of the People's Republic of China. There is no assurance that exchange rates between the RMB and the USD 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**

We do not have any 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.

## **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.

Cash and Cash Equivalents

Cash and cash equivalents include cash on hand and cash in bank

Accounts and Other Receivable

Accounts and other receivable 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 June 30, 2007.

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 natural gas.

Advances

The Company advances to certain vendors (for purchase of its material and equipment) and a consultant. The advances are interest free and unsecured.

Property and Equipment

Property and equipment are stated at cost. Expenditures for maintenance and repairs are charged to earnings as incurred; 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
Buildings	30 years

Long-Lived Assets

Effective January 1, 2002, the Company adopted Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS 144"), which addresses financial accounting and reporting for the impairment or disposal of long-lived assets and supersedes SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of," and the accounting and reporting provisions of APB Opinion No. 30, "Reporting the Results of Operations for a Disposal of a Segment of a Business." 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 June 30, 2007 there were no significant impairments of its long-lived assets.

### Construction In Progress

Construction in progress consists of the cost of constructing fixed assets for the Company's use. The major cost of construction in progress relates to material, labor and overhead.

### Contracts In Progress

Contracts in progress consist of the cost of constructing pipelines for customers. The major cost of construction relates to material, labor and overhead. Revenue from construction and 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 time. As of June 30, 2007, the Company has no contracts in progress.

### Fair Value of Financial Instruments

Statement of Financial Accounting Standard No. 107, "Disclosures about Fair Value of Financial Instruments," requires that the Company disclose estimated fair values of financial instruments. The carrying amounts reported in the statements of financial position for current assets and current liabilities qualifying as financial instruments are a reasonable estimate of fair value.

### Revenue Recognition

The Company's revenue recognition policies are in compliance 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 collectibility is reasonably assured. Payments received before all of the relevant criteria for revenue recognition are satisfied are recorded as unearned revenue. Revenue from gas sales is recognized when gas is pumped through pipelines to the end users. Revenue from construction and 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 time.

### Unearned Revenue

Unearned revenue represents prepayments by customers for gas purchases and advance payments on construction and 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 six months ended June 30, 2007 and 2006 were insignificant.

### Stock-Based Compensation

The Company accounts for its stock-based compensation in accordance with Statement of Financial Accounting Standards ("SFAS") No. 123R, "Share-Based Payment, an Amendment of Financial Accounting Standards Board ("FASB") Statement No. 123." The Company recognizes in the statement of operations the grant-date fair value of stock options and other equity-based compensation issued to employees and non-employees. The Company did not grant any options and no options were cancelled or exercised during the six months ended June 30, 2007 and 2006. As of June 30, 2007, there were no options outstanding.

### Income Taxes

The Company utilizes SFAS No. 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 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 June 30, 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.

### Local PRC Income Tax

Pursuant to the tax laws of China, general enterprises are subject to income tax at an effective rate of 33%. The Company 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, the Company's income is subject to a reduced tax rate of 15%.

### Basic and Diluted Earning Per Share

Earning per share is calculated in accordance with the Statement of Financial Accounting Standards No. 128 ("SFAS No. 128"), "Earnings per share". SFAS No. 128 superseded Accounting Principles Board Opinion No.15 (APB 15). Net earning per share for all periods presented has been restated to reflect the adoption of SFAS No. 128. Basic net earning per share is based upon the weighted average number of common shares outstanding. Diluted net earning per share is based on the assumption that all dilutive convertible shares and stock options were converted or exercised. At June 30, 2007, the Company had outstanding 1,140,286 warrants. The average stock price for the six month ended June 30, 2007 was less than the exercise price of the warrants; therefore, the warrants are not factored into the diluted earning per share calculation as they are anti-dilutive.



### Statement of Cash Flows

In accordance with Statement of Financial Accounting Standards No. 95, "Statement of Cash Flows," cash flows from the Company's operations is calculated based upon the local currencies. As a result, 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

### Segment Reporting

Statement of Financial Accounting Standards No. 131 ("SFAS 131"), "Disclosure about Segments of an Enterprise and Related Information" requires use of the "management approach" model for segment reporting. The management approach model is based on the way a company's management organizes segments within the company for making operating decisions and assessing performance. Reportable segments are based on products and services, geography, legal structure, management structure, or any other manner in which management disaggregates a company. SFAS 131 has no effect on the Company's consolidated financial statements as the Company consists of one reportable business segment. All revenue is from customers in People's Republic of China. All of the Company's assets are located in People's Republic of China

### Recent Pronouncements

In September 2006, FASB issued SFAS 157 "Fair Value Measurements." This Statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. This Statement applies under other accounting pronouncements that require or permit fair value measurements, the Board having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, this Statement does not require any new fair value measurements. However, for some entities, the application of this Statement will change current practice. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The management is currently evaluating the effect of this pronouncement on financial statements.



In September 2006, FASB issued SFAS 158 “Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R).” This Statement improves financial reporting by requiring an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income of a business entity or changes in unrestricted net assets of a not-for-profit organization. This Statement also improves financial reporting by requiring an employer to measure the funded status of a plan as of the date of its year-end statement of financial position, with limited exceptions. An employer with publicly traded equity securities is required to initially recognize the funded status of a defined benefit postretirement plan and to provide the required disclosures as of the end of the fiscal year ending after December 15, 2006. An employer without publicly traded equity securities is required to recognize the funded status of a defined benefit postretirement plan and to provide the required disclosures as of the end of the fiscal year ending after June 15, 2007. However, an employer without publicly traded equity securities is required to disclose the following information in the notes to financial statements for a fiscal year ending after December 15, 2006, but before June 16, 2007, unless it has applied the recognition provisions of this Statement in preparing those financial statements. The requirement to measure plan assets and benefit obligations as of the date of the employer’s fiscal year-end statement of financial position is effective for fiscal years ending after December 15, 2008. The management is currently evaluating the effect of this pronouncement on financial statements.

In February of 2007 the FASB issued SFAS 159, “The Fair Value Option for Financial Assets and Financial Liabilities—including an amendment of FASB Statement No. 115.” The statement permits entities to choose to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. The statement is effective as of the beginning of an entity’s first fiscal year that begins after November 15, 2007. The company is analyzing the potential accounting treatment.

FASB Staff Position on FAS No. 115-1 and FAS No. 124-1 (“the FSP”), “The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments,” was issued in November 2005 and addresses the determination of when an investment is considered impaired, whether the impairment on an investment is other-than-temporary and how to measure an impairment loss. The FSP also addresses accounting considerations subsequent to the recognition of other-than-temporary impairments on a debt security, and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. The FSP replaces the impairment guidance on Emerging Issues Task Force (EITF) Issue No. 03-1 with references to existing authoritative literature concerning other-than-temporary determinations. Under the FSP, losses arising from impairment deemed to be other-than-temporary, must be recognized in earnings at an amount equal to the entire difference between the securities cost and its fair value at the financial statement date, without considering partial recoveries subsequent to that date. The FSP also required that an investor recognize other-than-temporary impairment losses when a decision to sell a security has been made and the investor does not expect the fair value of the security to fully recover prior to the expected time of sale. The FSP is effective for reporting periods beginning after December 15, 2005. The adoption of this statement will not have a material impact on our consolidated financial statements.

FASB Interpretation 48 prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Benefits from tax positions should be recognized in the financial statements only when it is more likely than not that the tax position will be sustained upon examination by the appropriate taxing authority that would have full knowledge of all relevant information. The amount of tax benefits to be recognized for a tax position that meets the more-likely-than-not recognition threshold is measured as the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. Tax benefits relating to tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent financial reporting period in which that threshold is met or certain other events have occurred. Previously recognized tax benefits relating to tax

positions that no longer meet the more-likely-than-not recognition threshold should be derecognized in the first subsequent financial reporting period in which that threshold is no longer met. Interpretation 48 also provides guidance on the accounting for and disclosure of tax reserves for unrecognized tax benefits, interest and penalties and accounting in interim periods. Interpretation 48 is effective for fiscal years beginning after December 15, 2006. The change in net assets as a result of applying this pronouncement will be a change in accounting principle with the cumulative effect of the change required to be treated as an adjustment to the opening balance of retained earnings on January 1, 2007, except in certain cases involving uncertainties relating to income taxes in purchase business combinations. In such instances, the impact of the adoption of Interpretation 48 will result in an adjustment to goodwill. The adoption of this standard had no material impact on the Company's consolidated financial statements.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements," ("SAB 108"), which provides interpretive guidance on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. The Company adopted SAB 108 in the fourth quarter of 2006 with no impact on its consolidated financial statements.

## **RISK FACTORS**

We are subject to various risks that could have a negative effect on the Company and its financial condition. You should understand that these risks could cause results to differ materially from those expressed in forward looking statements contained in this report and in other Company communications. Because there is no way to determine in advance whether, or to what extent, any present uncertainty will ultimately influence our business, you should give equal weight to each of the following:

### **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.

**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 filling 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 filling 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. We do not currently have employment contracts with our senior executives. 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.

**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 must raise \$40 million in order complete the LNG Project.

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.

## **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 People's Republic of China has adopted currency and capital transfer regulations. These regulations may require that we comply with complex regulations for the movement of capital. Although we believe that we are currently in compliance with these regulations, should these regulations or the interpretation of them by courts or regulatory agencies change we may not be able to remit all income earned and proceeds received in connection with our operations or from the sale of our operating subsidiary to the U.S. or to our stockholders.

### **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 June 30, 2007, the exchange rate between the RMB and the United States dollar was 7.60 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.

**RISKS RELATED TO CORPORATE AND STOCK MATTERS**

**The limited prior public market and trading market 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.

**Our stock is a penny 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.**

Our stock is a penny stock. The SEC has adopted Rule 15g-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 or our independent registered public accountants cannot attest our adequacy in the internal control measures over our financial reporting, as required by Section 404 of the U.S. Sarbanes-Oxley Act, for the fiscal year ending December 31, 2007, we may be adversely affected.

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-KSB, 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. Even if our management attests to our internal control measures to be effective, our independent registered public accountants may not be satisfied with our internal control structure and procedures. We cannot guarantee the outcome of the report and it could result in an adverse impact on us in the financial marketplace due to the loss of investor confidence in the reliability of our financial statements, which could negative influence to our stock market price.

**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 3. Controls and Procedures**

The Chief Executive Officer and Chief Financial Officer conducted an evaluation of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective as of the end of the period covered by this report. There were no significant changes in internal control over financial reporting (as defined in Rule 13a-15f under the Exchange Act) that occurred during the fourth quarter of 2004 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**Part II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

None

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

None

**Item 3. Defaults Upon Senior Securities**

None.

**Item 4. Submission of Matters to a Vote of Security Holders**

Not applicable

**Item 5. Other Information**

None

**Item 6. Exhibits**

(a) Exhibits

**Exhibit Number Description of Exhibit**

10.1	Form of Consulting Services Agreement;
10.2	Form of Operating Agreement;
10.3	Form of Equity Pledge Agreement;
10.4	Form of Option Agreement; and
10.5	Form of Proxy Agreement
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)

37



**SIGNATURES**

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

China Natural Gas, Inc.

August 20, 2007

By: /s/ Qinan Ji

---

Qinan Ji  
Chief Executive Officer (Principal  
Executive Officer)

August 20, 2007

By: /s/ Xiaogang Zhu

---

Xiaogang Zhu  
Chief Financial Officer  
(Principal Financial and Accounting  
Officer)