China Natural Gas, Inc.
Form 10-Q
August 14, 2013

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended **June 30, 2013** or

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 For the transition period from __________ to __________

Commission File Number: **00134373**

CHINA NATURAL GAS, INC.

(Exact name of registrant as specified in its charter)

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

19th Floor, Building B, Van Metropolis

35 Tang Yan Road, Hi-Tech Zone

Xi'an, 710065, Shaanxi Province, China

+86-29-8832-7391

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

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

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

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

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

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

The number of shares outstanding of the registrant's common stock as of August 10, 2013 was 21,458,654.

CHINA NATURAL GAS, INC.

AND SUBSIDIARIES

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CHINA NATURAL GAS, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

AS OF JUNE 30, 2013 AND DECEMBER 31, 2012
(Stated in US Dollars)

	Note	June 30, 2013	(Audited) December 31, 2012
ASSETS			
CURRENT ASSETS:			
Cash and cash equivalents	3(f)	$7,385,901	$10,857,456
Accounts receivable, net	3(g)	2,580,664	2,148,379
Other receivables, net		1,005,614	458,605
Employee advances	3(h)	353,408	399,031
Inventories	3(i)	2,916,691	2,473,933
Advances to suppliers		9,259,807	4,869,606
Prepaid expense and other current assets		3,009,853	3,541,431
Total current assets		26,511,938	24,748,441
Investment in unconsolidated joint ventures	3(j)	-	1,587,000
Property and equipment, net	3(k)	181,454,681	179,515,563
Construction in progress	3(l)	61,900,042	53,393,933
Goodwill	3(m), 4	857,269	839,806
Other intangible assets	4	21,233,562	21,400,924
Prepaid expenses and other assets	5	7,538,785	7,015,142
TOTAL ASSETS		$299,496,277	$288,500,809
LIABILITIES AND STOCKHOLDERS' EQUITY			
CURRENT LIABILITIES:			
Senior notes- current maturities	6	$39,149,998	$38,352,498
Current portion of bank loan payable	7	4,860,000	4,761,000
Redeemable liabilities - warrants		17,500,000	17,500,000
Accounts payable and accrued liabilities		6,554,897	6,756,278
Other payable - related party		840,041	1,616,429
Short-term borrowing - related party		2,679,945	2,679,945
Unearned revenue		3,283,380	3,663,570
Accrued interest		2,854,030	1,936,584
Taxes payable		1,507,698	2,232,546
Total current liabilities		79,229,989	79,498,850
LONG-TERM LIABILITIES:			
Bank loan payable, net of current portion	7	3,240,000	4,761,000
Total liabilities		$82,469,989	$84,259,850

STOCKHOLDERS' EQUITY:			
Preferred stock, par value $0.0001 per share, 5,000,000 authorized, none issued and outstanding		$-	$-
Common stock, par value $0.0001 per share, 45,000,000 authorized, 21,458,654 issued and outstanding at June 30, 2013 and December 31, 2012, respectively		2,145	2,145
Additional paid-in capital		83,649,675	83,501,637
Accumulated other comprehensive income		26,073,493	21,276,931
Statutory reserves	10	12,737,218	11,818,087
Retained earnings		94,272,625	87,410,615
Noncontrolling interests		291,132	231,544
Total stockholders' equity		217,026,288	204,240,959
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY		$299,496,277	$288,500,809

See Accompanying Notes to the Financial Statements

CHINA NATURAL GAS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME
FOR THE THREE AND SIX MONTHS PERIODS ENDED JUNE 30, 2013 AND 2012
(Stated in US Dollars)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Revenues				
Natural gas	$31,765,252	$34,927,804	$63,945,320	$64,327,491
Gasoline	503,680	701,168	978,679	1,527,063
Installation and others	1,979,026	2,272,723	4,823,289	4,324,459
	34,247,958	37,901,695	69,747,288	70,179,013
Cost of revenues				
Natural gas	21,696,966	22,462,516	42,650,396	41,737,375
Gasoline	453,364	655,614	874,025	1,443,758
Installation and others	849,457	955,283	2,046,105	1,807,528
	22,999,787	24,073,413	45,570,526	44,988,661
Gross profit	11,248,171	13,828,282	24,176,762	25,190,352
Operating expenses				
Selling	6,034,037	5,619,864	11,587,891	10,570,664
General and administrative	1,177,469	1,636,029	2,709,459	4,347,675
	7,211,506	7,255,893	14,297,350	14,918,339
Income from operations	4,036,665	6,572,389	9,879,412	10,272,013
Other income (expense):				
Interest income	10,973	9,853	20,696	20,599
Interest expense	(171,992)	(275,643)	(361,371)	(707,680)
Loss on disposal of fixed assets	(358)	-	(57,403)	-
Loss on sales of long term investment	(500)	-	(80,150)	-
Other income (expense), net	9,543	18,763	35,742	(14,330)
Change in fair value of warrants	-	(1,146)	-	(1,229)

Foreign currency exchange loss	(4,456)	1,494	(5,269)	(504,446)
	(156,790)	(246,679)	(447,755)	(1,207,086)
Income before income tax	3,879,875	6,325,710	9,431,657	9,064,927
Provision for income tax	705,467	1,251,128	1,590,928	2,042,599
Net income	3,174,408	5,074,582	7,840,729	7,022,328
Less: Income (loss) attributable to noncontrolling interests	32,735	28,876	59,588	(199,183)
Net income attributable to China Natural Gas, Inc.	3,141,673	5,045,706	7,781,141	7,221,511
Other comprehensive income				
Foreign currency translation gain	3,494,137	(17,584)	4,796,562	1,741,216
Comprehensive income	$6,635,810	$5,028,122	$12,577,703	$8,962,727
Weighted average shares outstanding				
Basic	21,458,654	21,458,654	21,458,654	21,458,654
Diluted	21,458,654	21,458,654	21,458,654	21,458,654
Earnings per share				
Basic	$0.15	$0.24	$0.36	$0.34
Diluted	$0.15	$0.24	$0.36	$0.34

See Accompanying Notes to the Financial Statements

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CHINA NATURAL GAS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
AS OF JUNE 30, 2013 AND DECEMBER 31, 2012
(Stated in US Dollars)

	Common Stock		Additional Paid-in	Accumulative Other Comprehensive	Non-controlling	Retained Earnings		Total Stockholders'
	Shares	Amount	Capital	Income	Interest	Statutory Reserve	Unrestricted	Equity
Balance at 1/1/2012	21,458,654	$2,145	$82,909,485	$19,817,493	$-	$10,124,710	$77,903,478	$190,757,311
Stock based compensation	-	-	592,152	-	-	-	-	592,152
Purchases of a Noncontrolling interest equity	-	-	-	-	394,789	-	-	394,789
Cumulative translation adjustment	-	-	-	1,459,438	-	-	-	1,459,438
Net income	-	-	-	-	(163,245)	-	11,200,514	11,037,269
Appropriation of retain earnings	-	-	-	-	-	1,693,377	(1,693,377)	-
Balance at 12/31/2012	21,458,654	$2,145	$83,501,637	$21,276,931	$231,544	$11,818,087	$87,410,615	$204,240,959
Balance at 1/1/2013	21,458,654	$2,145	$83,501,637	$21,276,931	$231,544	$11,818,087	$87,410,615	$204,240,959
Stock based compensation	-	-	148,038	-	-	-	-	148,038
Cumulative translation adjustment	-	-	-	4,796,562	-	-	-	4,796,562
Net income	-	-	-	-	59,588	-	7,781,141	7,840,729
Appropriation of retain earnings	-	-	-	-	-	919,131	(919,131)	-
Balance at 6/30/2013	21,458,654	$2,145	$83,649,675	$26,073,493	$291,132	$12,737,218	$94,272,625	$217,026,288

See Accompanying Notes to the Financial Statements

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CHINA NATURAL GAS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE SIX MONTHS ENDED JUNE 30, 2013 AND 2012
(Stated in US Dollars)

	2013	2012
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	7,840,729	7,022,328
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	6,938,760	6,945,862
Provision for (recovery of) doubtful accounts	110,063	202,100
Loss (Gain) on disposal of equipment	57,403	-
Loss (Gain) on sales of long term investment	80,150	-
Stock-based compensation	148,038	296,076
Change in fair value of warrants	-	1,229
Change in assets and liabilities:		
Accounts receivable	(493,607)	1,035,676
Other receivables	(963,970)	(146,652)
Employee advances	53,069	(137,270)
Inventories	(387,209)	(591,244)
Advances to suppliers	(4,243,935)	(336,767)
Prepaid expense and other current assets	655,917	3,527,412
Accounts payable and accrued liabilities	494,285	1,830,593
Unearned revenue	(451,580)	(311,342)
Accrued interest	917,446	(25,477)
Taxes payable	(763,178)	(462,934)
Net cash provided by operating activities	9,992,381	18,849,590
CASH FLOWS FROM INVESTING ACTIVITIES:		
Payment for acquisition of property and equipment	(1,411,550)	(3,592,657)
Proceeds from sales of property and equipment	7,178	-
Proceeds from sales of long term investment	721,350	-
Additions to construction in progress	(10,367,064)	(10,459,937)
Prepayment on long-term assets	(170,460)	52,892
Payment for acquisition of business	-	(657,007)
Payment for intangible assets	-	(1,511,611)
Net cash used in investing activities	(11,220,546)	(16,168,320)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Repayment of short-term borrowing and other payable, related parties	(801,500)	-
Repayment of long-term debt	(1,603,000)	(793,500)
Repayment of senior notes	-	(3,333,334)
Increase in restricted cash	-	(1,890,641)
Net cash (used in) provided by financing activities	(2,404,500)	(6,017,475)
Effect of exchange rate changes on cash and cash equivalents	161,110	17,388

NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(3,471,555)	(3,318,817)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	10,857,456	9,622,883
CASH AND CASH EQUIVALENTS, END OF PERIOD	$7,385,901	$6,304,066
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Interest paid, net of capitalized interest	$284,978	$481,583
Income taxes paid	$2,001,258	$1,967,965
Non-cash transactions for investing and financing activities:		
Construction materials transferred to Construction in progress	$-	$67,142
Construction in progress transferred to property and equipment	$3,143,182	$18,507,550
Capitalized interest - amortization of discount of notes payable and issuance cost	$-	$2,040,389
Other assets transferred to construction in progress	$94,345	$2,395,267

See Accompanying Notes to the Financial Statements

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CHINA NATURAL GAS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

AS OF JUNE 30, 2013 AND DECEMBER 31, 2012

(Stated in US Dollars)

Note 1 - Organization

Organization and Line of Business

China Natural Gas, Inc. (the “Company,” “our,” “us” or “we”) was incorporated in the State of Delaware on March 31, 1999. The Company through its wholly owned subsidiaries and variable interest entity (“VIE”), Xi’an Xilan Natural Gas Co., Ltd. (“XXNGC”) and subsidiaries of its VIE, which are located in Hong Kong, Shaanxi Province, Henan Province and Hubei Province in the People’s Republic of China (“PRC”), engages in sales and distribution of natural gas and gasoline to commercial, industrial and residential customers through fueling stations and pipelines, construction of pipeline networks, installation of natural gas fittings and parts for end-users, and conversions of gasoline-fueled vehicles to hybrid (natural gas/gasoline) powered vehicles at automobile conversion sites. The consolidated balance sheets as of June 30, 2013 and December 31, 2012 and the consolidated statements of income and comprehensive income for the three and six months ended June 30, 2013 and 2012, and cash flows for the six months ended June 30, 2013 and 2012 include the accounts of China Natural Gas, Inc. and subsidiaries and VIE. Our subsidiaries are: Xilan Energy Co. Ltd. (“XEC”), Shaanxi Xilan Natural Gas Equipment Co. Ltd (“SXNGE”), Hubei Xian Natural Gas Co., Ltd (“HBXNG”), Lingbao Yuxi Natural Gas Co. Ltd. (“LYNG”), Shaanxi Jingbian Liquefied Natural Gas Co. Ltd (“JBLNG”), Henan Xilan Natural Gas Co. Ltd (“HXNGC”), Xi’an Xilan Auto Body Shop Co, Ltd. (“XXABC”) , Hanchuan Makou Yuntong Compressed Natural Gas Co., Ltd (“Makou”) and Xiantao City Jinhua Gas And Oil Co., Ltd. (“XTJH”).

Note 2 – Going Concern Uncertainties

These financial statements have been prepared assuming that Company will continue as a going concern, which contemplates the realization of assets and the discharge of liabilities in the normal course of business for the foreseeable future.

As of June 30, 2013, the Company had working capital deficit of current liabilities exceeding current assets by $52,718,051 due to the default of its senior notes payable. Management has taken certain action and continues to implement changes designed to improve the Company's financial results and operating cash flows. The actions involve certain cost-saving initiatives and growing strategies, including (a) reductions in headcount and corporate overhead expenses; and (b) obtainment of new short-term bank loans to finance our working capital, and long-term loans to fund our capital expenditure projects. Management believes that these actions will enable the Company to improve future profitability and cash flow in its continuing operations through December 31, 2013. As a result, the financial statements do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts and classification of liabilities that may result from the outcome of the Company's ability to continue as a going concern.

Note 3 – Summary of Significant Accounting Policies

(a.) *Basis of Presentation*

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

The consolidated financial statements include all adjustments necessary to present fairly the consolidated financial position, results of operations and cash flows of the Company for the periods presented.

(b.) *Use of Estimates*

The preparation of the consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Significant accounting estimates reflected in the Company's consolidated financial statements include revenue recognition, allowance for doubtful accounts, inventory obsolescence, construction in progress, warrants liability and useful lives of property and equipment. Actual results could differ from those estimates.

(c.) *Principles of Consolidation*

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

(d.) *Consolidation of Variable Interest Entity*

VIEs are entities that lack sufficient equity to finance their activities without additional financial support from other parties or whose equity holders lack adequate decision-making ability. Any VIE with which the Company is involved must be evaluated to determine the primary beneficiary of the risks and rewards of the VIE. Management makes ongoing reassessments of whether the Company is the primary beneficiary of XXNGC.

On February 21, 2006, the Company formed SXNGE as a wholly foreign owned enterprise ("WFOE") under the laws of the PRC. Through SXNGE, the Company entered into exclusive arrangements with XXNGC and its shareholders that give the Company the ability to substantially influence XXNGC's daily operations and financial affairs and appoint its senior executives. The Company is considered the primary beneficiary of XXNGC and it consolidates its accounts as a VIE. The Company's arrangements with XXNGC consist of the following agreements:

· *Consulting Service Agreement, dated August 17, 2007*. Under this agreement entered into between SXNGE and XXNGC, SXNGE provides XXNGC exclusive consulting services with respect to XXNGC's general business operations, human resources and research and development. In return, XXNGC pays a quarterly service fee to SXNGE, which is equal to XXNGC's revenue for such quarter. The term of this agreement is indefinite unless SXNGE notifies XXNGC of its intention to terminate this agreement. XXNGC may not terminate this agreement during its term. This agreement is retroactive to March 8, 2006.

· *Operating Agreement, dated August 17, 2007*. Under this agreement entered into between SXNGE, on the one hand, and XXNGC and certain shareholders of XXNGC, on the other hand, SXNGE agrees to fully guarantee XXNGC's performance of all operations-related contracts, agreements or transactions with third parties and, in return, XXNGC agrees to pledge all of its assets, including accounts receivable, to SXNGE. The XXNGC shareholders party to this operating agreement agree to, among other things, appoint as XXNGC's directors, individuals recommended by XXNGC, and appoint SXNGE's senior officers as XXNGC's general manager, chief financial officer and other senior officers. The term of this agreement is indefinite unless SXNGE notifies XXNGC of its intention to terminate this agreement with 30 days prior notice. XXNGC may not terminate this agreement during its term. This agreement is retroactive to March 8, 2006.

· *Equity Pledge Agreement, dated August 17, 2007*. Under this agreement entered into between SXNGE, on the one hand, and XXNGC and certain shareholders of XXNGC, on the other hand, to secure the payment obligations of XXNGC under the consulting service agreement described above, the XXNGC shareholders party to this equity pledge agreement have pledged to SXNGE all of their equity ownership interests in XXNGC. Upon the occurrence of certain events of default specified in this agreement, SXNGE may exercise its rights and foreclose on the pledged equity interest. Under this agreement, the pledgors may not transfer the pledged equity interest without SXNGE's prior written consent. This agreement will also be binding upon successors of the pledgor and transferees of the pledged equity interest. The term of the pledge is two years after the obligations under the Consulting Service Agreement have been fulfilled. This agreement is retroactive to March 8, 2006.

· *Option Agreement, dated August 17, 2007*. Under this agreement entered into between SXNGE, on the one hand, and XXNGC and certain shareholders of XXNGC, on the other hand, the XXNGC shareholders party to this option agreement irrevocably granted to SXNGE, or any third party designated by SXNGE, the right to acquire, in whole or in part, the respective equity interests in XXNGC of these XXNGC shareholders. The option agreement can be terminated by SXNGE by notifying XXNGC of its intention to terminate this agreement with 30 days prior notice. The option agreement is retroactive to March 8, 2006.

· *Addendum to the Option Agreement, dated August 8, 2008*. Under this addendum to the option agreement entered into between SXNGE, on the one hand, and XXNGC and certain shareholders of XXNGC, on the other hand, the XXNGC shareholders irrevocably granted to SXNGE an option to purchase the XXNGC shareholders' additional equity interests in XXNGC (the "Additional Equity Interest") in connection with any increase in XXNGC's registered capital subsequent to the execution of the option agreement described above, at $1.00 or the lowest price permissible under applicable law at the time that SXNGE exercises the option to purchase the Additional Equity Interest. The option agreement can be terminated by SXNGE by notifying XXNGC of its intention to terminate this agreement with 30 days prior notice. This addendum is retroactive to June 30, 2008.

· *Proxy Agreement, dated August 17, 2007*. Under this agreement entered into between SXNGE, on the one hand, and XXNGC and certain shareholders of XXNGC, on the other hand, the XXNGC shareholders irrevocably granted to SXNGE the right to exercise their shareholder voting rights, including attendance at and voting of their shares at shareholders meetings in accordance with the applicable laws and XXNGC's articles of association. This agreement is retroactive to March 8, 2006.

(e.) *Foreign Currency Translation*

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

The balance sheet amounts, with the exception of equity, were translated at the June 30, 2013 exchange rate of RMB 6.17 to $1.00 as compared to RMB 6.30 to $1.00 at December 31, 2012. The equity accounts were stated at their historical rate. The average translation rates applied to income and cash flow statement amounts for the six months ended June 30, 2013 and 2012 were RMB 6.24 and RMB 6.30 to $1.00, respectively.

(f.) *Cash and Cash Equivalents*

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

The Company maintains balances at financial institutions which, from time to time, may exceed Hong Kong Deposit Protection Board ("HKDPB") insured limits for the banks located in Hong Kong or may exceed Federal Deposit Insurance Corporation ("FDIC") insured limits for the banks located in the United States. Balances at financial institutions or state-owned banks within the PRC are not covered by insurance. As of June 30, 2013 and December 31, 2012, the Company had total deposits of $6,979,267 and $10,481,343, respectively, without insurance coverage or in excess of HKDPB or FDIC insured limits. The Company has not experienced any losses to date as a result of this policy.

(g.) *Accounts Receivable*

Accounts receivable are presented net of an allowance for doubtful accounts. Management periodically reviews the composition of accounts receivable and analyzes historical bad debts, customer concentrations, customer credit-worthiness, current economic trends and changes in customer payment patterns to evaluate the adequacy of the allowance.

Management considers accounts past due after three months. Delinquent account balances are allowed for when management has determined that the likelihood of collection is not probable. Uncollectible receivables are written off against the allowance for doubtful accounts when identified. The Company recorded allowances for doubtful accounts in the amount of $120,764 and $9,340 as of June 30, 2013 and December 31, 2012, respectively.

(h.) *Employee Advances*

From time to time, the Company advances predetermined amounts based upon internal Company policy to certain employees and internal units. As of June 30, 2013 and December 31, 2012, the Company had employee advances in the amount of $353,408 and $399,031, respectively.

(i.) *Inventories*

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

The following are the details of the inventories:

	June 30, 2013	December 31, 2012
Materials and supplies	$2,383,310	$2,108,837
Liquefied natural gas	346,803	113,203
Gasoline	186,578	251,893
	$2,916,691	$2,473,933

(j.) *Investments in Unconsolidated Joint Ventures*

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

The Company's investment in unconsolidated joint ventures that are accounted for on the equity method of accounting represents the Company's 49% interest in the JV. The investment in the JV amounted to $1,587,000 at December 31, 2012. On February 19, 2013, the JV held a shareholder meeting, decided that we transferred our investment in JV to Shaanxi Jinyuan Investment Co., Ltd for a sale price of $1,522,850 (RMB 9.5 million). The transfer was completed on February 27, 2013, which incurred a loss of $80,150 (RMB 0.5 million).

The financial position of the JV is summarized below:

	December 31, 2012
Current assets	$ 3,238,776
Noncurrent assets	-
Total assets	3,238,776
Current liabilities	-
Noncurrent liabilities	-
Equity	3,238,776
Total liabilities and equity	$ 3,238,776

(k.) *Property and Equipment*

Property and equipment are stated at cost. Expenditures for maintenance and repairs are charged to earnings as incurred while additions, renewals and betterments are capitalized. Depreciation of property and equipment is provided using the straight-line method for all assets with estimated lives as follows:

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

The following are the details of the property and equipment:

	June 30, 2013	December 31, 2012
Office equipment	$973,542	$ 936,749
Operating equipment	184,589,856	176,463,908
Vehicles	4,316,177	4,228,255
Buildings and improvements	39,460,121	38,557,910
Total property and equipment	229,339,696	220,186,822

Less accumulated depreciation	(47,885,015)	(40,671,259)
Property and equipment, net	$181,454,681	$ 179,515,563

Depreciation expense for the three months ended June 30, 2013 and 2012 was $3,355,334 and $3,349,778, respectively. Depreciation expense for the six months ended June 30, 2013 and 2012 was $6,610,108 and $ 6,539,477, respectively.

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(l.) *Construction in Progress*

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

As of June 30, 2013 and December 31, 2012, the Company had construction in progress in the amount of $61,900,042 and $53,393,933, respectively. Interest cost capitalized into construction in progress for the three months ended June 30, 2013 and 2012 amounted to $421,296 and $1,445,013, respectively. Interest cost capitalized into construction in progress for the six months ended June 30, 2013 and 2012 amounted to $837,963, and $2,896,407, respectively.

Construction in progress at June 30, 2013 and December 31, 2012 is set forth in the table below. The column of "estimated additional cost to complete" reflects the amounts currently estimated by management to be necessary to complete the relevant project. As of June 30, 2013, the Company was not contractually or legally obligated to expend the estimated additional cost to complete these projects, except to the extent reflected in Note 14 – Commitments and Contingencies to the consolidated financial statements.

Project Description	Location	June 30, 2013		Commencement date	Expected completion date		Estimated additional cost to complete	
Phase I of LNG Project	Jingbian County, Shaanxi Province, PRC	$8,897,064	(1)	December 2006	Uncertain	(2)	$50,000	(3)
Phases II and III of LNG Project	Jingbian County, Shaanxi Province, PRC	16,583,983	(4)	December 2006	Uncertain		190,900,000	(5)
Fangzhi District	Fangzhi District, Xi'an, PRC	12,822,884		October 2010	Uncertain		1,000,000	
Sa Pu Mother Station	Henan Province, PRC	1,463,086		July 2008	Uncertain		6,000,000	
International Port(6)	International Port District, Xi'an, PRC	10,119,654		May 2009	Uncertain		297,000,000	
LNG fueling stations	Shaanxi & Henan Province, PRC	1,918,321		Various	Various		11,050,000	
	PRC	10,095,050		Various	Various		800,000	

Other Construction in Progress Costs	$61,900,042	$506,800,000

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Project Description	Location	December 31, 2012	Commencement date	Expected completion date	Estimated additional cost to complete
Phase I of LNG Project	Jingbian County, Shaanxi Province, PRC	$ 8,424,350	December 2006	March 2014	$ 94,000
Phases II and III of LNG Project	Jingbian County, Shaanxi Province, PRC	14,660,048	December 2006	December 2015	192,800,000
Fangzhi District	Fangzhi District, Xi'an, PRC	8,904,054	October 2010	December 2013	4,120,000
Sa Pu Mother Station	Henan Province, PRC	1,376,421	July 2008	June 2013	6,100,000
International Port(6)	International Port District, Xi'an, PRC	9,835,400	May 2009	December 2020	295,300,000
LNG fueling stations	Shaanxi & Henan Province, PRC	1,646,358	Various	Various	11,050,000
Other Construction in Progress Costs	PRC	8,547,302	Various	Various	1,200,000
		$ 53,393,933			$ 510,664,000

(1) Includes $5,816,249 of construction cost and $3,080,815 of capitalized interest for Phase I of the LNG Project.

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

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

(4) Includes $10,043,798 of construction cost and $6,540,185 of capitalized interest for Phases II and III of the LNG project.

(5) This amount reflects the estimated costs of Phases II and III of the LNG project, including an estimated $177 million of construction costs and $14 million of capitalized interest. Such costs should be able to finance the construction of a facility capable of processing 3 million cubic meters of LNG per day, or

approximately 900 million cubic meters of LNG per year.

(6) Xi'an International Port District Committee, a local government agency in the PRC, pursuant to a conditional non-binding agreement, has appointed XXNGC to be the developer of natural gas infrastructure for Xi'an International Port District, a former agricultural area that has been zoned for urbanization. If XXNGC chooses to proceed with the project, it will be responsible for the construction and all costs related thereof a natural gas pipeline network that will service residential, commercial and industrial buildings and users, as well as fueling stations and related infrastructure. The estimated cost of $297,000,000 was based on a third-party feasibility study and management's estimate. The Company is the only natural gas provider in the surrounding area and expects that it would supply natural gas to the International Port District once construction is completed. If the Company decides not to proceed with this project, it expects to be able to obtain a refund from subcontractors of the $10,119,654 invested as of June 30, 2013 or sell the construction-in-progress assets to third parties.

(m.) *Goodwill*

The excess of the cost of an acquired entity over the net of the amounts assigned to assets acquired and liabilities assumed is recognized as goodwill. Goodwill is tested for impairment at the reporting unit level (operating segment or one level below an operating segment) on an annual basis in the fourth quarter or more frequently if indicators of impairment exist. The Company uses a two-step goodwill impairment test to identify the potential impairment and to measure the amount of goodwill impairment, if any. The first step is to compare the fair value of the reporting unit with its carrying amount, including goodwill. If the fair value of the reporting unit exceeds its carrying amount, goodwill is considered not impaired. If the carrying amount of a reporting unit exceeds its fair value, the second step of the goodwill impairment test is performed to measure the amount of impairment loss, if any. Under step two, the impairment loss is measured by comparing the implied fair value of the reporting unit goodwill with the carrying amount of that goodwill. If the carrying amount of the reporting unit goodwill exceeds the implied fair value of that goodwill, an impairment loss is recognized in an amount equal to that excess.

(n.) *Long-Lived Assets*

We evaluate the carrying value of long-lived assets to be held and used whenever events or changes in circumstances indicate that the assets might be impaired. Impairment losses are recorded on long-lived assets used in operations when indicators of impairment are present and the undiscounted cash flows estimated to be generated by those assets are less than the assets' carrying amounts. In that event, a loss is recognized based on the amount by which the carrying amount exceeds the fair market value of the long-lived assets. Loss on long-lived assets to be disposed of is determined in a similar manner, except that fair market values are reduced for the cost of disposal. Based on our review, no impairment indicators were noted at June 30, 2013.

(o.) *Fair Value of Financial Instruments*

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

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

The accounting standard regarding derivatives and hedging specifies that a contract that would otherwise meet the definition of a derivative but is both (a) indexed to the Company's own stock and (b) classified to stockholders' equity in the statement of financial position would not be considered a derivative financial instrument. This Financial Accounting Standards Board's ("FASB") accounting standard also provides a new two-step model to be applied in determining whether a financial instrument or an embedded feature is indexed to an issuer's own stock and thus able to qualify for the exception.

The following tables set forth by level within the fair value hierarchy the Company's financial assets and liabilities that were accounted for at fair value on a recurring basis as of June 30, 2013 and December 31, 2012.

	Carrying Value at June 30, 2013	Fair Value Measurement at June 30, 2013		
		Level 1	Level 2	Level 3
Redeemable liability – warrants	$ 17,500,000	$ -	$ 17,500,000	$ -
Total liability measured at fair value	$ 17,500,000	$ -	$ 17,500,000	$ -

	Carrying Value at December 31, 2012	Fair Value Measurement at December 31, 2012		
		Level 1	Level 2	Level 3
Redeemable liability – warrants	$ 17,500,000	$ -	$ 17,500,000	$ -
Total liability measured at fair value	$ 17,500,000	$ -	$ 17,500,000	$ -

Other than the assets and liabilities set forth in the table above, the Company did not identify any other assets or liabilities that are required to be accounted for at fair value on the balance sheet. The carrying value of long-term debt with variable interest rate approximates its fair value based on market rates available to the Company with similar terms (See Notes 6 and 7).

The following is a reconciliation of the beginning and ending balance of warrants liability measured at fair value on a recurring basis as of December 31, 2012:

	Fair Value Measurement at December 31, 2012
Beginning balance	$ 4
Change in fair value	(4)
Ending balance	$ -

The warrants expired at October 26, 2012. The Company recognized a loss of $1,146 and $1,229 for the three and six months ended June 30, 2012, to reflect the change in fair value of the warrants.

(p.) *Revenue Recognition*

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

(q.) *Stock-Based Compensations*

The Company records and reports stock-based compensation based on a fair-value-based method of accounting for stock-based employee compensation and transactions in which an entity issues its equity instruments to acquire goods and services from non-employees. Compensation for stock granted to non-employees is determined as the fair value of the consideration received or the fair value of equity instruments issued, whichever is more reliably measured.

(r.) *Income Taxes*

FASB's accounting standard regarding income taxes requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements or tax returns. Under this method, deferred income taxes are recognized for the tax consequences in future years of temporary differences between the tax bases of assets and liabilities and their financial reporting amounts at each period end based on enacted tax laws and statutory tax rates applicable to the periods in which the differences are expected to affect taxable income. Valuation allowances are established, when necessary, to reduce deferred tax assets to the amount expected to be realized. As at June 30, 2013 and December 31, 2012, there were no significant book to tax differences except for warrants liability and stock based compensation. An uncertain tax position is recognized as a benefit only if it is "more likely than not" that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. Penalties and interest incurred related to underpayment of income tax are classified as income tax expense in the year incurred. No significant penalties or interest relating to income taxes have been incurred during the three and six months ended June 30, 2013 and 2012.

XXNGC, the Company's PRC VIE, and XXNGC's subsidiaries operate in the PRC. Pursuant to the tax laws of PRC, general enterprises are subject to income tax at an effective rate of 25%. However, under PRC income tax regulation, any company deemed to be engaged in the natural gas industry in the West Regions of the PRC under such regulation enjoys a favorable income tax rate. Thus, XXNGC's income is subject to a reduced tax rate of 15%. And one of XXNGC's subsidiaries, JBLNG is subject to a reduced income tax rate of 15% beginning on January 1, 2013. Other XXNGC's subsidiaries are not deemed to be engaged in the natural gas industry in the West Regions under PRC income tax regulation and, accordingly, are subject to a 25% income tax rate.

The estimated tax savings as a result of the reduced tax rate enjoyed by XXNGC and JBLNG for the three months ended June 30, 2013 and 2012 amounted to approximately $425,336 and $455,318, respectively. The net effect on earnings per share, had the income tax been applied, would decrease basic and diluted earnings per share for the three months ended June 30, 2013 and 2012, from $0.15 to $0.13 and $0.24 to $0.21, respectively.

The estimated tax savings as a result of the reduced tax rate enjoyed by XXNGC and JBLNG for the six months ended June 30, 2013 and 2012 amounted to approximately $988,542 and $877,653 respectively. The net effect on earnings per share, had the income tax been applied, would decrease basic and diluted earnings per share for the six months ended June 30, 2013 and 2012, from $0.36 to $0.32 and $0.34 to $0.30, respectively.

China Natural Gas, Inc. was incorporated in the United States and has incurred net operating loss for income tax purpose for the period ended June 30, 2013. The estimated net operating loss carry-forwards for United States income tax purposes amounted to $13,435,918 as of June 30, 2013, which may be available to reduce future years' taxable income. These carry-forwards will expire, if not utilized through 2033. Management believes that the realization of the benefits arising from this loss appear to be uncertain due to Company's limited operating history and continuing losses for U.S. income tax purposes. Accordingly, the Company has provided a 100% valuation allowance at June 30, 2013 and December 31, 2012 for net deferred tax assets resulting from net operating loss carry forwards, stock based compensation and warrants liability. Management reviews this valuation allowance periodically and makes adjustments as warranted. The valuation allowances were as follows:

Valuation allowance	For the six months ended June 30, 2013	For the years ended December 31, 2012
Balance, beginning of period	$ 5,286,456	$ 4,222,489
Increase	306,687	1,063,967
Balance, end of period	$ 5,593,143	$ 5,286,456

Provision for income tax is as follow:

	For the three months ended June 30, 2013	2012	For the six months ended June 30, 2013	2012
Current	$705,467	$1,251,128	$1,590,928	$2,042,599
Deferred	-	-	-	-
	$705,467	$1,251,128	$1,590,928	$2,042,599

The following is a reconciliation of the provision for income tax at the PRC tax rate, to the income tax reflected in the Consolidated Statement of Income and Comprehensive Income:

	For the three months ended June 30, 2013		2012		For the six months ended June 30, 2013		2012	
Tax expense at statutory rate-US	35.0	%	35.0	%	35.0	%	35.0	%
Changes in valuation allowance-US	(35.0	)%	(35.0	)%	(35.0	)%	(35.0	)%
Foreign income tax rate-PRC	25.0	%	25.0	%	25.0	%	25.0	%
Effect of favorable tax rate	(9.7	)%	(6.3	)%	(9.4	)%	(7.2	)%
Other item (1)	2.9	%	1.1	%	1.3	%	4.7	%
Total provision for income taxes	18.2	%	19.8	%	16.9	%	22.5	%

(1) The 2.9% represents $289,274 in expenses incurred by the Company that are not deductible in the PRC for the three months ended June 30, 2013. The 1.1% represents $701,582 in expenses incurred by the Company that are not deductible in the PRC for the three months ended June 30, 2012. The 1.3% represents $876,248 in expenses incurred by the Company that are not deductible in the PRC for the six months ended June 30, 2013. The 4.7% represents $2,067,034 in expenses incurred by the Company that are not deductible in the PRC for the six months ended June 30, 2012.

The Company has cumulative undistributed earnings of foreign subsidiaries of approximately $80,804,331 as of June 30, 2013, which is included in consolidated retained earnings and will continue to be indefinitely reinvested in international operations. Accordingly, no provision has been made for U.S. deferred taxes related to future repatriation of these earnings, nor is it practicable to estimate the amount of income taxes that would have to be provided if the Company concluded that such earnings will be remitted in the future.

(s.) *Franchise Tax*

According to the laws of the State of Delaware, we are required to pay annual franchise tax to the state government based on the number of the authorized shares.

(t.) *Basic and Diluted Earnings Per Share*

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

(u.) *Reclassification*

Certain reclassifications have been made to the prior year financial statements to confirm with the current year presentation.

(v.) *Recent Accounting Pronouncements*

In January 2013, the FASB issued ASU No. 2013-01, “Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities” (“ASU 2013-01”). The Update clarifies that ordinary trade receivables and receivables are not in the scope of Accounting Standards Update No. 2011-11, Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities. Specifically, Update 2011-11 applies only to derivatives, repurchase agreements and reverse purchase agreements, and securities borrowing and securities lending transactions that are either offset in accordance with specific criteria contained in FASB Accounting Standards Codification® or subject to a master netting arrangement or similar agreement. The amendments in this Update are effective for fiscal years, and interim periods within those years, beginning on or after January 1, 2013. Management does not expect the adoption of this standard has a significant effect on the Company’s consolidated financial position or results of operations.

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In February 2013, the FASB issued ASU No. 2013-02, "Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income" ("ASU 2013-02"). The amendments require an organization to:

a. Present (either on the face of the statement where net income is presented or in the notes) the effects on the line items of net income of significant amounts reclassified out of accumulated other comprehensive income–but only if the item reclassified is required under U.S. GAAP to be reclassified to net income in its entirety in the same reporting period.

b. Cross-reference to other disclosures currently required under U.S. GAAP for other reclassification items (that are not required under U.S. GAAP) to be reclassified directly to net income in their entirety in the same reporting period. This would be the case when a portion of the amount reclassified out of accumulated other comprehensive income is initially transferred to a balance sheet account (e.g., inventory for pension-related amounts) instead of directly to income or expense.

The amendments are effective for reporting periods beginning after December 15, 2012, for public companies. Management does not expect the adoption of this standard has a significant effect on the Company's consolidated financial position or results of operations.

In February 2013, the FASB issued ASU No. 2013-03, "Clarifying the Scope and Applicability of a Particular Disclosure to Nonpublic Entities" ("ASU 2013-03"). The amendment clarifies that the requirement to disclose the level of the fair value hierarchy within which the fair value measurements are categorized in their entirety (as Level 1, Level 2, or Level 3) does not apply to private companies and nonpublic not-for-profits for items that are not measured at fair value in the statement of financial position, but for which fair value is disclosed. The amendments are effective upon issuance. Management does not expect the adoption of this standard has a significant effect on the Company's consolidated financial position or results of operations.

In March 2013, the FASB issued ASU No. 2013-04, "Obligations Resulting from Joint and Several Liability Arrangements for Which the Total Amount of the Obligation Is Fixed at the Reporting Date" ("ASU 2013-04"). The update provides guidance for the recognition, measurement, and disclosure of obligations resulting from joint and several liability arrangements for which the total amount of the obligation within the scope of this ASU is fixed at the reporting date, except for obligations addressed within existing guidance in US GAAP. The guidance requires an entity to measure those obligations as the sum of the amount the reporting entity agreed to pay on the basis of its arrangement among its co-obligors and any additional amount the reporting entity expects to pay on behalf of its co-obligors. The guidance in this ASU also requires an entity to disclose the nature and amount of the obligation as well as other information about those obligations. The amendments in this ASU are effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. Management does not expect the adoption of this standard will have a significant effect on the Company's consolidated financial position or results of operations.

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In March 2013, the FASB issued ASU No. 2013-05, “Parent’s Accounting for the Cumulative Translation Adjustment upon Derecognition of Certain Subsidiaries or Groups of Assets within a Foreign Entity or of an Investment in a Foreign Entity” (“ASU 2013-05”). The ASU clarifies that when a parent entity ceases to have a controlling financial interest in a subsidiary or group of assets that is a nonprofit activity or a business (other than a sale of in substance real estate or conveyance of oil and gas mineral rights) within a foreign entity, the parent is required to apply the guidance in Accounting Standards Codification 830-30 to release any related cumulative translation adjustment into net income. The ASU provides that the cumulative translation adjustment should be released into net income only if the sale or transfer results in the complete or substantially complete liquidation of the foreign entity in which the subsidiary or group of assets had resided. The amendments take effect prospectively for public companies for fiscal years beginning after December 15, 2013, and interim reporting periods within those years. Management does not expect the adoption of this standard will have a significant effect on the Company’s consolidated financial position or results of operations.

In March 2013, the FASB issued ASU No. 2013-07, “Liquidation Basis of Accounting” (“ASU 2013-07”). The ASU requires an entity to prepare its financial statements using the liquidation basis of accounting when liquidation is imminent. Liquidation would be considered imminent when the likelihood is remote that the reporting entity would return from liquidation and either: (a) a plan for liquidation has been approved by the person or persons with the authority to make such a plan effective and the likelihood is remote that the execution of the plan will be blocked by other parties or the entity will return from liquidation, or (b) a plan for liquidation is imposed by other forces, and the likelihood is remote that the entity will return from liquidation. If a plan for liquidation was specified in an entity's governing documents at its inception (for example, limited-life entities), then liquidation would be imminent only if the approved plan for liquidation differs from the plan specified at the entity’s inception. The amendments take effect for all entities reporting under U.S. GAAP, except investment companies that are regulated under the Investment Company Act of 1940. The standard is effective for annual reporting periods beginning after December 31, 2013, and interim reporting periods therein. Early adoption is permitted. Management does not expect the adoption of this standard will have a significant effect on the Company’s consolidated financial position or results of operations.

On July 18, the FASB issued ASU No. 2013-11, "Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists (a consensus of the FASB Emerging Issues Task Force)" ("ASU 2013-11"). The ASU presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists (a consensus of the FASB Emerging Issues Task Force), which requires an entity to present an unrecognized tax benefit as a reduction of a deferred tax asset for an net operating loss (NOL) carryforward, or similar tax loss or tax credit carryforward, rather than as a liability when (1) the uncertain tax position would reduce the NOL or other carryforward under the tax law of the applicable jurisdiction and (2) the entity intends to use the deferred tax asset for that purpose. The ASU does not require new recurring disclosures. It is effective prospectively for fiscal years, and interim periods within those years, beginning after December 15, 2013 and December 15, 2014, for public and nonpublic entities, respectively. Early adoption and retrospective application are permitted. Management does not expect the adoption of this standard will have a significant effect on the Company's consolidated financial position or results of operations.

Note 4 –Goodwill and Other Intangible Assets

Goodwill is the amount the Company paid to acquire 100% of the equity interests of Makou and 58.5284% of the equity interests of XTJH in excess of the fair value of Makou and XTJH's identifiable assets and liabilities, respectively. Annual impairment testing is performed during the fourth quarter of each year unless events or circumstances indicate earlier impairment testing is required. No impairment loss was recognized during the period ended June 30, 2013 and 2012.

Other intangible assets include primarily the technical license related to liquefied natural gas business, which consisted of the following:

	June 30, 2013	December 31, 2012
Operating rights	$5,445,305	$5,339,474
Technical license (LNG)	10,004,975	10,072,170
Land use rights	5,769,220	5,971,006
Other	14,062	18,274
Total	$21,233,562	$21,400,924

The operating rights are deemed to have an indefinite useful life as cash flows are expected to continue indefinitely. The operating rights will not be amortized until their useful life is deemed to be no longer indefinite.

The technical license (LNG) is being amortized over its estimated useful life of 20 years. Amortization expense for the three months ended June 30, 2013 and 2012 was $137,720 and $135,415, respectively. Amortization expense for the six months ended June 30, 2013 and 2012 was $273,732 and $271,000, respectively. Accumulated amortization at June 30, 2013 was $1,060,435.

The land use rights are being amortized over their estimated useful life of 30 years. For the three months ended June 30, 2013 and 2012, amortization expense amounted to $41,284 and $40,593, respectively. For the six months ended June 30, 2013 and 2012, amortization expense amounted to $82,055 and $81,236, respectively. As of June 30, 2013, accumulated amortization was approximately $425,677.

Estimated amortization for the next five years and thereafter is as follows:

2013	$355,787
2014	711,574
2015	711,574
2016	700,740
2017	700,740
thereafter	9,667,664
	$12,848,079

Note 5 – Prepaid Expenses and Other Assets

Prepaid expenses and other assets consisted of the following:

	June 30, 2013	December 31, 2012
Prepaid rent – natural gas stations	$454,375	$ 501,599
Prepayment for acquiring land use right	1,296,000	1,269,600
Advances on purchasing equipment and construction in progress	4,384,477	4,286,898
Refundable security deposits	1,403,933	957,045
Total	$7,538,785	$ 7,015,142

Prepaid rent represents prepayments for leasing the land of our fueling stations. In China, land rental usually requires an advancement and then amortized into expense on a straight-line basis over the term of the land lease.

All land in the PRC is government owned. However, the government grants users land use rights. The Company is in the process of negotiating the final purchase price with relevant local government and the land use rights have not yet been granted to the Company. Therefore, the Company did not amortize these amounts for land use rights.

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

Refundable security deposits are monies deposited with one of the Company's major vendors and a gas station landlord. These amounts will be returned to the Company if the other party terminates the business relationship or upon the expiration of the lease.

Note 6 –Senior Notes

The Company's securities purchase agreement with Abax Lotus Ltd. ("Abax") was amended on January 29, 2008 (as amended, the "Purchase Agreement"). On January 29, 2008, under the Purchase Agreement, the Company sold to Abax $20,000,000 in principal amount of its 5.0% Guaranteed Senior Notes due January 30, 2014 (the "Senior Notes") and warrants to purchase 1,450,000 shares of its common stock (the "Abax Warrants") and, on March 3, 2008, the Company issued to Abax an additional $20,000,000 in principal amount of Senior Notes.

On the dates set forth in the table below, the Company will be required to make repayments of the corresponding percentage of the principal amount (or such lesser principal amount as shall be outstanding then) in respect of the aggregate outstanding principal amount of the Senior Notes:

Date	Repayment Percentage	
July 30, 2011 (paid on August 5, 2011)	8.3333	%
January 30, 2012 (paid on March 7, 2012)	8.3333	%
July 30, 2012	16.6667	%
January 30, 2013	16.6667	%
July 30, 2013	25.0000	%
January 30, 2014	25.0000	%

The second repayment for 8.3333% of the principal of the Senior Notes was due on January 30, 2012. After negotiation with Abax, the note-holders agreed that the Company could make the payment on or before March 9, 2012. On March 7, 2012, the Company paid the principal due on January 30, 2012 in full plus accrued interest for the period from July 30, 2011 to January 29, 2012, as well as a penalty interest of $28,416 for the period from February 6, 2012 to March 7, 2012. Abax issued a waiver to exempt the Company from any other consequences of the late payment.

The repayment of 16.6666% of the principal of the notes payable plus accrued interest of the period from January 29, 2012 to July 30, 2012 was due on July 30, 2012. And the repayment of 16.6666% of the principal of the notes payable plus accrued interest of the period from July 31, 2012 to January 30, 2013 was due on January 30, 2013. The company did not make these payments at the time they were due and the payments remain unpaid.

On September 5, 2012, the Company received another notice from the Holders that the Holders elected to exercise their right to accelerated payment of the Senior Notes as a result of the continued Default (the “Acceleration Notice”). The immediate acceleration of all amounts owing under the Senior Notes totals approximately RMB 249,450,516.

Further, on September 10, 2012, the Company received a demand notice from the Holders' legal counsel on behalf of the Holder for the payment of all amounts owing under the Senior Notes (the "Demand Notice") within 15 days from the date of the Demand Notice. The Demand Notice stated that if the Company failed to meet the demand, the Holders intend to pursue all of its legal rights under the transaction documents, including, without limitation:

Requiring the Trustee to initiate suit in the courts of New York with respect to the Company's failure to pay the entire amount due to the Holders under the Senior Notes;

Initiating involuntary bankruptcy proceedings with respect to the Company under the U.S. Federal Bankruptcy Code;

Initiating arbitration in Hong Kong against the Company for breaches of the Company's obligations under the SPA;

Exercising its rights under the Warrant Agreement to require the redemption of all Warrants held by it at the Redemption Price (as defined therein); and

All other rights under the transaction documents relating to the Senior Notes in relation to the Default, which may include, foreclosing on the security interest in 65% of all outstanding equity interest of the Company's wholly owned subsidiary, Shaanxi Xilan Natural Gas Equipment Co., Ltd., and all funds in the account where the proceeds from the Senior Notes were deposited.

In addition to the demands disclosed above, the Holders have also asserted that by virtue of the Default the Company is obliged to redeem the Warrants and pay to the Holders $17.5 million.

The Company disputes the amount allegedly owed, and has been in negotiation with the Holders but has not able to come to a resolution with the Holders.

On September 11, 2012, the holders of a majority of the Senior Notes (the "Holders") notified the Company on August 21, 2012 (the "Default Notice") that the Company was in default of the Senior Notes for failure to make the interest payment due and a mandatory redemption of the Senior Notes on July 30, 2012 (the "Default"). In the notice, the Holders also demanded that the Company make all payments due as of July 30, 2012 under the Senior Notes to avoid acceleration of all payments under the Senior Notes and foreclosure of collaterals pledged to secure the Senior Notes.

On February 8, 2013, an Involuntary Petition for Bankruptcy, entitled In re China Natural Gas, Inc. (Case No. 13-10419), was filed against China Natural Gas, Inc. (the "Company") by three creditors of the Company, namely Abax Lotus Ltd., Abax Nai Xin A Ltd., and Lake Street Fund LP (the "Petitioners"). The petition was filed in the United

States Bankruptcy Court, Southern District of New York (the “Bankruptcy Court”). The Petitioners have claimed in the Involuntary Petition that they have debts totaling $42,218,956.88 as a result of the Company’s failure to make payments on the 5% Guaranteed Senior Notes issued in 2008. On or about June 26, 2013, the Company filed a consent to the Involuntary Petition. On July 12, 2013, an Order for Relief was entered in Bankruptcy Court.

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Senior notes consist of the following:

	June 30, 2013	December 31, 2012
Notes payable	$39,149,998	$38,352,498
Less discount	-	-
	39,149,998	38,352,498
Less current portion	(39,149,998)	(38,352,498)
	$-	$-

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

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

In connection with the issuance of the Senior Notes, the Company paid $2,122,509 in debt issuance costs, which are being amortized over the life of the Senior Notes. The Company amortized all outstanding amounts of debt issuance costs during the third quarter of 2012. For the three and six months ended June 30, 2012, the Company amortized $102,458 and $204,916 of the issuance costs, which was recorded as capitalized interest included in construction in progress.

The Abax Warrants are presently exercisable and have an exercise price of $7.37 per share, although Abax has not exercised any of the Abax Warrants. As a result of the default of the Senior Notes, the Holders elected to exercise their right to accelerated payment of the Senior Notes in September 2012. The Company had reclassified the derivative liability to current liabilities during the third quarter of 2012.

The Abax Warrants are considered derivative instruments required to be bifurcated from the original security because there is a redemption requirement if the holder does not exercise the Warrants. If Abax does not exercise the Abax Warrants prior to their expiration date of January 29, 2015, Abax can require the Company to repurchase the Abax Warrants for $17,500,000. This amount is shown as a debt discount and is being amortized over the term of the Senior Notes. The Company amortized all outstanding amounts of debt discount during the third quarter of 2012. For the three and six months ended June, 2012, the Company amortized $921,259 and $1,835,473 of the discounts, which were capitalized into construction in progress. The Holders have asserted that by virtue of the Default the Company is obliged to redeem the Warrants and pay to the Holders $17.5 million. The Company disputes the amount allegedly owed, and has been in negotiation with the Holders but has not able to come to a resolution with the Holders.

Note 7 –Bank Loan Payable

The Company’s bank loan payable as of June 30, 2013 consists of:

	June 30, 2013	December 31, 2012
A loan from Pudong Development Bank Xi’an Branch, due various dates from 2013 to 2014	$8,100,000	$ 9,522,000
Less current portion	(4,860,000)	(4,761,000)
	$3,240,000	$ 4,761,000

The loan is secured by XXNGC’s equipment and vehicles located within the PRC. The carrying net value of the assets pledged is $9,489,972 as of June 30, 2013. Interest expense for the three and six months ended June 30, 2013 was $132,031 and $281,888, respectively (interest rate applied at June 30, 2013 was 6.40%). Interest expense for the three and six months ended June 30, 2012 was $237,711 and $481,583, respectively (interest rate applied at June 30, 2012 was 6.90%). According to the loan agreement, the interest rate is fixed throughout each single year and will only be adjusted at the beginning of the next year, based on the base interest rate on the same category of loans for the same term published by the People’s Bank of China. XXNGC also entered into a guaranty with the lender to guarantee the repayment of the loans. According to an amendment to the loan agreement with the Bank, which was signed on October 2011, the Company is required to make repayments on the long term loan as follows:

Date	Repayment Percentage	Repayment Amount
October 5, 2011 (paid on October 10, 2011)	4.2 %	$810,000
December 5, 2011 (paid on December 5, 2011)	20.8 %	4,050,000
March 5, 2012 (paid on March 5, 2012)	4.2 %	810,000
December 5, 2012 (paid on December 5, 2012)	20.8 %	4,050,000
March 5, 2013 (paid on March 5, 2013)	8.3 %	1,620,000
December 5, 2013	16.7 %	3,240,000
March 5, 2014	8.3 %	1,620,000
December 5, 2014	16.7 %	3,240,000
	100.0 %	$19,440,000

If the default of the Senior Notes is not resolved, the Company may be deemed to be in default on its fixed asset loan from Shanghai Pudong Development Bank (“SPDB”) as the Holders initiate involuntary bankruptcy proceedings with respect to the Company and the Company does not obtain prior written approval from SPDB. The default of the loan with SPDB may result in full or partial acceleration of the repayment of the loan.

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Note 8 – Warrants

No warrants were granted, forfeited or exercised during the six months ended June 30, 2013 and 2012, respectively.

The following is a summary of warrants outstanding and exercisable as of June 30, 2013 and 2012:

Warrants Outstanding and Exercisable as of June 30, 2013

Exercise Price	Number	Average Remaining Contractual Life
$ 7.37	1,450,000	1.58
	1,450,000	

Warrants Outstanding and Exercisable as of June 30, 2012

Exercise Price	Number	Average Remaining Contractual Life
$ 14.86	383,654	0.32
$ 7.37	1,450,000	2.58
	1,833,654	

Note 9 – Defined Contribution Plan

The Company is required to participate in a defined contribution plan operated by the local municipal government in accordance with PRC law and regulations. The contribution was $180,126 and $122,479 for the three months ended June 30, 2013 and 2012, respectively. The contribution was $388,517 and $302,222 for the six months ended June 30, 2013 and 2012, respectively.

Note 10 – Stockholders' Equity

a) Statutory Reserve

The PRC Company Law, which is applicable to PRC companies with foreign ownership, stipulates that 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; and

iii. allocations to the discretionary surplus reserve, if approved in the shareholders' general meeting.

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As of June 30, 2013 and December 31, 2012, the remaining amount needed to fulfill the 50% registered capital requirement was approximately $61,055,290 and $61,974,421, respectively.

b) Stock-based Compensation

2009 Stock Option and Stock Award Plan

On March 11, 2009, the Board approved by written consent the China Natural Gas, Inc. 2009 Employee Stock Option and Stock Award Plan (the "Plan"). Pursuant to the Plan, there are currently 1,460,000 shares of common stock of the Company authorized for issuance and the Company has granted 669,900 stock options as of June 30, 2013, of which 274,750 have been exercised and 176,700 have been cancelled and are available for reissuance. Thus, there are currently 966,800 shares of common stock of the Company available for future issuance under the Plan and 218,450 options outstanding. The exercise price for all of the outstanding options is $4.90 per share.

Compensation expense of $0 and $148,038 was recorded during the three months ended June 30, 2013 and 2012, respectively, relating to options granted under the Plan. Compensation expense of $148,038 and $296,076 was recorded during the six months ended June 30, 2013 and 2012, respectively, relating to options granted under the Plan.

As of June 30, 2013, all the compensation expense had been recognized.

The following is a summary of the status of stock options outstanding and exercisable as of June 30, 2013:

Outstanding Options			Exercisable Options		
Exercise Price	Number	Average Remaining Contractual Life	Exercise Price	Number	Average Remaining Contractual Life
$4.90	218,450	1.75 years	$4.90	218,450	1.75 years

Note 11 – Earnings per Share

The following is a calculation of basic and diluted earnings per common share:

	For the three months ended June 30,		For the six months ended June 30,	
Basic earnings per share	2013	2012	2013	2012
Net income	$3,141,673	$5,045,706	$7,781,141	$7,221,511
Weighted shares outstanding-Basic	21,458,654	21,458,654	21,458,654	21,458,654
Earnings per share-Basic	$0.15	$0.24	$0.36	$0.34
Diluted earnings per share				
Net income	$3,141,673	$5,045,706	$7,781,141	$7,221,511
Weighted shares outstanding-Basic	21,458,654	21,458,654	21,458,654	21,458,654
Effect of diluted securities-Warrants	-	-	-	-
Effect of diluted securities-Options	-	-	-	-
Weighted shares outstanding-Diluted	21,458,654	21,458,654	21,458,654	21,458,654
Earnings per share–Diluted	$0.15	$0.24	$0.36	$0.34

The Company had outstanding warrants of 1,450,000 as of June 30, 2013. For the three and six months ended June 30, 2013, all 1,450,000 outstanding warrants were excluded from the diluted earnings per share calculation as the exercise price was greater than the average stock price during these periods. The Company had outstanding warrants of 1,833,654 as of June 30, 2012. For the three and six months ended June 30, 2012, all 1,833,654 outstanding warrants were excluded from the diluted earnings per share calculation as the exercise price was greater than the average stock price during these periods.

The Company had 218,450 outstanding employee stock options as of June 30, 2013 and 2012. For the three and six months ended June 30, 2013 and 2012, the outstanding options were excluded from the diluted earnings per share calculation as the exercise price was greater than the average option price during these periods.

Note 12 – Related Party Transactions

a) Other payable - related party

On February 24, 2011, the Company borrowed $793,500 from the JV for working capital purposes. This payable is due on demand with no interest rate, and is offset to $0 on February 27, 2013, as we transferred our investment in JV to Shaanxi Jinyuan investment Co., Ltd.

As of June 30, 2013, the Company borrowed a total of $840,041 from Ms. Rongxiu Xiang, a manager and shareholder of XTJH, for working capital purposes. This payable is due on demand with no interest rate.

b) Borrowings from related party

As of June 30, 2013, the Company borrowed a total of $2,679,945 from Mr. Hao Qu, a former employee of XXNGC and a shareholder of the Company, for working capital purposes. The loans were originally due in one year and required interest of 4.4075% per year, which is the annual USD lending rate applied by the Bank of China. The principal and interest was required to be paid on specified due dates beginning on February 16, 2012 through October 31, 2012. On May 17, 2012, May 18, 2012, November 1, 2012, February 16, 2013, March 28, 2013, May 17, 2013 and May 18, 2013 the Company entered into agreements with Mr. Qu, pursuant to which certain borrowings would be due in 2013 and 2014, rather than in 2012, and would bear a higher rate of interest. The Company has not repaid any principal of the borrowings to date.

Borrowings from Mr. Qu at June 30, 2013, consist of the following:

Short-term maturing on	
February 15, 2013, at 6.2250% (extended to February 15, 2014)	$900,000
March 27, 2013, at 6.2250% (extended to March 27, 2014)	$420,000
May 16, 2013, at 6.2250%(extended to May 16, 2014)	$699,975
May 17, 2013, at 6.2250%(extended to May 17, 2014)	$299,970
October 31, 2013, at 6.2250%	$360,000
	$2,679,945

Borrowings from Mr. Qu at December 31, 2012, consist of the following:

Short-term maturing on	
February 15, 2013, at 6.2250% (extended to February 15, 2014)	$900,000
March 27, 2013, at 6.2250% (extended to March 27, 2014)	$420,000
May 16, 2013, at 6.2250%	$699,975
May 17, 2013, at 6.2250%	$299,970
October 31, 2013, at 6.2250%	$360,000
	$2,679,945

Note 13 –Concentrations

Concentration of natural gas vendors:

	Three months ended June 30, 2013	2012	Six months ended June 30, 2013	2012
Number of natural gas vendors	4	4	4	4
Percentage of total natural gas purchases	93 %	82 %	90 %	83 %

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As of June 30, 2013 and December 31, 2012, the Company had $146,342 and $407,717, respectively, prepayment to its major suppliers.

The Company maintained long-term natural gas purchase agreements with one of its vendors, Qinshui Lanyan Coal Bed Methane Co., Ltd ("Qinshui Lanyan") as of June 30, 2013. The Company does not expect any issues or difficulty in renewing the supply contracts with these vendors going forward.

Note 14 – Commitments and Contingencies

Lease Commitments

The Company entered into a series of long-term lease agreements with outside parties to lease land use rights for the Company's CNG fueling stations located in the PRC. The agreements have terms ranging from 10 to 30 years. The Company makes annual prepayments for most of these lease agreements. The Company also entered in numerous office leases where the premises are located in various cities in the PRC such as Xi'an, Wuhan, Yichang, Huangshi, and Yidu. The minimum future payments for leasing land use rights and offices at June 30, 2013 are as follows:

Year ending December 31, 2013	643,496
Year ending December 31, 2014	2,420,598
Year ending December 31, 2015	2,031,568
Year ending December 31, 2016	2,002,933
Year ending December 31, 2017	2,239,967
Thereafter	30,409,030
Total	$39,747,592

For the three months ended June 30, 2013 and 2012, the land use right and office lease expenses were $638,062 and $556,668, respectively. For the six months ended June 30, 2013 and 2012, the land use right and office lease expenses were $1,229,280 and $1,120,664, respectively.

Property and Equipment Purchase Commitments

As of June 30, 2013, the Company has purchase commitments totaling $5,257,955 for materials, supplies, services and property and equipment for constructing the LNG plant and other construction projects.

Natural Gas Purchase Commitments

The Company has existing long-term natural gas purchase agreements with its major suppliers.

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The Company continued to seek lower-cost sources of supply and did not have commitments for the purchasing volume of natural gas with any suppliers except Qinshui Lanyan. According to the agreement with Qinshui Lanyan, the Company should purchase from Qinshui Lanyan a daily volume of approximately 200,000 cubic meters of coal bed gas. Prices of natural gas are strictly controlled by the PRC government.

Capital Contribution

We failed to comply with PRC law in our recent contribution of capital to JBLNG and will be subject to possible fines, penalties and administrative actions until the capital contribution is registered in compliance with PRC law.

In August 2008, the board of directors of XXNGC passed a resolution to increase the registered capital of JBLNG to RMB 118, 305,000 through the form of intangible asset contributions. In September 2008, JBLNG obtained its updated business license reflecting the increased registered capital. Pursuant to XXNGC's board resolution, China Natural Gas, Inc. transferred its right to use the two licenses it obtained relating to the design of our LNG facility directly to JBLNG as JBLNG's registered capital. Since the Company is not a shareholder of JBLNG, PRC laws does not permit this type of capital contribution to JBLNG. In addition, PRC law does not allow the contribution of capital in the form of an intangible asset, such as the licenses in issue, where the assets are not owned by the contributor. We are restructuring the capital contribution as a cash contribution and revising our LNG licenses so that the licensee is JBLNG and believe that this capital contribution and license restructuring will comply with PRC laws. However, until we have completed this process, the relevant regulatory authorities may impose fines or penalties, or require us to cease the operations of JBLNG, until such time as these defects are remedied. Any such fines, penalties or delay in operations could have a material and adverse effect on our LNG business in terms of our future growth, financial conditions and results of operations. Currently we do not estimate such fines, penalties and administrative actions to be probable, so we do not recognize them as contingent liabilities in our consolidated financial statements.

VIE Structure

In order to comply with PRC laws limiting foreign ownership of Chinese companies, we conduct our natural gas business through Xi'an Xilan Natural Gas Co., Ltd. by means of contractual arrangements which may not be as effective as direct ownership or may be deemed in violation of PRC restrictions on foreign investment in our industry.

The government of the PRC restricts foreign investment in natural gas businesses in China. Accordingly, we operate our business in China through our VIE, XXNGC. XXNGC holds the licenses, approvals and assets necessary to operate our natural gas business in China. We have no equity ownership interest in XXNGC and rely on contractual arrangements with XXNGC and its shareholders that allow us to substantially control and operate XXNGC. These contractual arrangements may not be as effective in providing control over XXNGC as direct ownership would be.

For example, XXNGC could fail to take actions required for our business despite its contractual obligation to do so. If XXNGC fails to perform under its agreements with us, we may have to spend substantial costs and resources to enforce such arrangements and may have to rely on legal remedies under the laws of the PRC, which may not be effective. In addition, we cannot assure you that XXNGC's shareholders and management would always act in our best interests.

Although we believe that we comply with current regulations of the PRC, we cannot assure you that the PRC government would agree that our structure or operating arrangements comply with the PRC’s licensing, registration or other regulatory requirements under existing policies or with requirements or policies that may be adopted in the future. If the PRC government determines that our structure or operating arrangements do not comply with applicable laws, it could revoke our business and operating licenses, require us to discontinue or restrict our operations, restrict our right to collect revenues, require us to restructure our operations, impose additional conditions or requirements with which we may not be able to comply, impose restrictions on our business operations or on our customers, or take other regulatory or enforcement actions against us that could be harmful to our business. In addition, the equity pledge in the Equity Pledge Agreement between SXNGE and XXNGC and XXNGC's shareholders has not been registered and may be deemed to be unenforceable under PRC laws.

Other than the proxy agreement between SXNGE, XXNGC and XXNGC's chairman and shareholders, which does not contain a choice of law or jurisdictional clause, our contractual arrangements with XXNGC are governed by PRC laws and they provide for the resolution of disputes through arbitration in the PRC. Accordingly, these contracts would be interpreted in accordance with PRC laws and any disputes would be resolved in accordance with PRC legal procedures. If XXNGC or its shareholders fail to perform their respective obligations under these contractual arrangements, we may have to (i) spend substantial costs and resources to enforce such arrangements, and (ii) rely on legal remedies under PRC laws, including seeking specific performance or injunctive relief, and claiming damages, which we cannot be sure would be effective. However, the legal environment in the PRC is not as developed as in the United States and uncertainties in the Chinese legal system could limit our ability to enforce these contractual arrangements. In the event that we are unable to enforce these contractual arrangements, our business, financial condition and results of operations could be materially and adversely affected. Currently we do not estimate the possibility of such defaults in enforcing the contractual arrangements to be probable, and it will be extremely difficult to make any reliable to the amounts of the potential losses that may be caused by such defaults, so we do not recognize it as a contingent liability in our consolidated financial statements.

Individuals Claims to Certain Shares

Certain shares in XXNGC, our VIE, may be subject to adverse claims.

Six individuals have previously claimed to own 1,200,000 shares of XXNGC's common stock, our main operating company and VIE. They have claimed that they acquired these shares from other shareholders of XXNGC. Based on XXNGC's registered capital of RMB 69,000,000 when it became a joint stock limited company in 2004, we believe that the 1,200,000 shares represented 1.74% of XXNGC's outstanding common stock at the time when the six individuals claimed to have acquired the 1,200,000 shares of XXNGC. While we and XXNGC dispute their claim of ownership over the 1,200,000 shares, there is no assurance that XXNGC will prevail if these six individuals pursue their claim in legal proceedings. If these six individuals are found to have legitimate ownership over these shares, XXNGC's shareholding structure may change and our revenues from our contractual arrangements with XXNGC may be reduced. Currently we do not estimate the possibility of such change to the shareholding structure to be probable, so we do not recognize it as a contingent liability in our financial statements.

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Legal Proceedings

Other than described below, there have been no material developments in the legal proceedings in which we were involved during the six months ended June 30, 2013. For a description of previously reported legal proceedings refer to Part I, Item 3, “Legal Proceedings” of the Company’s Annual Report on Form 10-K for the year ended December 31, 2012.

a) On May 14, 2012, the Securities and Exchange Commission (“SEC”) filed a Complaint (the “Complaint”) in the U.S. District Court for the Southern District of New York against Qinan Ji and the Company, captioned Securities and Exchange Commission v. China Natural Gas, Inc. and Qinan Ji (12 CV 3824) (the “SEC Action”). The SEC Action alleged that the Company violated Section 17(a)(2) of the Securities Act of 1933 (“Securities Act”), and Sections 10(b), 13(a), 13(b)(2)(A), 13(b)(2)(B) and 14(a) of the Securities Exchange Act of 1934 (“Exchange Act”) (as well as certain rules promulgated under such sections), and that Mr. Ji violated Section 17(a) of the Securities Act, Sections 10(b), 13(a), 13(b)(2)(A), 13(b)(2)(B), 13(b)(5) and 14(a) of the Exchange Act (as well as certain rules promulgated under such sections), Section 304 of the Sarbanes Oxley Act of 2002 and aiding and abetting certain of the Company’s alleged violations. The SEC Action further alleged among other things that, in January 2010, the Company made two-short term loans totaling $14.3 million ($9.9 million to Taoxiang Wang and $4.4 million to a real estate company called Shaanxi Juntai Housing Purchase Co. Ltd. (“Juntai”)) and disclosed them in its periodic reports as loans made to unrelated third parties. The SEC Action alleged that the true and undisclosed purpose of the loans was to benefit a company called Xi’an Demaoxing Real Estate Co., Ltd. (“Demaoxing”), and that Demaoxing was 90% owned by Mr. Ji’s son and 10% owned by Mr. Ji’s nephew. The SEC Action further alleged that Taoxiang Wang was a sham borrower selected to conceal Demaoxing’s receipt of the loan proceeds and that Juntai was Demaoxing’s business partner and borrowed the money to undertake a joint real estate project with Demaoxing.

On or about June 6, 2013, the Court entered a judgment in the SEC action, memorializing a settlement of the SEC Action agreed to by the Company and the staff of the SEC (the “SEC Settlement”). Pursuant to the SEC Settlement, without the Company admitting or denying any allegations against it, a judgment was entered that: (a) permanently restrains and enjoins the Company from future violations of Section 17(a)(2) of the Securities Act and Sections 13(a), 13(b)(2)(A), 13(b)(2)(B), and 14(a) of the Exchange Act and Rules 12b-20, 13a-1, 13a-11, 13a-13, and 14a-9 thereunder; and (b) orders the Company to pay an aggregate civil penalty in the amount of $815,000 (the “Settlement Payment”) pursuant to Section 20(d) of the Securities Act and Section 21(d)(3) of the Exchange Act. The Settlement Payment is due on or before August 6, 2013.

The Company's Settlement Payment is being held in escrow pending approval of the Settlement Payment by the Bankruptcy Court. A hearing has been scheduled in the Bankruptcy Court for approval of the SEC Settlement on August 6, 2013.

b) On May 22, 2012, Kousa, Mallano and Steinmetz, shareholders of the Company ("Delaware Plaintiffs"), filed a putative Shareholder Class Action and Derivative Complaint ("Delaware Complaint") against the Company and certain members of the Company's Board ("Delaware Director Defendants") in the Court of Chancery of the State of Delaware. The Delaware Complaint alleges a direct class action claim for breach of fiduciary duty against the Delaware Director Defendants, a derivative claim for breach of fiduciary duty against the Delaware Director Defendants, and a separate derivative claim for breach of fiduciary duty against Ji. The Delaware Complaint alleges that the Delaware Director Defendants breached their fiduciary duties to the Company and its shareholders by preserving Ji's control over the Company despite his alleged wrongdoing and the threatened delisting of the Company's shares by NASDAQ, thereby causing the Company's shares to be delisted. The Delaware Complaint separately alleges that Ji engaged in self-dealing and other conduct that breached his fiduciary duties to the Company and its shareholders. The Delaware Complaint seeks certification of a class action, authorization to proceed as a derivative action, and unspecified money damages, including attorneys' fees and costs. The claims are directed against the individual defendants and not against the Company.

On July 30, 2012, Ji filed a motion to dismiss the Delaware Complaint. On August 14, 2012, the Company and the remaining Delaware Director Defendants filed a motion to stay or dismiss the Delaware Complaint. The parties agreed, with the approval of the Court, to bifurcate briefing on the motion to stay and the motions to dismiss. On October 16, 2012, after briefing and oral argument, the Chancery Court stayed the separate derivative claim against Ji pending the outcome of the SEC investigation and Federal Securities Action, but denied the motion to stay as to the other counts in the Delaware Complaint against the Delaware Director Defendants and directed the parties to proceed with briefing on the motions to dismiss without prejudice to the Plaintiffs' right to amend the Delaware Complaint. The Court also stayed all discovery pending the outcome of the motions to dismiss. On July 2, 2013, the Court approved a stipulation among the parties providing that the Plaintiffs would file an amended complaint on or before the earlier to occur of (i) any date directed by this Court, or (ii) twenty-one (21) days after notice from any party that Plaintiffs are required to do so, which notice may be given at any time. As a result of the October 16, 2012 Order and the July 2, 2013 Stipulation and Order, the case is effectively stayed pending a notice from one of the parties in the case instructing Plaintiffs to file an amended complaint, or the issuance by the Court of an order directing that the Plaintiffs file an amended complaint.

c) As previously disclosed in the Current Reports on Form 8-K filed by the Company with the Securities and Exchange Commission (the "SEC") on December 31, 2007 and January 29, 2008, the Company entered into a Securities Purchase Agreement with Abax Lotus Ltd. (the "Investor") on December 30, 2007 which was amended on January 29, 2008 (the "SPA"). Pursuant to the SPA, the Company issued to the Investor 5% Guaranteed Senior Notes due 2014 (the "Senior Notes") in aggregate principal amount of RMB 145,000,000 (approximately US$20,000,000) on January 29, 2008. Also, as previously disclosed in the Current Report on Form 8-K filed by the Company with the SEC on March 12, 2008, also pursuant to the SPA, the Investor exercised its option to purchase an additional RMB145,000,000 in aggregate principal amount of Senior Notes. The Senior Notes were issued in connection with the Indenture dated as of January 29, 2008 (the "Indenture"). The aggregate principal amount of the Senior Notes at issuance was RMB290,000,000 (approximately US$40,000,000). In addition, the Company agreed to issue to the Investor seven-year warrants (the "Warrants") exercisable for up to 2,900,000 shares of the Company's common stock at an initial exercise price equal to $7.3652 per share (subject to adjustment) pursuant to the Warrant Agreement dated January 29, 2008 (the “Warrant Agreement”) by and among the Warrant Agent and Warrant Registrar as a holder of the Warrants (as defined therein).

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Also as previously disclosed in the Company's Current Report on Form 8-K filed with the SEC on September 11, 2012, the holders of a majority of the Senior Notes (the "Holders") notified the Company on August 21, 2012 (the "Default Notice") that the Company was in default of the Senior Notes for failure to make the interest payment due and a mandatory redemption of the Senior Notes on July 30, 2012 (the "Default"). In the notice, the Holders also demanded that the Company make all payments due as of July 30, 2012 under the Senior Notes to avoid acceleration of all payments under the Senior Notes and foreclosure of collaterals pledged to secure the Senior Notes.

On September 5, 2012, the Company received another notice from the Holders that the Holders elected to exercise their right to accelerated payment of the Senior Notes as a result of the continued Default (the "Acceleration Notice"). The immediate acceleration of all amounts owing under the Senior Notes totals approximately RMB249,450,516.

Further, on September 10, 2012, the Company received a demand notice from the Holders' legal counsel on behalf of the Holder for the payment of all amounts owing under the Senior Notes (the "Demand Notice") within 15 days from the date of the Demand Notice. The Demand Notice stated that if the Company failed to meet the demand, the Holders intend to pursue all of its legal rights under the transaction documents, including, without limitation:

Requiring the Trustee to initiate suit in the courts of New York with respect to the Company's failure to pay the entire amount due to the Holders under the Senior Notes;

Initiating involuntary bankruptcy proceedings with respect to the Company under the U.S. Federal Bankruptcy Code;

Initiating arbitration in Hong Kong against the Company for breaches of the Company's obligations under the SPA;

Exercising its rights under the Warrant Agreement to require the redemption of all Warrants held by it at the Redemption Price (as defined therein); and

All other rights under the transaction documents relating to the Senior Notes in relation to the Default, which may include, foreclosing on the security interest in 65% of all outstanding equity interest of the Company's wholly owned subsidiary, Shaanxi Xilan Natural Gas Equipment Co., Ltd., and all funds in the account where the proceeds from the Senior Notes were deposited.

In addition to the demands disclosed above, the Holders have also asserted that by virtue of the Default the Company is obliged to redeem the Warrants and to pay to the Holders $17.5 million, and has taken action to redeem the Warrants. The Company disputes the amount allegedly owed.

As disclosed above, on February 8, 2013, an Involuntary Petition for Bankruptcy, entitled In re China Natural Gas, Inc. (Case No. 13-10419), was filed against China Natural Gas, Inc. (the "Company") by three creditors of the Company, namely Abax Lotus Ltd., Abax Nai Xin A Ltd., and Lake Street Fund LP (the “Petitioners”). The petition was filed in the United States Bankruptcy Court, Southern District of New York (the “Bankruptcy Court”). The Petitioners have claimed in the Involuntary Petition that they have debts totaling $42,218,956.88 as a result of the Company’s failure to make payments on the 5% Guaranteed Senior Notes issued in 2008. On or about June 26, 2013, the Company filed a consent to the Involuntary Petition. On July 12, 2013, the Order for Relief was entered in the Bankruptcy Court.

d) Vandevelde v. China Natural Gas, Inc., et al. (Skeway v. China Natural Gas, Inc.) (Case No. 1:10CV00728, United States District Court for the District of Delaware). As previously disclosed, on August 26, 2010, an individual investor filed a putative class action complaint against the Company and certain of its former officers and directors alleging that the defendants violated the U.S. securities laws. The Court appointed another individual investor as lead plaintiff, and he then filed an amended complaint. The Company filed a motion to dismiss which, on July 6, 2012, the Court granted in its entirety. In its order, the Court also granted the plaintiffs leave to amend their complaint. In the second amended complaint, the plaintiffs allege that, in violation of Section 10(b) of the Securities Exchange Act of 1934 (and Rule 10b-5 thereunder), the defendants made false or misleading statements in the Company’s Annual Reports on Form 10-K for the years ended December 31, 2009, and December 31, 2010, and in various quarterly reports, by purportedly failing to disclose a series of loans and related party transactions. The second amended complaint also asserts claims against certain of the Company’s former officers and directors for violations of Section 20(a) of the Securities Exchange Act of 1934. The suit seeks unspecified monetary damages. On September 25, 2012, the Company filed a motion to dismiss the second amended complaint. On April 1, 2013, the Company notified the Court that certain of the Company’s creditors had filed an involuntary petition for bankruptcy and that, under the U.S. Bankruptcy Code, the filing of that petition operates as an automatic stay of the suit. On April 9, 2013, the Court entered an order administratively closing the case and directing the parties to notify the Court when either the bankruptcy litigation had been resolved or one of the individual defendants was served, so that the Court could reopen the case or take other appropriate action. At the time the Court administratively closed the case, the Company’s motion to dismiss the second amended complaint was fully briefed but had not yet been decided by the Court. On June 17, 2013, the plaintiffs filed a motion seeking permission to effect service on the individual defendants through the Company’s former counsel in a separate action, which the Company has opposed. That motion is pending. The Company cannot at this time provide any assurance that the outcome of this suit will not be materially adverse to its financial condition, consolidated results of operations, cash flows or business prospects.

In addition, the Company is involved in disputes and legal actions from time to time in the ordinary course of our business. The Company does not believe that any of these matters, individually or in the aggregate, will have a material adverse effect on our operations.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Forward-Looking Statements

This Quarterly Report contains statements that are forward-looking and, as such, are not historical facts. Rather, these statements constitute projections, forecasts and forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements are not guarantees of performance. They involve known and unknown risks, uncertainties, assumptions and other factors which may cause the actual results, performance or achievements of the Company to be materially different from any future results, performance or achievements expressed or implied by these statements. Such statements can be identified by the fact that they do not relate strictly to historical or current facts. These statements use words such as “believe,” “expect,” “should,” “strive,” “plan,” “intend,” “esti “anticipate” or similar expressions. When the Company discusses its strategies or plans, it is making projections, forecasts or forward-looking statements. Actual results and stockholders’ value will be affected by a variety of risks and factors, including, without limitation, the recent crisis in worldwide financial markets, international, national and local economic conditions, merger, acquisition and business combination risks, financing risks, geo-political risks, and acts of terror or war. Many of the risks and factors that will determine these results and stockholder values are beyond the Company’s ability to control or predict. These statements are necessarily based upon various assumptions involving judgment with respect to the future. You should carefully read the risk factor disclosure contained in “Item 1A. Risk Factors” of our Annual Report on Form 10-K for the year ended December 31, 2012, where many of the important factors currently known to management that could cause actual results to differ materially from those in our forward-looking statements are discussed.

All such forward-looking statements speak only as of the date of this Quarterly Report. We are under no obligation to, nor do we intend to, release publicly any updates or revisions to any forward-looking statements contained herein to reflect any change in our expectations with regard thereto or any change in events, conditions or circumstances on which any such statement is based.

Overview

We are an integrated natural gas operator in the People’s Republic of China (referred to herein as China or the PRC), primarily involved in distribution of compressed natural gas, or CNG, through the CNG fueling stations owned by our variable interest entity, or VIE, Xi’an Xilan Natural Gas Co., Ltd. (referred to as XXNGC). As of June 30, 2013 our VIE owned and operated 30 CNG fueling stations, including 19 CNG fueling stations in Shaanxi Province, 10 CNG fueling stations in Henan Province and 1 CNG fueling station in Hubei Province. Our VIE owns our CNG fueling stations while we lease the land upon which our VIE-owned CNG fueling stations operate. For the three months ended June 30, 2013, we sold 29,235,059 cubic meters of CNG through our fueling stations, compared to 35,034,467 cubic meters for the three months ended June 30, 2012. For the six months ended June 30, 2013, we sold 65,109,913 cubic meters of CNG through our fueling stations, compared to 71,420,087 cubic meters for the six months ended June 30, 2012. Our VIE and its subsidiary, Lingbao Yuxi Natural Gas Co. Ltd. ("LYNG"), also install natural gas pipelines for, and distribute and sell piped natural gas to, residential and commercial customers in the city of Xi'an in Shaanxi Province, including Lantian County, and the districts of Lintong and Baqiao, and in the city of Lingbao in Henan Province, through a high pressure pipeline network of approximately 120 kilometers.

In addition, we have expanded into liquefied natural gas ("LNG") business and generate significant revenue from the LNG business. Our first LNG production facility, Shaanxi Jingbian Liquefied Natural Gas Co. Ltd. ("JBLNG"), located in Jingbian County, Shaanxi Province, commenced commercial production and sales on July 16, 2011. As of June 30, 2013, we had begun construction of 11 LNG fueling stations in Shaanxi, Henan and Hubei Provinces. Our VIE, XXNGC signed a contract with Zhangjiagang CIMC Sanctum Cryogenic Equipment Co., Ltd to buy 50 smart semi-trailers, eight of which have begun operations as of June 30, 2013.

We are pursuing multiple, synergistic paths of growth through our VIE, XXNGC, and XXNGC's subsidiaries, all of which are based in the PRC. We intend to:

- continue to grow our LNG business through the ongoing construction of JBLNG and through the construction of LNG fueling stations in Shaanxi, Henan and Hubei Provinces;

- capitalize on the opportunities arising from the busy shipping activities on the Yangtze River by expanding into Hubei Province through the construction of LNG fueling stations located in harbors along the Yangtze River, inland LNG fueling stations and reserve LNG stations along the course of the Yangtze River, as well as continued development of conversion technologies and operations to modify river vessels to run on a mixture of LNG and diesel; and

- continue to expand our CNG business into Hubei Province by construction of new stations.

For additional information regarding these growth initiatives, please see "*Recent Developments*" below.

Current Operations

We currently operate five main business lines:

- distribution and sales of CNG through our VIE-owned CNG fueling stations serving hybrid (natural gas/gasoline) powered vehicles. As of June 30, 2013, our VIE owned and operated 30 fueling stations in total;

- installation, distribution and sales of piped natural gas to residential and commercial customers through our VIE-owned pipelines. We distributed and sold piped natural gas to approximately 123,402 residential customers as of June 30, 2013;

- production and sales of LNG through our LNG production facility in Jingbian County, Shaanxi Province. Revenues from commercial production and sales of LNG started on July 16, 2011. We have eight semi-trailers in operation serving LNG powered vehicles as of June 30, 2013.

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- distribution and sales of gasoline through our VIE-owned CNG fueling stations for gasoline and hybrid (natural gas/gasoline) powered vehicles (two of our VIE-owned CNG fueling stations were selling gasoline as of June 30, 2013); and
- conversion of gasoline-fueled vehicles to hybrid (natural gas/gasoline) powered vehicles at our automobile conversion workshops.

We purchase all of the natural gas that we sell and distribute to our customers from our suppliers, and we are not directly involved in the mining or production of natural gas. We currently sell our natural gas in three forms: (i) we compress natural gas into CNG and sell it to our customers through CNG fueling stations, (ii) we distribute natural gas through pipelines to commercial and residential customers, (iii) we liquefy natural gas and sell and distribute to our customers.

We had total revenues of $34,247,958 and $37,901,695 for the three months ended June 30, 2013 and 2012, respectively, and revenues of $69,747,288 and $70,179,013 for the six months ended June 30, 2013 and 2012, respectively. We had net income of $3,174,408 and $5,074,582 for the three months ended June 30, 2013 and 2012, respectively, and net income of $7,840,729 and $7,022,328 for the six months ended June 30, 2013 and 2012, respectively.

Recent Developments

LNG Business

As of June 30, 2013, we had invested $68.6 million in Phase I of the LNG project located in Jingbian Country, Shaanxi Province and expected to invest approximately an additional $0.1 million to satisfy installment payments to contractors. We commenced test runs of Phase I of the LNG plant during 2010 and, in December 2010, we conducted and completed further test runs, including testing the operation of various components and equipments of the plant. We completed production preparation and trial production in June 2011. On July 16, 2011, we completed most of the construction of Phase I of the LNG plant and began commercial production and sale of LNG. Phase I of the LNG plant has a processing capacity of 500,000 cubic meters of LNG per day, or approximately 150 million cubic meters of LNG per year. Customers of our LNG business mainly include city gas companies supplying industrial, commercial and residential pipeline end users, such as ENN Energy Holdings Ltd., Kunlun Energy Company Ltd. and Shanxi Guoyun Liquefied Natural Gas Ltd.. The launch of the LNG plant is an important part of our integration strategies, which include strategic plans to develop our own network of LNG fueling stations in Shaanxi, Henan and Hubei Provinces.

The total expected cost of $68.7 million for the construction of Phase I of the LNG project is higher than what we originally anticipated. The increased costs were attributable to unforeseen cost overruns and escalations, including increased material and labor costs incurred to reinforce pilings based upon modified engineering analysis, and increased prices for land use rights, which we believe resulted from the energy resource exploration activities in nearby areas. Construction of Phase I of the LNG plant experienced delays due to policy changes with respect to tariff exemptions for core equipment imported by the Company and the increased international shipment time for ordered equipment.