



**Unaudited Interim
Consolidated Financial Statements
March 31, 2009**

May 14, 2009

**Epsilon Energy Ltd.
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EPSILON ENERGY LTD.
Consolidated Balance Sheets
(Unaudited; All amounts stated in US\$)

	<u>March 31, 2009</u>	<u>December 31, 2008</u>
ASSETS		
Current assets:		
Cash and cash equivalents.....	\$ 7,189,318	\$ 8,233,442
Accounts receivable	7,498,940	7,139,107
Notes receivable	351,671	359,401
Other current assets	211,108	262,979
Total current assets.....	15,251,037	15,994,929
Property and equipment:		
Net property and equipment (Note 3)	94,845,328	84,353,485
Other assets:		
Restricted cash (Note 4)	25,021,000	33,703,308
Other deferred charges and miscellaneous assets.....	18,368	17,842
Total other assets.....	25,039,368	33,721,150
Total assets.....	\$ 135,135,733	\$ 134,069,564
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 11,307,155	\$ 14,636,468
Line of credit (Note 4)	24,989,070	19,184,134
Current portion of notes payable.....	15,649	15,574
Total current liabilities	36,311,874	33,836,176
Long-term liabilities:		
Notes payable.....	15,976	18,999
Other liabilities:		
Asset retirement obligations.....	337,929	319,763
Future income tax liabilities.....	2,600,000	2,600,000
Total other liabilities	2,937,929	2,919,763
Total liabilities.....	39,265,779	36,774,938
Commitments and Contingencies (Note 6).....	-	-
Description of Business and Going Concern (Note 1).....	-	-
Shareholders' equity:		
Share capital (Note 5)	138,258,979	138,259,259
Contributed surplus (Note 5).....	5,769,159	5,401,361
Deficit	(37,393,895)	(36,558,958)
Accumulated other comprehensive loss	(10,764,289)	(9,807,036)
Sub total	(48,158,184)	(46,365,994)
Total shareholders' equity.....	95,869,954	97,294,626
Total liabilities and shareholders' equity.....	\$ 135,135,733	\$ 134,069,564

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

EPSILON ENERGY LTD.
Consolidated Statements of Operations and Deficit
(Unaudited; all amounts stated in US\$)

	Three Months Ended March 31,	
	2009	2008
Revenues:		
Oil & gas revenues.....	\$ 1,635,433	\$ 1,536,587
Other revenues	72,084	-
Total revenues.....	1,707,517	1,536,587
Operating costs and expenses:		
Project operating costs	467,249	281,227
Amortization, depletion and accretion	696,711	427,500
General and administrative	1,306,192	1,538,208
Total operating costs and expenses.....	2,470,152	2,246,935
Operating loss	(762,635)	(710,348)
Other income (expense):		
Other income (expense)	(72,302)	426,587
Net loss	(834,937)	(283,761)
Deficit, beginning of period	(36,558,958)	(2,871,042)
Deficit, end of period	\$ (37,393,895)	\$ (3,154,803)
Basic and diluted net loss per share	\$ (0.02)	\$ (0.01)
Weighted average number of shares outstanding	50,315,323	45,698,323

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

EPSILON ENERGY LTD.
Consolidated Statements of Cash Flows
(Unaudited; all amounts stated in US\$)

	Three Months Ended March 31,	
	2009	2008
Cash flows from operating activities:		
Net loss for the period	\$ (834,937)	\$ (283,761)
Items not involving cash:		
Amortization, depletion and accretion.....	696,711	427,500
Stock based compensation.....	367,798	309,284
Net loss on assets sold	-	639
Changes in non-cash balances related to operations (Note 9)	(6,502,800)	(952,070)
Net cash used in operating activities.....	(6,273,228)	(498,408)
Cash flows from investing activities:		
Additions to oil and natural gas properties (Note 9).....	(8,299,663)	(6,834,128)
Additions to other property and equipment	(5,124)	(94,488)
Proceeds from assets sold	-	125,841
Changes in restricted cash (Note 4)	8,682,308	-
Changes in other assets and other liabilities	7,203	9,308
Net cash (used in) or provided by investing activities	384,724	(6,793,467)
Cash flows from financing activities:		
Common share issuance costs	(280)	-
Proceeds from lines of credit (Note 4).....	5,804,936	-
Change in long-term debt	(3,023)	-
Net cash flows provided from financing activities	5,801,633	-
Effect of currency rates on cash and cash equivalents	(957,253)	(1,601,311)
Decrease in cash	(1,044,124)	(8,893,186)
Cash and cash equivalents at beginning of period	8,233,442	47,075,600
Cash and cash equivalents at end of period	\$ 7,189,318	\$ 38,182,414
Cash and cash equivalents consist of:		
Cash.....	\$ 7,189,318	\$ 8,833,414
Interest bearing short-term deposits.....	\$ -	\$ 29,349,000
Total cash and cash equivalents.....	\$ 7,189,318	\$ 38,182,414
Supplementary cash flow information:		
Interest received.....	\$ 190,210	\$ 544,803
Interest paid	\$ 220,036	\$ -
Income taxes paid	\$ -	\$ -

Non cash transactions:

The Corporation had non-cash transactions during the presented periods. See Note 9 “Changes in Non-Cash Balances Related to Cash Flows”.

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

EPSILON ENERGY LTD.
Consolidated Statements of Comprehensive Loss
and Accumulated Other Comprehensive Loss
(Unaudited; all amounts stated in US\$)

	Three Months Ended March 31,	
	2009	2008
Comprehensive loss:		
Net loss	\$ (834,937)	\$ (283,761)
Other comprehensive loss:		
Unrealized foreign exchange losses.....	(957,253)	(1,601,312)
Comprehensive loss	\$ (1,792,190)	\$ (1,885,073)
	Three Months Ended March 31,	
	2009	2008
Accumulated Other Comprehensive Loss:		
Balance, beginning of period	\$ (9,807,036)	\$ 161,575
Currency translation adjustments	(957,253)	(1,601,312)
Balance, end of period.....	\$ (10,764,289)	\$ (1,439,737)

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

Epsilon Energy Ltd.

Notes to the Unaudited Interim Consolidated Financial Statements

Unaudited for the three months ended and as at March 31, 2009 and the three months ended March 31, 2008.

1. Description of Business and Going Concern

Epsilon Energy Ltd. (the “Corporation” or “Epsilon”) was incorporated under the laws of the Province of Alberta on March 14, 2005. On October 24, 2007, the Corporation became a publicly traded entity on the Toronto Stock Exchange under the trading symbol “EPS”. The Corporation is engaged in the acquisition, exploration, development and production of oil and natural gas reserves in the United States, Canada, the Republic of Yemen (“Yemen”), the Federal Democratic Republic of Ethiopia (“Ethiopia”) and the Sultanate of Oman (“Oman”).

The unaudited interim consolidated financial statements have been prepared by management in accordance with Canadian generally accepted accounting policies and follow the same accounting policies as the most recent annual audited financial statements, except as highlighted in Note 2 “*Accounting Pronouncements*”. The interim consolidated financial statement note disclosures do not include all of those required by Canadian generally accepted accounting principles (“GAAP”) applicable for annual consolidated financial statements. Accordingly, these interim consolidated financial statements should be read in conjunction with the Corporation’s 2008 audited consolidated financial statements.

The financial statements of the Corporation have been prepared on a going concern basis, which presumes that the Corporation will be able to realize its assets and discharge its liabilities in the normal course of business for the foreseeable future. The Corporation is relying upon its ability to continue to achieve profitable oil and natural gas production from its projects to continue as a going concern. Given the lead time associated with many of its exploration and development activities, the Corporation’s ability to continue as a going concern is dependent on many factors. Those factors include the results of future exploration, development and production activities, the timing, scope and pace of such activities, and events outside of the Corporation’s direct control, such as the global credit market crisis and oil and gas commodity price volatility.

As at March 31, 2009 the Corporation had a negative working capital balance of \$21.1 million, incurred a net loss of \$0.8 million and had negative cash flow from operations of \$6.3 million. The Corporation currently anticipates incurring substantial expenditures to further its capital development program. Factors that will affect the Corporation’s ability to continue as a going concern include:

- Continued commercial production from its existing producing properties;
- Commencement of commercial production and profitable operations from exploration and development properties;
- Managing future international exploratory activities in a cost effective manner;
- Effectively managing the timing, pace, scope and the allocation of funds for capital expenditures within currently available capital resources;
- The continued support and cooperation of its lender; and
- Raising additional capital, as warranted, to accelerate or supplement the Corporation’s capital expenditures by bringing in industry partners, additional debt financing, equity financing, sale of full or partial property interests, or a combination thereof.

The accompanying consolidated financial statements do not include any adjustments that might result if the Corporation is unable to continue as a going concern. Such adjustments could be material.

2. Accounting Pronouncements

Goodwill and Intangible Assets

In February 2008, the CICA issued section 3064 of the CICA Handbook “*Goodwill and Intangible Assets*”, which replaces section 3062 of the CICA Handbook “*Goodwill and Other Intangible Assets*” and section 3450 of the CICA Handbook “*Research and Development Costs*”. These new sections of the CICA Handbook are applicable to fiscal years beginning on or after October 31, 2008 and establish standards for recognition, measurement, presentation and disclosure of goodwill subsequent to its initial recognition and of intangible assets by profit-oriented enterprises. Standards concerning goodwill are unchanged from the standards included in the previous section 3062. On January 1, 2009, the Corporation adopted this section. This new standard did not have a material impact on the Corporation’s consolidated financial statements.

3. Property and Equipment

The following table summarizes the Corporation’s oil and natural gas property and other equipment as at March 31, 2009 and December 31, 2008:

	<u>Gross Cost</u>	<u>Accumulated Depletion, Depreciation and Amortization</u>	<u>Net Book Value</u>
As at March 31, 2009:			
Oil and natural gas properties			
United States ⁽¹⁾	\$ 78,355,395	\$ 4,085,903	\$ 74,269,492
Canada	610,205	-	610,205
Yemen ⁽²⁾	49,188,947	34,071,330	15,117,617
Ethiopia.....	1,436,820	-	1,436,820
Oman.....	2,889,859	27,803	2,862,056
Other	212,593	-	212,593
Total oil and natural gas properties	<u>\$ 132,693,819</u>	<u>\$ 38,185,036</u>	<u>\$ 94,508,783</u>
Office equipment:			
Software	95,660	46,367	49,293
Hardware.....	127,530	41,582	85,948
Furniture & fixtures, vehicles and other	277,680	76,376	201,304
Total office equipment	<u>500,870</u>	<u>164,325</u>	<u>336,545</u>
Grand total	<u>\$ 133,194,689</u>	<u>\$ 38,349,361</u>	<u>\$ 94,845,328</u>

	<u>Gross Cost</u>	<u>Accumulated Depletion, Depreciation and Amortization</u>	<u>Net Book Value</u>
As at December 31, 2008:			
Oil and natural gas properties			
United States ⁽¹⁾	\$ 71,295,961	\$ 3,419,849	\$ 67,876,112
Canada	600,451	-	600,451
Yemen ⁽²⁾	47,316,330	34,071,330	13,245,000
Ethiopia.....	1,851,114	-	1,851,114
Oman.....	280,577	27,803	252,774
Other	170,141	-	170,141
Total oil and natural gas properties	<u>\$ 121,514,574</u>	<u>\$ 37,518,982</u>	<u>\$ 83,995,592</u>
Office equipment:			
Software	95,753	38,608	57,145
Hardware.....	127,590	35,220	92,370
Furniture & fixtures, vehicles and other	<u>272,403</u>	<u>64,025</u>	<u>208,378</u>
Total office equipment	<u>495,746</u>	<u>137,853</u>	<u>357,893</u>
Grand total	<u>\$ 122,010,320</u>	<u>\$ 37,656,835</u>	<u>\$ 84,353,485</u>

Notes:

- (1) The Corporation recognized inception to period-end abandonment costs pertaining to unproved properties totaling \$239,681 at March 31, 2009 and December 31, 2008, which was included in the amortization base for its United States proved properties.
- (2) At December 31, 2008, the Corporation recognized unproved property impairments totaling \$34,099,133 (comprising \$34,071,330 for Yemen and \$27,803 relating primarily to Qatar). See Note 3 "Property and Equipment – Unproved Property Impairment".

Cost Center Categorization

To date, the Corporation's oil and gas production has pertained solely to its properties in the United States. As at March 31, 2009 and as at December 31, 2008, the United States capitalized oil and natural gas properties classified as unproved and not subject to depletion totaled \$38,625,185 and \$45,055,464, respectively. As at March 31, 2009 and as at December 31, 2008, \$754,338 of capitalized costs pertaining to Yemen were classified as proved and the remaining Yemen costs were classified as unproved. Yemen proved property costs applied to a shut-in well that had no production during the first quarter of 2009 and all of 2008. As at March 31, 2009 and December 31, 2008, all capitalized costs associated with the Corporation's properties in Canada, Ethiopia, Oman and other miscellaneous international areas were categorized as unproved.

Capitalized General and Administrative Costs (“G&A”)

Capitalized G&A costs consist of wages, travel and other G&A costs directly associated with specific capital projects. Capitalized G&A costs for each country cost center for the three months ended March 31, 2009 and 2008 were as follows:

	Three Months Ended March 31,	
	2009	2008
Capitalized G&A Costs:		
United States	\$ 125,451	\$ 97,768
Canada	2,373	-
Yemen.....	27,242	173,882
Oman.....	125,511	-
Ethiopia.....	9,519	-
Other	11,488	-
Total.....	<u>\$ 301,584</u>	<u>\$ 271,650</u>

Unproved Property Impairment

There were no unproved property impairments for the three months ended March 31, 2009. On December 31, 2008, the Corporation assessed the carrying value of its unproved properties on Block 41 in Yemen and determined that such costs were partially impaired. At December 31, 2008, the Corporation recorded an unproved property impairment of \$34,071,330 covering its interests on Block 41 in Yemen. Management’s assessment of the fair value of its unproved property costs for Block 41 at December 31, 2008 was approximately \$12.5 million. The valuation of oil and gas reserves contains significant measurement uncertainty, including such factors as market conditions, credit markets, category of oil and natural gas reserves, the location of oil and natural gas reserves and assumptions used to calculate the volumes of commercially producible oil and natural gas reserves and the resulting cash flows from such production.

4. Loan Facilities and Letter of Credit

Loan Facilities

At March 31, 2009 and December 31, 2008, the Corporation had two credit lines in place totaling \$26,000,000 and had utilized \$24,989,070 of credit available at March 31, 2009 and \$19,184,134 of credit available at December 31, 2008. A discussion of each loan facility follows:

- *Northwestern Bank, Traverse City, Michigan:* USD\$11,000,000, secured by a lien on the Corporation’s New York assets in the amount of \$10,000,000 and a \$1,000,000 minimum deposit at Northwestern Bank. Terms of the credit line include an interest rate of prime less 1/4 percent. As at March 31, 2009, the Corporation had an outstanding amount of \$10,134,500 under the terms of this credit line, leaving \$865,500 of available unused credit. As at December 31, 2008, the Corporation had an outstanding amount of \$9,204,500 under the terms of this credit line, leaving \$1,795,500 of available unused credit.
- *TD Bank, Toronto, Canada:* USD\$15,000,000, secured by Canadian dollar equivalent of 115% of the borrowed amount. At March 31, 2009, the amount of restricted cash and cash equivalents by TD Bank was based on full utilization of the credit line coupled with a reserve for currency fluctuations. Terms of the credit line include an interest rate of prime plus 0.5%. As at March 31, 2009, the Corporation had an outstanding amount of \$14,854,570 under the terms of this credit line, all of which was secured by \$18,436,040 of restricted cash, leaving \$145,430 of available unused credit. As at December 31, 2008, the Corporation had an outstanding amount of \$9,979,634 under the terms of this credit line, leaving \$5,020,366 of available unused credit.

Letter of Credit - Yemen

Under terms of the Block 41 PSA, as operator the Corporation must post a letter of credit in favor of the Ministry of Minerals covering the gross amount of expected expenditures during each calendar year. During 2008, the Corporation initially posted a \$16,000,000 letter of credit secured by \$17,600,000 of restricted cash deposits at TD Bank. The letter of credit was subsequently reduced as documented details pertaining to the work program on Block 41 were presented to the Ministry of Minerals by the Corporation. At March 31, 2009, the balance of that letter of credit had been reduced to \$4,500,000, which was secured by restricted cash of \$5,584,960. See Note 12 “*Subsequent Events – Yemen Letter of Credit*”

Restricted Cash

At March 31, 2009 and December 31, 2008, the Corporation’s restricted cash balances consisted of the following:

	March 31, 2009	December 31, 2008
Restricted Cash:		
Northwestern Bank – loan facility	\$ 1,000,000	\$ 1,000,000
TD Bank – loan facility	18,436,040	21,328,244
TD Bank – Yemen letter of credit	5,584,960	11,375,064
Total	<u>\$ 25,021,000</u>	<u>\$ 33,703,308</u>

5. Shareholders’ Equity

(a) Authorized shares

The Corporation is authorized to issue an unlimited number of Common Shares with no par value and an unlimited number of Preferred Shares with no par value.

(b) Issued

The following table summarizes the components of share capital for the three months ended March 31, 2009 and the year ended December 31, 2008:

	Number of Shares Issued	Amount
Balance at December 31, 2007	45,698,323	\$ 109,725,936
Activity during first three months of 2008.....	-	-
Balance at March 31, 2008	45,698,323	109,725,936
Warrants exercised ⁽¹⁾	17,000	42,500
Warrants exercised ⁽¹⁾	-	11,269
Shares issued for Bought Deal ⁽²⁾	5,600,000	33,442,500
Issuance costs for Bought Deal ⁽²⁾	-	(2,228,832)
Repurchase of Common Shares ⁽³⁾	(1,000,000)	(2,734,114)
Balance at December 31, 2008	50,315,323	138,259,259
Issuance costs for Bought Deal ⁽²⁾	-	(280)
Balance at March 31, 2009	<u>50,315,323</u>	<u>\$ 138,258,979</u>

Notes:

- (1) Warrants covering 17,000 Common Shares at an exercise price of \$2.50 per share and a term of 18 months from the date of closing were issued in connection with a private placement completed during 2007. All of the aforementioned warrants were exercised during June 2008.
- (2) On August 25, 2008, the Corporation sold 5,600,000 Common Shares at a price of \$5.97 (CDN\$6.25) per common share for gross proceeds of \$33,442,500 (CDN\$35,000,000). Terms included an Underwriter’s

over-allotment option of 15%, or 840,000 Common Shares, exercisable within thirty days of the closing date of the transaction. The over-allotment option was not exercised by the Underwriters.

- (3) Effective October 1, 2008, the Corporation obtained approval of a Notice of Intention to commence a normal course issuer bid through the facilities of the Toronto Stock Exchange, permitting the Corporation to repurchase, for cancellation, up to 2,000,000 of its Common Shares between October 1, 2008 and September 30, 2009. Prior to commencement of the Notice of Intention, the Corporation's average price per share of Common Shares issued was \$2.75 per Common Share. As of December 31, 2008, the Corporation had repurchased 1,000,000 of its Common Shares through this facility at an average price of \$0.69 per Common Share. There were no shares repurchased during the period ended March 31, 2009.

(c) Stock Options

The following table summarizes stock option activity for the three months ended March 31, 2009 and the year ended December 31, 2008:

	As at March 31, 2009		As at December 31, 2008	
	Number of Options	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price
Stock Options				
Outstanding:				
Beginning of period.....	3,317,449	\$ 2.60	2,565,632	\$ 2.31
Granted.....	-	\$ -	977,817	\$ 3.78
Exercised.....	-	\$ -	-	-
Forfeited.....	(162,698)	\$ 4.00	(226,000)	\$ 4.33
End of period.....	3,154,751	\$ 2.53	3,317,449	\$ 2.60
Exercisable at period-end.	1,984,476	\$ 1.76	1,836,166	\$ 1.81

The following table summarizes information about stock options outstanding at March 31, 2009 and December 31, 2008:

<u>Exercise Price</u>	<u>Number of Options Outstanding</u>	<u>Number of Options Exercisable</u>	<u>Black-Scholes Option Pricing Model Valuation</u>	<u>Weighted Average Remaining Contractual Life (in years)</u>
As at March 31, 2009:				
\$ 0.85	272,619	136,310	\$ 100,883	4.70
\$ 1.00	856,000	856,000	557,768	6.63
\$ 2.00	347,500	314,167	327,451	2.69
\$ 2.50	621,132	547,999	907,687	6.60
\$ 4.00	845,000	130,000	1,138,385	8.85
\$ 5.60	50,000	-	68,560	9.38
\$ 6.10	162,500	-	325,957	9.20
Total	<u>3,154,751</u>	<u>1,984,476</u>	<u>\$ 3,426,691</u>	<u>6.80</u>
As at December 31, 2008:				
\$ 0.85	315,317	-	\$ 29,206	4.95
\$ 1.00	856,000	856,000	557,768	6.88
\$ 2.00	347,500	314,167	320,576	2.94
\$ 2.50	621,132	547,999	896,742	6.84
\$ 4.00	865,000	118,000	1,003,418	9.10
\$ 5.34	100,000	-	65,301	9.67
\$ 5.60	50,000	-	42,850	9.63
\$ 6.10	162,500	-	220,181	9.45
Total	<u>3,317,449</u>	<u>1,836,166</u>	<u>\$ 3,136,042</u>	<u>7.11</u>

(d) Warrants

There were no outstanding warrants during the three months ended March 31, 2009. The following table summarizes warrant activity for the year ended December 31, 2008:

	<u>Year Ended December 31, 2008</u>	
	<u>Number of Shares</u>	<u>Weighted Average Exercise Price</u>
Warrants Outstanding:		
Beginning of year	17,000	\$ 2.50
Granted	-	-
Exercised	(17,000)	2.50
Expired	-	-
End of year	-	\$ 0.00
Exercisable at year-end..	-	\$ 0.00

(e) Contributed Surplus

The following table summarizes contributed surplus for the three months ended March 31, 2009 and the year ended December 31, 2008:

	Three Months Ended March 31, 2009	Year Ended December 31, 2008
Contributed surplus:		
Balance, beginning of period	\$ 5,401,361	\$ 1,512,133
Valuation of re-purchase of Common Shares	-	2,042,710
Amortization of stock options granted	367,798	1,846,518
Balance, end of period	<u>\$ 5,769,159</u>	<u>\$ 5,401,361</u>

(f) Stock Based Compensation

Stock based compensation for the three months ended March 31, 2009 and 2008, respectively, were comprised of the following:

	Three Months Ended March 31, 2009	2008
Stock Based Compensation:		
Stock option amortization	\$ 367,798	\$ 309,284
Total stock based compensation.....	<u>\$ 367,798</u>	<u>\$ 309,284</u>

6. Commitments and Contingencies

Yemen

In accordance with the Farm-in Agreement with the Oil and Gas Mine Company dated September 10, 2007, the Corporation is obligated to pay the Oil and Gas Mine Company \$3,000,000 upon a Declaration of Commerciality, which is defined as “the act of approval by the Ministry of Minerals on the behalf of the Republic of Yemen for an operator to develop a Commercial Discovery under an existing production sharing agreement.” The \$3,000,000 payment will only be incurred in the event the Corporation makes a commercial oil or natural gas discovery on Block 41 and the Ministry of Minerals grants a license to commercially produce such discovery. Due to the contingent nature of this item, it is not reflected in the Corporation’s Balance Sheet at March 31, 2009.

Oman – Block 55 Exploration and Production Sharing Agreement (“EPSA”)

On January 26, 2009, the Corporation was awarded a 100% working interest in Block 55, an onshore oil and natural gas concession in Oman. In management’s opinion, Block 55 is prospective for commercial oil and natural gas exploitation. Exploration plans during the initial three year exploration program include acquiring 800 kilometers of seismic data, reprocessing 4,133 kilometers of existing seismic data and a drilling program covering a minimum of four initial exploratory wells designed to exploit Block 55’s oil and natural gas potential.

Terms of the EPSA include an initial bonus payment of \$2,000,000 and a commitment to spend a minimum of \$25,500,000 over an initial three-year exploration period comprising the following items:

- 3D seismic: acquire 300 square kilometers; reprocess 133 square kilometers
- 2D seismic: acquire 500 square kilometers, reprocess 4,000 square kilometers
- Drill four wells

At the Corporation's option, the initial exploration period can be extended for an additional three year period provided the Corporation commits to spend \$28,500,000 comprising the following items:

- Acquire 600 square kilometers of 3D seismic or 500 square kilometers of 2D seismic
- Drill three wells

Commercial crude oil production carries a contractual term of 20 years and will be allocated as follows:

- 40% of crude oil production is designated for cost recovery.
- 60% of crude oil production is designated as profit oil and will be allocated as follows:
 - Up to 10,000 bbls/d - 80% government of Oman; 20% Operator
 - 10,000 to 20,000 bbls/d - 82.5% government of Oman; 17.5% Operator
 - Over 20,000 bbls/d - 83.5% government of Oman; 16.5% Operator

The Corporation is obligated to pay income taxes to the government of Oman. However, under terms of the Block 55 EPSA, the government of Oman undertakes to pay such taxes on behalf of the Corporation from the government of Oman's share of crude oil and/or natural gas.

The Corporation is the official operator of Block 55 and is considering bringing in industry partners, raising additional capital, or a combination of both to fund the exploitation of this concession. Leaving aside the \$2,000,000 bonus payment, the Corporation does not expect to spend a significant amount of capital towards this concession until 2010 or later.

Bakken Shale Drilling Commitment

The Corporation entered into an agreement with an unrelated privately held Canadian company on August 28, 2008, whereby the Corporation agreed to pay 100% of the costs to drill a minimum of two horizontal wells in the Bakken shale in order to earn a 50% working interest in acreage controlled by the unrelated private company. The agreement was further amended on December 19, 2008, whereby the Corporation agreed to advance to the unrelated private company CDN\$2,712,000 prior to September 1, 2009 to drill the first earning well. Should the Corporation fail to do so, the Corporation must pay the unrelated private company liquidating damages of CDN\$2,000,000 and forfeit the Corporation's rights under the agreement. In addition, the unrelated private company shall then acquire the Corporation's other Bakken shale leasehold (purchased at the October 6, 2008 Saskatchewan Crown land sale and from Spartan on November 9, 2008) for CDN\$563,832. Furthermore, the unrelated private company is indebted to the Corporation in the amount of CDN\$439,205, as evidenced by a promissory note dated October, 6, 2008. The unrelated private company shall be entitled to offset the full amount that it may owe the Corporation should the Corporation fail to fund the first earning well and pay the liquidated damage amount outlined above.

New York – Trenton-Black River Well Units

In June 2005, a new integration statute was enacted by the State of New York whereby leasehold interest owners could elect to participate in the drilling of a well by choosing one of the following options:

- 1) Integrated non-participating owner – leasehold owner elects to not pay their proportionate share of costs up-front. The leasehold owner participates in their proportionate share after payout of a non-consent penalty plus costs.
- 2) Integrated participating owner – leasehold owner elects to pay their proportionate share of costs up-front.
- 3) Integrated royalty owner – leasehold interest owner elects to receive a proportionate 12.5% royalty interest.

During 2006, the Department of Environmental Conservation classified the Corporation's interest in several wells drilled prior to the statute change, and by way of public hearing, as an integrated non-participating owner. As a result, the Corporation was charged a non-consent penalty on its pro-rata share of costs to drill and complete various wells by Fortuna Energy Inc., the operator. The Corporation believes its interest in the subject wells should have been classified as an integrated participating owner upon payment of its pro-rata share of costs, effectively negating the non-consent penalty the operator could charge prior to disbursing the Corporation's pro-rata share of profits. The Corporation formally appealed the Department of Environmental Conservation's ruling, and, if successful, will require the non-consent penalty withheld by the operator to be disbursed to the Corporation. As a result, there is no anticipated effect on the Corporation's established working interest. As at March 31, 2009, the outcome of the Corporation's appeal was not determinable.

As at March 31, 2009, the Corporation was classified as an integrated non-participating owner in 7 gross (0.10 net) wells, including 3 gross (0.06 net) for which the non-consent penalty had been paid out.

Office leases

At March 31, 2009, the Corporation had the following offices:

- Traverse City, Michigan – office lease agreement effective April 1, 2007 with a two year term and monthly lease payments of \$4,375.
- Houston, Texas – office lease agreement effective November 26, 2008 with a five year term and monthly lease payments of \$6,347.
- Sana, Yemen - office lease agreement effective November 1, 2007 with a two year term and monthly lease payments of \$5,900.
- Abu Dhabi, United Arab Emirates: office lease agreement effective December 15, 2008 with a one year term and annual lease payment of \$57,183.
- Toronto, Canada - The Corporation's office in Toronto, Canada is owned by the Executive Chairman and is utilized at no charge to the Corporation. See Note 8 "Related Party Transactions".

The Corporation's future commitments are summarized in the following table:

	Payments Due by Period				
	Total	Less than 1 Year	1 – 3 Years	4 – 5 Years	After 5 Years
Future Commitments:					
Accounts payable ...	\$ 11,307,155	\$ 11,307,155	\$ -	\$ -	\$ -
Line of credit ⁽¹⁾	24,989,070	24,989,070			
Long-term debt.....	31,625	15,649	15,976		
Operating leases'	501,000	216,000	152,000	133,000	
Purchase obligations ⁽²⁾	2,171,000	2,171,000	-	-	-
Other long-term obligations.....	25,500,000	-	25,500,000	-	-
Total	\$ 64,499,850	\$ 38,698,874	\$ 25,667,976	\$ 133,000	\$ -

Notes:

(1) The line of credit is secured by restricted cash, which will be used to pay off the line of credit. See Note 4 "Loan Facilities and Letter of Credit".

(2) \$2,171,000 is the USD equivalent of CDN\$2,712,000 at March 31, 2009.

Arbitration – Pinpoint Drilling and Directional Services LLC

On November 5, 2008, the Corporation was notified by its contract operator that Pinpoint Drilling and Directional Services LLC (“Pinpoint”) had served a Notice of Arbitration covering invoices totaling \$1,158,550 for drilling services performed by Pinpoint on the Corporation’s Highway 706 project in Pennsylvania during 2008. At March 31, 2009 and December 31, 2008, the Corporation had capitalized the entire disputed amount including \$545,909 paid near the time the Notice of Arbitration was filed and \$612,641 which the Corporation has asserted is invalid due to negligent performance by Pinpoint, which remained unpaid at year-end. The arbitration will take place in 2009.

Drilling services performed by Pinpoint on Highway 706 to date has been in accordance with a drilling contract dated May 16, 2008 between Pinpoint and the Corporation’s contract operator for a term of one year. Under terms of the Contract, the Corporation is subject to a stand-by day rate of \$14,800 per day. On February 17, 2009, the Corporation, through its contract operator, informed Pinpoint that the Corporation’s Board of Directors had approved terminating the drilling contract upon completion of drilling the Hardic 2H. Pinpoint completed drilling the Hardic 2H on March 18, 2009.

7. Financial Instruments

Risk Management

The Corporation, as part of its operations, enters into agreements which include financial instruments. The Corporation does not utilize derivative instruments to manage various types of risks. The Corporation is exposed to the following risks related to financial assets and liabilities:

Liquidity Risk

Liquidity risk is the risk that the Corporation will not be able to meet its financial obligations as they become due. Liquidity describes a Corporation’s ability to access cash. Companies operating in the upstream oil and gas industry require sufficient cash in order to fund capital programs necessary to explore, develop and produce oil and natural gas, and to repay debt. The Corporation actively monitors its cash requirements to ensure it has sufficient available funds to meet current and foreseeable financial requirements at a reasonable cost. The Corporation prepares annual capital expenditure budgets, which are regularly monitored and updated as warranted. The Corporation also utilizes authorizations for expenditures to further manage capital expenditures.

At March 31, 2009, the Corporation had negative working capital of \$21,060,837. However, when taking into account restricted cash securing the Corporation’s loan facilities and line of credit, working capital would have been \$3,960,163. See Note 4 “*Loan Facilities and Letter of Credit*”. In addition, the Corporation has commitments under existing agreements as described in Note 6 “*Commitments and Contingencies*”. Given the Corporation’s working capital position inclusive of restrictive cash, management assesses liquidity risk to be moderately high.

Commodity Price Risk

The Corporation sells its current oil and natural gas production at market rates and does not have any commodity based derivatives. Fluctuations in oil and natural gas prices can materially impact the current and future profitability of the Corporation.

Interest Rate Risk

The Corporation maintains its short-term deposits in instruments that are redeemable within three months without penalty, and thereby is exposed to interest rate fluctuations. The Corporation does not utilize any interest rate based derivatives. The Corporation analyzes interest rate risk by calculating the effect of percent changes in the interest earned on its cash, cash equivalents and restricted cash. For example, a 5% plus or minus change in the 0.34% average interest rate earned during the first three months of 2009 based on the average of the Corporation’s cash, cash equivalents and restricted cash balances as at March 31, 2009 and December 31, 2008 would have resulted in a change in the net loss

for the first three months of 2009 of approximately \$2,000. In addition the Corporation has \$24,989,070 of variable interest rate debt and a 5% plus or minus change in the average interest rate charged during the first three months of 2009 based on the average of the Corporation's debt balances as at March 31, 2009 and December 31, 2008 would have resulted in a change in the net loss for the first three months of 2009 of approximately \$10,000.

Foreign Currency Risk

The Corporation is exposed to risks arising from fluctuations in foreign currency exchange rates, primarily between Canadian and U.S. dollars. The Corporation does not utilize any foreign currency based derivatives. Since its Initial Public Offering in 2007, the Corporation has held the majority of its short term investments in Canadian dollars. This strategy was effective until the exchange rate for Canadian to US dollars declined as much as 30% in favor of the US Dollar during October 2008. Management believes the drop in the exchange rate is a short term phenomenon. In order to manage this risk and to defer the realization of any resulting currency loss from converting Canadian dollars to US dollars, the Corporation has loan facilities in US Dollars totaling \$26,000,000 in place. At March 31, 2009, the outstanding balance of such loan facilities was \$24,989,070. See Note 4 "*Loan Facilities and Line of Credit*".

The Corporation regularly analyzes foreign currency risk between Canadian dollars and US dollars by calculating the effect of percent changes in the foreign currency exchange rates against period end cash, cash equivalents and restricted cash balances. For example, applying a 5% plus or minus change in the 1.2613 conversion rate of Canadian to US dollars at March 31, 2009 against the Corporation's Canadian denominated cash, cash equivalents and restricted cash balances at March 31, 2009 would have affected the value of such balances by approximately \$2,031,000. Substantially all of the Corporation's business operations are conducted in either US dollars or Canadian dollars.

Credit Risk

Credit risk arises from the possibility that the entities which the Corporation has receivables from or has invested in may experience difficulties and be unable to fulfill their obligations. The Corporation mitigates this risk of credit loss by taking a security interest in underlying assets of the investment. Accounts receivable are assessed on a regular basis by management to ensure the credit worthiness of debtors and the ultimate collection thereof. The Corporation's accounts receivable balances consist of receivables pertaining to its natural gas and oil production in New York and West Virginia and for pro-rata share of costs of operations from its joint interest partners in New York, West Virginia, and Yemen, all of which individually may comprise in excess of 10% of the Corporation's overall accounts receivable balances. The Corporation's maximum credit exposure is approximately two months of oil and natural gas production for revenue receivables. The Corporation has the right to offset the amount owed by its joint interest partners against any revenue it disburses to them. As at March 31, 2009 and December 31, 2008, there are no provisions for doubtful accounts pertaining to accounts receivable balances for its oil and natural gas revenues or its joint interest partners. The maximum credit risk that the Corporation is exposed to is the current carrying value of its accounts receivable.

The Corporation had outstanding joint interest receivables from Oil and Gas Mine Company of \$6,502,597 and \$5,590,881 at March 31, 2009 and December 31, 2008, respectively, for their pro-rata share of costs pertaining to Block 41 in Yemen. As at March 31, 2009, \$5,590,881 of the balance due from Oil and Gas Mine Company was in default. See Note 12 "*Subsequent Events – Oil and Gas Mine Company Default*".

Fair Value

The Corporation's carrying value of cash and cash equivalents, restricted cash, accounts receivable, notes receivable, accounts payable and accrued liabilities, line of credit, and notes payable approximate their fair value due to the immediate or short-term maturity of these instruments.

8. Related Party Transactions

The Corporation reports its related party transactions on an exchange amount basis. A summary of such transactions follows:

Executive Chairman

The Corporation utilizes administrative services provided by 706147 Ontario, Inc., a company owned by the Executive Chairman's spouse. In addition, the Corporation shares office space with Capital Z Corporation, a company owned by the Executive Chairman, at no charge. Related party transactions with the Corporation's Executive Chairman were conducted in Canadian dollars and the exchange rate differences were immaterial. A summary of related party transactions between the Corporation and its Executive Chairman follows:

	Three Months Ended March 31, 2009	Year Ended December 31, 2008
706147 Ontario, Inc.:		
Administrative services.....	\$ 12,113	\$ 56,859
Accounts payable.....	\$ -	\$ -

Director

On February 7, 2007, the Corporation obtained a 25% undivided participating interest in Gastem Inc.'s undeveloped oil and natural gas interests covering approximately 1,184,000 acres (249,000 net) in the St. Lawrence Lowlands and in the Gaspé Peninsula of Quebec. Under terms of the agreement, the Corporation may elect to participate on a well-by-well basis with a 25% working interest in any current or future properties Gastem Inc. may acquire in Quebec. In return, the Corporation granted Gastem Inc. the right to participate for 25% of the Corporation's interest in certain future wells to be drilled in the Corporation's Amber Bank project in West Virginia by spending up to \$1.05 million. The Corporation's carrying value of the portion of its Amber Bank project's leasehold attributable to Gastem Inc.'s participation was nominal. The agreement was consummated with the expectation that Raymond Savoie, Gastem Inc.'s President, would become a director of the Corporation. Mr. Savoie became a director of the Corporation on July 16, 2007. Related party transactions with Gastem Inc. were conducted in US dollars. A summary of related party transactions between the Corporation and Gastem Inc. follows:

	Three Months Ended March 31, 2009	Year Ended December 31, 2008
Gastem Inc.:		
Accounts receivable.....	\$ 322	\$ 21
Joint venture costs.....	\$ 17,299	\$ 76,876
Joint venture revenues.....	\$ 55,722	\$ 309,917
Accounts payable.....	\$ -	\$ 14,995

Director and former President and CEO

Austin Exploration LLC, a company owned by a Director who is also the former President and CEO of the Corporation, is also a participant in the Corporation's Empire project. Western Land Services Inc., a company owned by the same person, provides oil and natural gas lease brokerage services to the Corporation in accordance with a Project Services Agreement between Western Land Services and the Corporation. Under terms of the Project Services Agreement, Western Land Services agreed to provide services to the Corporation at its lowest corporate rates less 10%. Substantially all of the service amounts provided by Western Land Services are capitalized with oil and natural gas properties. Related party transactions with the President of Epsilon Energy USA, Inc. were conducted in US dollars. A

summary of related party transactions between the Corporation and its Director who is also the former President and CEO follows:

	Three Months Ended March 31, 2009	Year Ended December 31, 2008
Austin Exploration LLC:		
Accounts receivable.....	\$ 22,067	\$ 109,652
Joint venture costs.....	\$ 165,958	\$ 2,654,594
Joint venture revenues	\$ 233,917	\$ 902,291
Accounts payable.....	\$ -	\$ 75,115
Western Land Services:		
Lease brokerage services	\$ 132,826	\$ 1,667,898
Accounts payable.....	\$ 34,392	\$ 138,819

9. Changes in non-cash balances related to cash flows

Non-cash changes to the *Changes in Non-cash Balances Related to Operations* component of cash flows used in operations for the three months ended March 31, 2009 and 2008, respectively, were comprised of the following:

	Three Months Ended March 31, 2009	2008
Changes to Non-Cash balances:		
Accounts receivable.....	\$ (359,834)	\$ (659,462)
Other current assets	51,872	123,549
Accounts payable, accrued and other liabilities...	(6,194,838)	(416,157)
Total changes to non-cash balances related to operations	<u>\$ (6,502,800)</u>	<u>\$ (952,070)</u>

Non-cash changes relating to the *Additions to Oil and Natural Gas Properties* component of cash used in investing activities for the three months ended March 31, 2009 and 2008, respectively, were comprised of the following:

	Three Months Ended March 31, 2009	2008
Additions to Oil and Natural Gas properties:		
Total additions for the period	\$ 11,179,245	\$ 8,342,810
Non-cash changes:		
Asset retirement obligations	(15,115)	(61,752)
Cost of assets sold.....	-	126,480
Accrued liabilities.....	(2,864,467)	(1,573,410)
Total cash additions to oil and natural gas properties	<u>\$ 8,299,663</u>	<u>\$ 6,834,128</u>

10. Reportable Geographical Segments

As at March 31, 2009, the Corporation's operations by geographical area included the United States, Canada, Yemen, Ethiopia, and Oman. See Note 3 "Property and Equipment". Summarized reportable geographical segment data follows:

	Three Months Ended March 31,	
	2009	2008
Reportable Segments:		
United States:		
Revenues	\$ 1,707,517	\$ 1,536,587
Operating costs.....	\$ 467,249	\$ 281,227
Capital expenditures.....	\$ 7,059,435	\$ 7,708,352
Canada:		
Revenues	\$ -	\$ -
Operating costs.....	\$ -	\$ -
Capital expenditures.....	\$ 9,754	\$ -
Yemen:		
Revenues	\$ -	\$ -
Operating costs.....	\$ -	\$ -
Capital expenditures.....	\$ 1,872,617	\$ 634,458
Ethiopia:		
Revenues	\$ -	\$ -
Operating costs.....	\$ -	\$ -
Capital expenditures ⁽¹⁾	\$ (414,294)	\$ -
Oman:		
Revenues	\$ -	\$ -
Operating costs.....	\$ -	\$ -
Capital expenditures.....	\$ 2,630,557	\$ -

Notes:

- (1) The negative amount for the three months ended March 31, 2009 includes an accrual adjustment for prior period costs.

11. Capital Disclosures

There were no material changes in the Corporation's approach to capital management or externally imposed capital requirements during the first three months of 2009 or during 2008.

12. Subsequent Events

Oil and Gas Mine Company Default

As at March 31, 2009, Oil and Gas Mine Company, a non-operated joint interest owner in Block 41, owed the Corporation \$6,502,597, which covered their pro-rata share of costs pertaining to Block 41 in Yemen as of that date. Of that amount, \$5,590,881 was in default. On April 20, 2009, Oil and Gas Mine Company paid the Corporation \$2,000,000 and verbally agreed to pay the remaining amount in default within thirty days.

TD Bank Loan Facility

On April 8, 2009, the Corporation utilized \$5,000,000 of its restricted cash to reduce its line of credit with TD Bank by the same amount.

Yemen Letter of Credit

On April 14, 2009, the Ministry of Minerals reduced the Corporation's line of credit in Yemen by \$4,188,000, leaving a balance outstanding of \$312,000 pertaining to the Yemen line of credit.

Ethiopia Production Sharing Agreement

On May 14, 2009, the Corporation announced that it had signed a Production Sharing Agreement ("PSA") with the Ministry of Mines and Energy (the "Ministry") in Democratic Republic of Ethiopia. The PSA covers an area of 79,345 square kilometers in northwest Ethiopia. Terms of the PSA include an initial three-year exploration period that includes a minimum financial commitment of \$3,000,000 to drill one exploratory well and to acquire a minimum of 200 kilometers of 2D seismic. In the event the Company makes a commercial discovery, the initial percentage split of profit oil and/or gas will be 80% for Epsilon and 20% for the Ministry.