



**Management's Discussion and Analysis
("MD&A")**

**For the Years Ended
December 31, 2009 and 2008**

Dated March 25, 2010

***Epsilon Energy Ltd.
150 Jardin Drive, Suite 9
Concord, ON, Canada L4K 3P9***

***(905) 738-7877
www.epsilonenergy ltd.com***

EPSILON ENERGY LTD.
MD&A FOR THE YEAR ENDED DECEMBER 31, 2009

EPSILON ENERGY LTD.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Overview

This Management's Discussion and Analysis ("MD&A") is intended to assist in the understanding of trends and significant changes in or results of operations and the financial condition for the years presented. The MD&A has been prepared by management as at March 25, 2010 in accordance with Canadian Generally Accepted Accounting Principles ("GAAP") and should be read in conjunction with the audited consolidated financial statements as at December 31, 2009 and 2008, and for the years then ended, respectively, together with accompanying notes, the Statement of Reserves Data and Other Oil and Gas Information on December 31, 2009, the Annual Information Form ("AIF") dated March 25, 2010 and Form 51-101 F3 "Report of Management and Directors on Reserves Data and Other Information" dated March 25, 2010. These documents and additional information about Epsilon Energy Ltd. (the "Corporation") are available on SEDAR at www.sedar.com.

Unless otherwise indicated, all dollar values in this MD&A are, with the exception of per unit amounts, expressed in thousands of U.S. dollars.

Cautionary Statement Regarding Forward Looking Information and Statements

Certain statements contained in this report constitute forward-looking statements. The use of any of the words "anticipate", "continue", "estimate", "expect", "may", "will", "project", "should", "believe" and similar expressions and statements relating to matters that are not historical facts constitute "forward looking information" within the meaning of applicable Canadian securities legislation. These statements involve known and unknown risks, uncertainties and other factors that may cause actual results or events to differ materially from those anticipated. Such forward-looking statements are based on reasonable assumptions but no assurance can be given that these expectations will prove to be correct and the forward-looking statements included in this report should not be unduly relied upon. These statements are made only as of the date of this report.

In particular, this report contains forward-looking statements including, but not limited to, the following:

- oil and natural gas production rates;
- commodity prices for crude oil or natural gas;
- supply and demand for oil and natural gas;
- the estimated quantity of oil and natural gas reserves, including reserve life;
- capital expenditure programs;
- future exploration, development and production costs;
- timing of drilling plans;
- planned construction and expansion of facilities;
- plans for and results of exploration and development activities;
- expectations regarding the Corporation's ability to raise capital and to continually add to oil and natural gas reserves through acquisitions, exploration and development; and
- treatment under governmental regulatory regimes and tax laws.

The Corporation's actual results could differ materially from those anticipated in these forward-looking statements as a result of the risk factors set forth below and elsewhere in this report:

- general economic, political, market and business conditions;
- risks inherent in oil and natural gas operations;
- uncertainties associated with estimating oil and natural gas reserves;
- competition for capital, acquisitions of reserves, undeveloped lands, drilling equipment and skilled personnel;
- geological, technical, drilling and processing problems;

EPSILON ENERGY LTD.
MD&A FOR THE YEAR ENDED DECEMBER 31, 2009

- incorrect assessments of the value of acquisitions;
- the availability of capital on acceptable terms;
- volatility in market prices for oil and natural gas;
- reliance on key operational and management personnel;
- actions by governmental authorities, including regulatory, environmental and taxation policies;
- fluctuations in foreign exchange, interest rates and stock market volatility; and
- other risk factors discussed under “*Risk Factors*” within the Corporation’s AIF dated March 25, 2010.

These factors are not all inclusive. Except as required under applicable securities laws, the Corporation undertakes no obligation to update or revise any forward-looking statements.

Corporate Overview

The Corporation is engaged in the acquisition, exploration, development and production of natural gas reserves targeting the Marcellus shale. The Corporation also has participating interests and production sharing agreements in other natural gas and oil plays within North America, the Middle East and Africa. Established in 2005, the Corporation has been a producer of natural gas and oil since 2006. From early 2007 until mid-2009, the Corporation also had projects and operations in Yemen and Oman, as part of its then strategy of targeting high potential oil and gas plays in the Middle East. The Corporation’s ongoing business strategy involves focused targeting of natural gas and oil properties within the United States and Canada, as well as the high potential oil & gas properties in Africa with the goal of converting its leasehold interests into proven natural gas and oil reserves, followed by production that optimizes cash flow and return on investment. The common shares of the Corporation trade on The Toronto Stock Exchange under the symbol “EPS”. Also refer to “*Risk Factors*” in the Corporation’s Annual Information Form dated March 25, 2010.

Selected Annual Information

Selected financial data covering the years ended December 31, 2009, 2008 and 2007, respectively, are as follows (amounts rounded to thousands, except per share amounts):

	<u>2009</u>	<u>2008</u>	<u>2007</u>
Revenues	\$ 5,439	\$ 8,300	\$ 3,670
Cost of operations.....	28,194	45,482	6,745
Operating loss.....	(22,755)	(37,182)	(3,075)
Other income (expense)	2,526	6,094	851
Net loss before income taxes.....	(20,229)	(31,088)	(2,224)
Future income tax expense.....	-	2,600	-
Net loss.....	<u>\$ (20,229)</u>	<u>\$ (33,688)</u>	<u>\$ (2,224)</u>
Basic and diluted net loss share.....	\$ (0.40)	\$ (0.71)	\$ (0.08)
Weighted average number of shares outstanding.....	50,325,998	47,504,000	27,148,000
Dividends per share	\$ -	\$ -	\$ -
Net cash provided by or (used in) operating activities	\$ (554)	\$ (6,596)	\$ 1,116
Net cash provided by or (used in) investing activities	\$ 23,600	\$ (72,945)	\$ (44,017)
Net cash provided by (used in) financing activities	\$ (19,171)	\$ 49,768	\$ 83,408
Total assets	\$ 84,381	\$ 134,070	\$ 117,323
Total long term financial liabilities	\$ -	\$ 19	\$ -

EPSILON ENERGY LTD.
MD&A FOR THE YEAR ENDED DECEMBER 31, 2009

Recent Events

Sale of Epsilon Energy Yemen Ltd.

On February 2, 2010, Epsilon Energy International Ltd., a wholly-owned subsidiary of the Corporation, and the sole shareholder of Epsilon Energy Yemen Ltd. (“**Epsilon Yemen**”) entered into an agreement for the sale of all of the issued and outstanding shares of Epsilon Yemen to an unrelated third party purchaser for US\$0.1 million, pending the grant of an unconditional extension of Epsilon Yemen’s Block 41 interests. The agreement calls for Epsilon Energy International Ltd. to receive 20% of proceeds from any subsequent sale of all or any part of the included 57.14% working interest in Block 41 or, in the event that commerciality is declared, 25% of the cost recovery pool monies received from the government of Yemen, in either case, the total amount not to exceed US\$5 million. There can be no assurance that the unconditional extension of the Block 41 interests will be obtained.

Farmout Agreement with Chesapeake

On February 3, 2010, the Corporation closed a Farmout Agreement with Chesapeake Energy Corporation (“**Chesapeake**”). At closing Chesapeake paid to the joint venture \$5 million in cash and will earn a 50% interest in the Corporation’s upstream Marcellus Shale assets by paying a further \$95 million over time by carrying the first \$95 million of the Corporation’s 50% share of leasehold, drilling, completing, equipping and gathering costs attributable to the prospect.

Resignation of Director

Mr. John K. Wilson, a director of the Corporation, resigned effective January 20, 2010.

Overall Performance

During 2009, the Corporation generated a net loss of \$20,229 as compared to a \$33,688 net loss for 2008. At December 31, 2009, the Corporation had surplus working capital (inclusive of restricted cash) of \$14,222, as compared to \$15,862 of surplus working capital (inclusive of restricted cash) at December 31, 2008.

Operational Outlook and Property Overview

A summary of the Corporation’s projects by country are as follows:

United States

Pennsylvania Marcellus Shale

As of December 31, 2009, the Corporation had approximately 11,500 net leasehold acres in Pennsylvania where the Corporation as an operator, held a 100% working interest. To date, the Corporation has drilled eight wells (5 horizontal, 3 vertical) in the Marcellus shale on its Highway 706 project in northeastern Pennsylvania. All eight wells are currently producing at a combined rate of 10 Mmcf per day, with two compressors in operation with total capacity of 12-14 Mmcf per day.

On February 3, 2010, a joint venture was formed with Chesapeake which aims to develop the Pennsylvania Marcellus acreage. Chesapeake is now the operator and will earn a 50% interest in the Corporation’s upstream Marcellus Shale assets by carrying the first \$95,000 of the Corporation’s 50% share of leasehold, drilling, completing, equipping and gathering costs attributable to the prospect.

New York

In New York, where the Corporation holds an interest in approximately 30,200 gross (14,700 net) acres, the Corporation’s acreage is prospective for natural gas production in both the Marcellus shale, (shallow unconventional natural gas play) and the Trenton-Black River formation (deep conventional natural gas

EPSILON ENERGY LTD.
MD&A FOR THE YEAR ENDED DECEMBER 31, 2009

play). As of the date of this report the Corporation had prepared the location for and spudded four wells in New York.

NY Marcellus Shale

In NY Marcellus Shale, where the Corporation holds approximately 50% interest in the leasehold and is the operator, it continues to evaluate potential exploration, development and production opportunities in the Marcellus shale, including but not limited to, participating in competitor wells, developing its existing leasehold acreage and/or entering in joint ventures with other companies. As such, the Corporation has commenced the early stages of forming a large Marcellus shale project, including staking well locations, planning infrastructure and seeking regulatory approvals. Marcellus shale drilling permits utilizing larger hydro-fractures are currently on hold pending completion of a Supplemental Generic Environmental Impact Statement by the New York Department of Environmental Conservation.

NY Trenton-Black River

The Corporation is also focused on exploration of the prolific Trenton-Black River formation, a deep conventional natural gas reservoir target. The Corporation holds various non-operated working interests with multiple operators in well units from less than 1%, up to approximately 12%.

At December 31, 2009, net production from Trenton-Black River formation was approximately 0.5 Mmcf/d. Due to its current focus on the Marcellus shale in Pennsylvania and New York, the Corporation is not allocating a significant amount of capital to fund participation in drilling future wells targeting the Trenton-Black River formation in New York. See “*Commitments and Contingencies – New York – Trenton-Black River Well Units*”.

Ohio

The Bailey’s Mill project is located in Belmont and Monroe counties and consists of approximately 38,500 gross (8,400 net) leasehold acres, in which the Corporation holds a 25% non-operated working interest. Due to its current focus on the Marcellus shale in Pennsylvania and New York, the Corporation does not anticipate allocating a significant amount of funds to continue participating in drilling future wells on its Bailey’s Mill project.

West Virginia

On June 16, 2009, the Corporation sold all of its oil and natural gas properties in West Virginia to an unrelated third party for a net amount of \$12,932 and recognized a loss of \$7,143 on the transaction. Included in the transaction were 36,535 gross (14,717 net) leasehold acres, 112 gross (59.59 net) wells and a 63% interest in the Blue Jacket gathering system. The property sale represented approximately 55% of the Corporation’s North American proved oil and natural gas reserves at December 31, 2008, and approximately 50% of its daily natural gas production at the time of the sale. The Corporation has deployed the proceeds of the transaction primarily to further its development activities in the Marcellus shale in Pennsylvania.

Canada

Saskatchewan

On August 28, 2008, the Corporation entered into an agreement with a private Canadian company covering joint oil and natural gas exploration and development activities in a 63,360 gross acre Area of Mutual Interest (“**AMI**”) covering the Bakken oil play in southeast Saskatchewan province. The project lies within the favorable Saskatchewan province royalty area. The private Canadian company is the operator of the AMI. The Corporation agreed to pay 100% of the costs to drill a minimum of two horizontal wells in order to earn a 50% working interest in approximately 8,960 gross (7,800 net) acres controlled by the unrelated private company.

EPSILON ENERGY LTD.
MD&A FOR THE YEAR ENDED DECEMBER 31, 2009

On October 9, 2008, the Corporation acquired additional prospective Bakken oil play interests in approximately 31,370 gross (13,800 net) acres jointly with the same private Canadian company via a competitive bid at the Saskatchewan crown lease sale. In this acreage, the Corporation plans to drill one well on the Ceylon Project area and a second well in the Weyburn Project area in late 2010 after completion of seismic studies.

Drilling operations in the AMI commenced in August 2009 and are expected to cost approximately CDN\$2,400 for the first well. The first well, the Torquay, has been drilled horizontally, fractured and is currently in test production. The Corporation estimates it will spend a minimum amount of approximately \$5,000 on this project. During 2009, the Corporation paid \$2,214 for the cost to drill the first of the two aforementioned earning wells. The second well obligation of \$2,400 will be partially substituted for a 3D seismic program, which is expected to cost \$1,200. The remaining balance after the completion of 3D seismic program will be committed to the next well that is expected to be drilled in late 2010. See “*Commitments and Contingencies – Bakken Shale Drilling Commitment*”.

Quebec

The Corporation has an elective participating interest of up to 25% in a portion of Gastem Inc.’s (TSXV: GMR) leasehold acreage in the St. Lawrence Lowlands (covering Utica shale and Trenton-Black River targets) and in the Gaspe Peninsula (covering Silurian and Devonian targets). Within Gastem Inc.’s St. Lawrence Lowlands leasehold acreage, Forest Oil Corporation recently spent CDN\$10,000 to earn a 60% interest in what is now referred to as the Yamaska project. The Corporation elected not to participate on the first two exploratory wells drilled within the Yamaska project, while electing to participate in future operations with a 5% working interest.

Middle East - Yemen and Oman

During the year ending December 31, 2009 the Corporation revised its business strategy to focus on oil and gas exploration and development in North America. In November 2009 the Corporation withdrew from the Exploration and Production Sharing Agreement covering Block 55 in Oman, where it was the official operator and began to actively market its Yemen interests.

As such, as of December 31, 2009 the Corporation wrote off its assets in Oman as detailed below. The Corporation also booked an adjusting entry to write down its Yemen assets to their fair market value of \$100 and reclassified in its consolidated financial statements as assets held for sale.

Ethiopia – Northwest Area Study 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 (30,635 square miles) in northwest Ethiopia. Terms of the PSA include an initial three-year exploration period that includes a minimum financial commitment of \$3,000 to drill one exploratory well and to acquire a minimum of 200 kilometers of 2D seismic. In the event the Corporation makes a commercial discovery, the initial percentage split of profit oil and/or gas will be 80% for the Corporation and 20% for the Ministry.

RESULTS OF OPERATIONS

The following discussion encompasses the Corporation’s revenues and costs of operations. Unless noted otherwise, the discussion pertains to the Corporation’s Appalachian basin segment in the United States, as all other identified geographical operating segments were essentially in the start-up phase during the presented years and had no reportable revenues or operating costs during the presented years.

**EPSILON ENERGY LTD.
MD&A FOR THE YEAR ENDED DECEMBER 31, 2009**

TOTAL REVENUES

	Years Ended December 31,	
	2009	2008
Total Revenues	5,439	8,300
Net natural gas production (Mcf) ...	1,080,777	749,167
Average natural gas price (\$/Mcf) ..	5.02	9.30
End of year net production exit rate (Mcf/d).....	6,357	2,502
Net oil production (bbls)	81	11,992
Average oil price (\$/bbl)	120.64	86.98

Total revenues decreased by \$2,861 from \$8,300 in 2008 to \$5,439 in 2009 primarily due to:

- A 46% decrease in the average natural gas price received during 2009 as compared to 2008 accounting for \$4,759 of decrease that was partially offset by an increase in volume of 331,610 Mcf (\$3,084) in natural gas production in 2009.
- A \$1,033 reduction of oil revenues in 2009, as compared to 2008. The oil revenues were from West Virginia properties that the Corporation sold on June 16, 2009.
- A \$153 reduction in gas gathering fees from the Corporation's Blue Jacket project in West Virginia.

PROJECT OPERATING COSTS

	Years Ended December 31,	
	2009	2008
Project operating costs.....	1,340	1,792

Project operating costs consist of lease operating expenses necessary to extract gas and oil, including transporting it to a sales point and production taxes assessed by the state in which production occurs. Substantially all production taxes apply to the states of Ohio and West Virginia, where the production tax rate is a certain percentage of gross revenues. In New York and Pennsylvania, the Corporation's wells are exempt from production taxes.

Project operating costs decreased by \$452 from \$1,792 in 2008 to \$1,340 in 2009 primarily due to:

- A decrease of \$602 of lease operating expenses due to the sale of West Virginia property, which was partially offset by the addition of \$406 operating expenses after the commencement of operations at the Corporation's Highway 706 project in Pennsylvania and to a lesser extent the test production at Torquay well in Saskatchewan .
- A decrease of \$256 in production taxes and royalty expenses during 2009 as compared to 2008, due to 46% lower average natural gas prices and no production taxes during the second half of 2009.

IMPAIRMENT OF UNPROVED PROPERTIES

EPSILON ENERGY LTD.
MD&A FOR THE YEAR ENDED DECEMBER 31, 2009

	Years Ended December 31,	
	2009	2008
Impairment of unproved properties	18,784	34,099

During 2009 the Corporation recorded an unproved property impairment of \$17,861 pertaining to Block 41 in Yemen, writing down the value of the assets to the fair market value of \$100, and recorded an unproved property impairment of \$923 pertaining to Oman. During 2008, the Corporation recorded total unproved property impairments of \$34,099 after assessing the carrying value of its unproved properties on Block 41 in Yemen (\$34,071) and Qatar (\$28). The impairment in Yemen in 2008 reflected a write-down to the estimated fair value of the Corporation's unproved property costs for Block 41 in Yemen of approximately \$12.5 million at December 31, 2008.

DEPLETION, DEPRECIATION AND ACCRETION ("DD&A")

	Years Ended December 31,	
	2009	2008
Depletion, depreciation and accretion	3,458	2,071

In line with the Full Cost Accounting principle, the Corporation capitalizes all costs related to the exploration for and development of natural gas and crude oil reserves. The capitalized costs and future development costs are depleted on the unit-of-production method based on estimated proved reserves. Costs of significant unproved properties, net of impairments, are excluded from the depletion, depreciation and accretion calculation. See section "Full Cost Accounting" below.

The Depletion, Depreciation and Accretion ("DD&A") expense increased by \$1,387 from \$2,071 in 2008 to \$3,458 in 2009 primarily due to the change in depletion expense rate from \$2.38/Mcfe for the year ended December 31, 2008 to a rate of \$6.33/Mcfe for the first three quarters of 2009. The higher depletion expense was mainly due to the sale of proved and probable reserve in West Virginia and Pennsylvania during 2009, which reduced the Corporation's proved and probable reserves for purposes of depletion expense calculation. This increase was partially offset with a lower depletion expense rate of \$1.70/Mcfe for the fourth quarter with the availability of updated reserve data.

GENERAL AND ADMINISTRATIVE

	Years Ended December 31,	
	2009	2008
General and administrative....	4,611	7,519

General and Administrative ("G&A") consists of general corporate expenses such as compensation, legal fees, accounting fees, professional fees, consulting services, travel and other related corporate costs such as stock options granted.

The G&A expenses decreased by \$2,908 from \$7,519 in 2008 to \$4,611 in 2009 primarily due to a \$1,768 decrease in general corporate expenses as a result of cost containment measures that were implemented during the second half of 2009 and a reduction of \$1,140 in stock-option expense.

EPSILON ENERGY LTD.
MD&A FOR THE YEAR ENDED DECEMBER 31, 2009

GAIN ON SALE OF ASSETS

	Years Ended December 31,	
	2009	2008
Gain on sale of assets	2,751	5,013

During 2009, the Corporation recorded a net gain of \$2,751 reflecting \$7,142 loss (net of tax) from the sale of its oil and natural gas property interests in West Virginia offset by a gain of \$9,893 from the sale of non-core acres located in eastern Pennsylvania. A gain of \$5,013 was recorded during the year ended December 31, 2008, reflecting a gain on the sale of non-core unproved leasehold in the Appalachian basin.

INTEREST AND OTHER INCOME (EXPENSE)

	Years Ended December 31,	
	2009	2008
Interest and other income (expense) ...	(225)	1,081

The Corporation incurred net interest expense of \$225 during 2009 due to reduction of cash balances that were used for funding the Corporation's operations while during 2008 the Corporation earned net interest income of \$1,144. In addition, during 2008 the Corporation wrote off \$140 pertaining to unsuccessful start-up costs for a commodity trading company in the Middle East while receiving \$77 of operator overhead fees from the Block 41 joint venture in Yemen.

INCOME TAXES

	Years Ended December 31,	
	2009	2008
Future income tax (recovery) expense	-	2,600

Due to the volatile nature of oil and natural gas exploration, development, and production activities, there are numerous uncertainties with respect to projecting future revenues and operating costs, which are integral components of future net income projections. These uncertainties include such items as production levels, capital expenditure levels, oil and natural gas commodity prices, reserve estimates, and lease operating costs. Actual results may vary significantly from projected amounts.

For the year ended December 31, 2008 the Corporation recorded a future income tax expense of \$2,600. A future income tax recovery of \$2,600 in 2009 was included in the gain on sale of assets, representing the Corporation's recognition of deductible temporary differences (mainly pertaining to the sale of its oil and natural gas property interests in West Virginia) to the extent that they offset the taxable temporary differences and recording of a valuation allowance for any remaining deductible temporary differences. Future income tax assets were not booked as they were not assessed by the management to be more likely than not to be realized as assets.

Determination of the Corporation's income tax and other tax liabilities requires the interpretation of complex laws and regulations. All tax filings are subject to audit and potential reassessment after the lapse

**EPSILON ENERGY LTD.
MD&A FOR THE YEAR ENDED DECEMBER 31, 2009**

of considerable time. Accordingly, the actual income tax liability may differ from that estimated and recorded by the Corporation's management.

NET LOSS

	Years Ended December 31,	
	2009	2008
Net Loss.....	(20,229)	(33,688)
Basic and diluted loss per share	(0.40)	(0.71)

The net loss for the year ended December 31, 2009 of \$20,229 (\$0.40 per share) as compared to a net loss of \$33,688 (\$0.71 per share) for 2008 was primarily attributable to a combination of following factors, all of which were discussed earlier:

- \$2,861 attributable to lower revenue
- \$2,908 lower G&A costs and \$452 lower project operating costs during 2009 compared to 2008
- \$18,784 impairment pertaining to Block 41 in Yemen and \$922 impairment pertaining to Oman in 2009 versus \$34,099 in 2008
- A gain of \$9,893 on the sale of the Corporation's oil & gas property interests in Pennsylvania in October 2009 partially offset by a loss of \$7,142 on the sale of West Virginia properties in June 2009;
- \$5,013 gain booked on the sale of non-core unproved leasehold interests in Ohio in 2008
- \$225 interest expense booked in 2009 versus \$1,081 interest revenue in 2008
- \$2,600 income tax recovery included in the gain on sale of assets, in 2009 versus a \$2,600 income tax expense recorded in 2008.

FOURTH QUARTER

Total revenues increased by \$479 from \$1,913 in the fourth quarter of 2008 to \$2,392 in the fourth quarter of 2009 primarily due to:

- 306,250 Mcfe increase in natural gas production volume mainly due to the increased production from Highway 706 project in Pennsylvania, which accounted for an increase of \$2,615.
- Offset mostly by a 46% decrease in the average natural gas price received during the fourth quarter of 2009 as compared to the fourth quarter of 2008 accounting for \$2,096 of variance.
- The balance of the variance of \$40 was a result of \$247 increase in oil revenues during the fourth quarter of 2009 versus the same period in 2008, offset by having no gathering fees in 2009 versus gathering fees of \$287 during the fourth quarter of 2008.

Total project operating costs decreased by \$153 from \$453 in the fourth quarter of 2008 to \$300 in the fourth quarter of 2009 primarily due to:

- A decrease of \$88 in production taxes during the fourth quarter of 2009 as compared to the fourth quarter of 2008, as the taxes in 2008 related primarily to West Virginia that was sold in 2009. In 2009, there were no property taxes in Pennsylvania.
- A decrease of \$65 of lease operating expenses due to the sale of West Virginia property, which was partially offset by the addition of operating expenses after the commencement of operations at the Corporation's 100% owned Highway 706 project in Pennsylvania.

During the fourth quarter of 2009 the Corporation recorded unproved property impairment pertaining to Yemen (\$17,861) and Oman (\$922) for a total of \$18,784 while the same period of 2008 the impairment booked for Yemen was \$34,099.

EPSILON ENERGY LTD.
MD&A FOR THE YEAR ENDED DECEMBER 31, 2009

The DD&A expense increased by \$610 from \$327 in the fourth quarter of 2008 to \$937 in the fourth quarter of 2009 primarily due to a change in accounting estimate whereby in 2008, less depletion expense was recorded as a result of adjustments made to reflect a lower than anticipated final annual depletion rate for the entire year of 2008. In 2009 the final depletion rate was used only for the depletion calculation for the fourth quarter.

The G&A expenses decreased by \$1,050 from \$1,820 in the fourth quarter of 2008 to \$770 in the fourth quarter of 2009 primarily due to a decrease of \$593 in stock-option expense and continuation of cost containment measures implemented during the second quarter of 2009.

During the fourth quarter of 2009, the Corporation booked a gain of \$7,143 from the sale of non-core acres located in eastern Pennsylvania, while during the fourth quarter of 2008 the Corporation incurred \$72 loss on sale of assets, reflecting an adjustment to Ohio properties in the Appalachian basin that were sold in the second quarter of 2008.

There was a tax expense of \$2,600 that was booked during the fourth quarter of 2008, which was reversed during the fourth quarter of 2009 as an adjustment to gain on sale of assets reflecting the income tax effect of the loss on sale of West Virginia assets.

SUMMARY OF QUARTERLY RESULTS

Summary quarterly information is presented in the table below. All amounts rounded to thousands of dollars, except for per share amounts.

(in thousands of dollars, except shares outstanding and per share amounts)	Three months Ended							
	Mar 31, 2008	Jun 30, 2008	Sep 30, 2008	Dec 31, 2008	Mar 31 2009	Jun 30, 2009	Sep 30, 2009	Dec 31, 2009
Revenues:								
Gas.....	1,297	1,831	1,986	1,855	1,650	665	607	2,374
Oil.....	240	543	490	(229)	(15)	6	-	19
Gathering fees, net	-	-	-	287	72	61	-	-
Total revenues	1,537	2,374	2,476	1,913	1,707	732	607	2,393
Operating costs.....	281	387	671	453	467	385	188	300
Impairment of unproved properties.....	-	-	-	34,099	-	2,172	581	16,031
DD&A	428	580	737	327	697	612	1,212	937
G&A	1,538	2,637	1,524	1,820	1,306	1,166	1,369	770
Cost of operations	2,247	3,604	2,932	36,699	2,470	4,335	3,350	18,038
Operating loss.....	(710)	(1,230)	(456)	(34,786)	(763)	(3,603)	(2,743)	(15,645)
Gain (loss) on sale of assets	(1)	5,086	-	(72)	-	(9,728)	(14)	12,493
Other income (loss)	427	302	308	43	(72)	(114)	(55)	16
Net income (loss) before income taxes	(284)	4,158	(148)	(34,815)	(835)	(13,445)	(2,812)	(3,137)
Income tax expense (recovery)	-	-	-	2,600	-	-	-	-
Net (loss) income	(284)	4,158	(148)	(37,415)	(835)	(13,445)	(2,812)	(3,137)
Basic and diluted weighted average # of shares outstanding	45,698,323	45,698,323	51,315,323	51,315,323	51,315,323	51,315,323	51,315,323	50,325,998
Basic and diluted net income (loss) per share....	(0.01)	0.09	0.00	(0.79)	(0.02)	(0.27)	(0.05)	(0.06)

LIQUIDITY AND CAPITAL RESOURCES

EPSILON ENERGY LTD.
MD&A FOR THE YEAR ENDED DECEMBER 31, 2009

Working Capital

At December 31, 2009, the Corporation had a working capital surplus (inclusive of restricted cash) of \$14,222, as compared to \$15,862 of surplus working capital (inclusive of restricted cash) at December 31, 2008. The \$1,640 decrease in working capital at December 31, 2009, as compared to December 31, 2008 is primarily attributable to \$26,928 spent on capital expenditures during 2009 and payment of its line of credit at TD bank in full partially compensated by release of restricted cash and a net amount of \$25,563 received from the sale of the Corporation's non-core oil and natural gas property interests in West Virginia and Pennsylvania.

The Corporation has continued with its plan to sell its non-core assets to fund future operations and repay debt. During the fourth quarter of 2009 the Corporation received \$12,631 from the sale of non-core leasehold acres in Pennsylvania that was then used to pay the outstanding balance of \$7,500 of its line of credit at Northwestern Bank. As of December 31, 2009, the Corporation is debt free. (See Note 5 of Consolidated Financial Statements for the years ending December 31, 2009 and 2008). It is expected that cash on hand and cash flow from the sale of natural gas as part of the farm-out agreement with Chesapeake should be more than sufficient to fund the Corporation's exploration plans, particularly in the Marcellus shale project and other projects in North America and Africa.

Cash Flow from Operations

During 2009, the Corporation used \$554 in its operating activities, a decrease of \$6,042 as compared to 2008.

In 2009, the loss of \$20,229 before a \$2,751 net gain on the sale of assets and a \$523 negative adjustment pertaining to changes in the Corporation's non-cash balances related to operations, were partially offset by a positive \$22,948 of non-cash add-backs covering impairments, amortization, depletion and accretion and stock based compensation.

During 2008, the Corporation generated a net loss of \$33,688 before adjusting for a \$5,013 net gain on the sale of assets. Cash used in operations during 2008 was further adjusted by a \$8,512 negative adjustment pertaining to changes in the Corporation's non-cash balances related to operations and by a positive \$40,617 of non-cash add-backs covering impairments, amortization, depletion and accretion and stock based compensation.

Outstanding Share Capital

The following table summarizes the components of share capital for the years ended December 31, 2009 and 2008 respectively:

	Number of Shares Issued	Amount
Balance at December 31, 2007	45,698,323	\$ 109,726
Warrants exercised	17,000	42
Warrants exercised	-	11
Shares issued for Bought Deal	5,600,000	33,443
Issuance costs for Bought Deal	-	(2,229)
Repurchase of Common Shares.....	(1,000,000)	(2,734)
Balance at December 31, 2008	<u>50,315,323</u>	<u>138,259</u>
Exercise of Stock Options	10,675	13
Balance at December 31, 2009	<u>50,325,998</u>	<u>\$138,272</u>

EPSILON ENERGY LTD.
MD&A FOR THE YEAR ENDED DECEMBER 31, 2009

Property and Equipment

	Years Ended December 31,	
	2009	2008
Property and equipment	66,691	84,353

Total property and equipment decreased by \$17,662 from \$84,353 in 2008 to \$66,691 in 2009 primarily due to:

- Lower capital investment in the Corporation's Yemen, West Virginia, and New York projects.
- Partially compensated by acceleration of operations in the Highway 706 project in Pennsylvania in 2009 versus 2008 and drilling costs of the first well in the Bakken shale

Reportable Geographical Operating Segments

As of December 31, 2009, the Corporation held interests in the following countries: United States, Canada, Yemen, Ethiopia, and Oman. From its inception through the first nine months of 2009, the Corporation's oil and natural gas revenues have been derived solely from the Appalachian basin in the United States.

Reportable Segments:	Years Ended December 31,	
	2009	2008
United States:		
Revenues.....	\$ 5,421	\$ 8,300
Operating costs	1,329	1,792
Capital expenditures	20,441	34,484
Canada:		
Revenues.....	18	-
Operating costs	11	-
Capital expenditures	2,712	535
Yemen:		
Revenues.....	-	-
Operating costs	-	-
Capital expenditures	2,785	15,126
Ethiopia:		
Revenues.....	-	-
Operating costs	-	-
Capital expenditures	243	1,851
Other International:		
Revenues.....	-	-
Operating costs	-	-
Capital expenditures	747	451
Total Reportable Segments:		
Revenues	5,439	8,300
Operating costs	1,340	1,792
Capital expenditures.....	26,928	52,447

EPSILON ENERGY LTD.
MD&A FOR THE YEAR ENDED DECEMBER 31, 2009

COMMITMENTS AND CONTINGENCIES

Yemen

In accordance with the Farm-in Agreement with OGMC dated September 10, 2007 covering the Corporation's acquisition of a 57.14% paying interest in the Block 41 Production Sharing Agreement from OGMC, the Corporation was obligated to pay OGMC \$3,000 upon a Declaration of Commerciality. The \$3,000 payment would only be incurred in the event the Corporation made a commercial oil or natural gas discovery on Block 41 and the Ministry of Minerals granted a license to commercially produce such discovery. Due to the unlikely contingent nature of this item, it was not reflected in the Corporation's Balance Sheet at December 31, 2009 and 2008 respectively.

The Corporation has withdrawn from Yemen and is currently negotiating final settlements with contractors. Management is of the opinion that no additional accrual or disclosure is required for any possible settlements.

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

On January 26, 2009, the Corporation was awarded a 100% operated working interest in Block 55, an onshore oil and natural gas concession in Oman, in return for a \$25.5 million work commitment over three years and sharing in commercial production, if any, which would be shared over a 20 year contractual term.

In an effort to conserve its capital, during 2009, the Corporation did not pay any up-front costs for Block 55 to the government of Oman. In November 2009, Epsilon notified the Ministry of Oil and Gas, Sultanate of Oman, that Epsilon was withdrawing from the previously signed EPSA covering Block 55 in Oman where it was the official operator. The Corporation has reversed a capital accrual of \$2,250 in up-front costs pertaining to Block 55 in Oman and is of the opinion that no additional accrual or disclosure for exit costs is required.

Saskatchewan - 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. During 2009, the Corporation paid \$2,214 for the cost to drill the first of the two aforementioned earning wells. The second well obligation of \$2,400 will be partially substituted for a 3D seismic program, which is expected to cost \$1,200. The remaining balance after the completion of 3D seismic program will be committed to the next well that is expected to be drilled in late 2010.

New York – Trenton-Black River Well Units

During 2006, the Department of Environmental Conservation (“DEC”) classified the Corporation's interest in several wells drilled prior to a statute change as an integrated non-participating owner. As a result, the Corporation was charged a non-consent penalty (300% of 100% of the total drilling and completion costs) 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 DEC'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 a non-operator, the Corporation is not liable to make any non-consent payments.

Due to this contingency, there were no amounts initially recorded on the Corporation's consolidated financial statements prior to payout. In the case where payout has occurred, the Corporation recorded its share of costs and revenues on a prospective basis beginning with the month that each well had been determined to have achieved payout. As at December 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. As of December 31, 2009, the Corporation had received a favorable

EPSILON ENERGY LTD.
MD&A FOR THE YEAR ENDED DECEMBER 31, 2009

decision on its F Andrews well appeal from the NY DEC commissioner. The decision was not appealed by Fortuna Energy Inc. and the Corporation is currently awaiting final settlement numbers. This decision will result in reimbursement of the non-consent penalty charged to the Corporation for that well. There has been no decision issued for the remaining wells that the Corporation has appealed.

Ethiopia

The terms of the Production Sharing Agreement signed with the Ministry in Democratic Republic of Ethiopia include an initial three-year exploration period that includes a minimum financial commitment of \$3,000 to drill one exploratory well and to acquire a minimum of 200 kilometers of 2D seismic. In the event the Corporation makes a commercial discovery, the initial percentage split of profit oil and/or gas will be 80% for the Corporation and 20% for the Ministry. Through December 31, 2009, the Corporation had incurred \$2,094 under the terms of this agreement.

Forward Sale of Natural Gas

As of December 31, 2009, the Corporation had two outstanding forward sales contracts: First contract commenced on November 1, 2009 for natural gas sale of 3 MMcf per day at a fixed price of \$5.15 per Mcf amounting to a total commitment over six months of \$2,954. The outstanding commitment as of December 31, 2009 was \$1,854.

The second contract, which was signed on December 15, 2009, effective January 1, 2010 calls for natural gas sale of 3 MMcf per day at a fixed price of \$5.50 per Mcf amounting to a total commitment over six months of \$2,987.

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

	Payments Due by Period			
	Total	Less than 1 Year	1 – 3 Years	4 Years and After
Future Commitments:				
Accounts payable and accrued liabilities	\$ 3,461	\$ 3,450	\$ 11	\$ -
Operating leases.....	1,326	522	728	76
Purchase obligations ⁽¹⁾	2,733	2,733	-	-
Other long-term obligations ⁽²⁾	3,319	-	3,319	-
Total.....	\$ 10,839	\$6,705	\$ 4,058	\$ 76

Notes:

- (1) Saskatchewan - Bakken Shale Drilling Commitment and 3-D Seismic payment due March 2010.
- (2) Estimated remaining costs pertaining to the Production Sharing Agreement in Ethiopia.

CRITICAL ACCOUNTING ESTIMATES

The Corporation's financial and operating results incorporate certain estimates including:

- Estimated revenues, royalties and operating costs on production as at a specific reporting date but for which actual revenues and costs have not yet been received;
- Estimated capital expenditures on projects that are in progress;
- Estimated depletion, depreciation and accretion that are based on estimates of oil and gas reserves that the Corporation expects to recover in the future;
- Estimated value of asset retirement obligations that are dependent upon estimates of future costs and timing of expenditures;

EPSILON ENERGY LTD.
MD&A FOR THE YEAR ENDED DECEMBER 31, 2009

- Estimated future recoverable value of property, plant and equipment.
- Estimated future income tax assets and liabilities for estimated tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis; and
- Estimated valuation allowance to reduce income tax assets, if it is more likely than not that all or some portions of such tax assets will not be realized.

Below are explanations of significant critical accounting estimates. Also see Note 3 – “*Accounting Pronouncements*” within the annual consolidated financial statements for the years ended December 31, 2009 and 2008.

Full Cost Accounting

The Corporation utilizes the full cost method of accounting for its crude oil and natural gas properties. Accordingly, all costs related to the exploration for and development of crude oil and natural gas reserves, whether successful or not, are capitalized. The capitalized costs and future development costs are depleted on the unit-of-production method based on estimated proved reserves. Costs of significant unproved properties, net of impairments, are excluded from the depletion, depreciation and accretion calculation. Properties excluded from the depletion calculation are assessed periodically to ascertain whether impairment has occurred.

The carrying amount of crude oil and natural gas properties may not exceed their recoverable amount (the “**Ceiling Test**”). The costs are assessed to be recoverable if the sum of the undiscounted cash flows expected from the production of proved reserves and the lower of cost or market of unproved properties exceeds the carrying value of the crude oil and natural gas assets. If the carrying value of the crude oil and natural gas assets is assessed to be unrecoverable, an impairment loss is recognized to the extent that the carrying value exceeds the sum of the discounted cash flows expected from the production of proved and probable reserves and the lower of cost or market of unproved properties. The cash flows are estimated using future product prices and costs, which are discounted using a risk-free rate of interest.

Proceeds from the sale of oil and natural gas property interests are credited against the applicable country cost center. A gain or loss is recognized only if the resulting credit of proceeds from the sale results in a change to the depletion rate of the associated country cost center of 20% or more.

The alternative method of accounting for crude oil and natural gas properties is the successful efforts method. The major difference in applying the successful efforts method is that exploratory dry holes and geological and geophysical exploration costs are charged against net earnings in the year they are incurred rather than being capitalized. The use of the full cost method usually results in higher capitalized costs and higher DD&A rates than the successful efforts method.

Crude Oil and Natural Gas Reserves

The Corporation retains qualified independent reserves evaluators to estimate the Corporation's proved and probable crude oil and natural gas reserves. The estimation of reserves involves the exercise of judgment. Forecasts are based on engineering data, expected rates of production and the timing of future capital expenditures, all of which are subject to major uncertainties and interpretations. The Corporation expects that over time its reserve estimates will be revised upward or downward based on updated information such as the results of future drilling, testing and production levels. Reserve estimates can have a significant impact on net earnings, as they are a key component in the calculation of DD&A and for determining potential asset impairment. For example, a revision to the reserve estimate would result in a higher or lower DD&A charge to net earnings. Downward revisions to reserve estimates could also result in a write-down of crude oil and natural gas properties.

When estimating oil and natural gas reserves and their associated net cash flows, there are numerous factors that contain significant measurement uncertainties that are beyond the Corporation’s control. Those factors include, but are not limited to, volumetric reserve estimates, future commodity pricing, future operating

EPSILON ENERGY LTD.
MD&A FOR THE YEAR ENDED DECEMBER 31, 2009

costs and the timing of and amount of future capital costs. When assessing the fair market value of reserves, additional factors must be considered such as current market conditions, credit markets, location of reserves, classification of reserves based on risk of recovery, political risk and other factors, all of which may contribute to significant measurement uncertainty. Due to the complexity involved, reserve estimates and fair market value estimates will vary greatly from one reserve estimator to another.

Asset Retirement Obligations (“ARO”)

The Corporation is required to recognize a liability for future abandonment and site restoration costs associated with the Corporation's crude oil and natural gas properties in accordance with existing laws, contracts or other policies. The fair value of the estimated ARO is recorded as a long-term liability, with a corresponding increase in the carrying amount of the related asset known as the asset retirement cost, which is depleted on a unit-of-production basis over the life of the reserves. The liability is adjusted each reporting period to reflect the passage of time, with the accretion charged to earnings, and for revisions to the estimated future cash flows, if any. Actual costs incurred upon settlement of the obligations are charged against the liability. The ARO is based on estimated costs, taking into account the anticipated method and extent of restoration consistent with legal requirements, technological advances, industry practices and the possible use of the site. Since these estimates are specific to the sites involved, there are many individual assumptions underlying the Corporation's total ARO amount. These individual assumptions can be subject to change based on experience. Restoration technologies and costs are constantly changing, as are regulatory, political, environmental, safety and public relations considerations. The Corporation estimates future retirement costs based on current estimates adjusted for inflation and credit risk, which are expected to be incurred at the end of the associated properties economic life. The estimates for inflation and credit risk used to calculate ARO are also subject to measurement uncertainty. The Corporation assumed an estimated credit adjusted risk-free rate calculated on a yearly basis and an estimated inflation rate of 2% to calculate the net present value of the asset retirement obligations. The total future ARO was estimated based on the Corporation's net ownership interest in all wells and facilities in the Appalachian basin in the U.S., and includes estimated costs to reclaim and abandon the wells and facilities and the estimated timing of the costs to be incurred in future periods.

Stock-Based Compensation

The Corporation records stock-based compensation expense using the fair value method. The fair value of an option is calculated at the grant date using the Black-Scholes option pricing model and expensed over the vesting term of the option. The Corporation records the cumulative stock-based compensation as a contributed surplus. When options are exercised, contributed surplus is reduced and share capital is increased by the amount of accumulated stock-based compensation for the exercised option. Any consideration received on the exercise of stock options is credited to share capital. The determination of stock-based compensation expense is based on assumptions regarding stock volatility, risk-free interest rates and the term of the options. These assumptions, by their nature, are subject to measurement uncertainty. An increase in volatility, the risk-free rate or the term would increase the calculated expense.

Income Taxes

The determination of the Corporation's income and other tax liabilities requires the interpretation of complex laws and regulations. All tax filings are subject to audit and potential reassessment after the lapse of considerable time. Accordingly, the actual income tax liability may differ from that estimated and recorded by the Corporation's management. A valuation allowance is recorded against any future income tax asset if the Corporation is not “more likely than not” to realize the tax deduction. The valuation allowance for income taxes, if any, is subject to measurement uncertainty pertaining to projected future production levels, future capital expenditures, future commodity prices and future operating costs, all of which could vary significantly from actual results.

International Financial Reporting Standards (“IFRS”)

EPSILON ENERGY LTD.
MD&A FOR THE YEAR ENDED DECEMBER 31, 2009

In October 2009, the Accounting Standards Board issued a third and final IFRS Omnibus Exposure Draft confirming that publicly accountable enterprises will be required to apply IFRS, in full and without modification, for financial periods beginning on January 1, 2011. The adoption date of January 1, 2011 will require the restatement, for comparative purposes, of amounts reported by the Corporation for the year ended December 31, 2010, including the opening balance sheet as at January 1, 2010.

The Corporation has commenced the process to transition from current Canadian GAAP to IFRS. Resource requirements have been identified and all IFRS requirements will be met with internal employees supplemented with consultants as required. Regular progress reporting to the Audit Committee of the Board of Directors on the status of the IFRS conversion has been implemented. At this time, the Corporation has begun the process of training key personnel. This has occurred through external IFRS oil and gas training and workshops that have been attended by key members of the finance team in 2009. A training session will be scheduled for the Audit Committee during the second half of 2010.

The Corporation is continually assessing the impact of the convergence of Canadian GAAP with IFRS on the Corporation's results of operations, financial position and disclosures. Under the direction and oversight of the Board of Directors and Audit Committee, the Corporation's management has commenced the transition and is working to ensure successful implementation within the required time frame. The Corporation recognizes that the changeover to IFRS has complex implications on a combination of accounting, financial reporting, IT and business systems. Consequently, the Corporation has engaged a professional accounting firm to conduct a Business Impact Study, to assist in the development a Project Plan, and to provide assistance in considering various accounting policy decisions which will be required throughout the transition period.

The Corporation's IFRS transition project consists of three key phases:

- (i) Scope and Plan - This phase involves performing a high level impact analysis to identify areas that may be affected by the transition to IFRS. The results of this analysis are priority ranked according to complexity and the amount of time required to assess the impact of changes in transitioning to IFRS.
- (ii) Impact Analysis and Evaluation - During this phase, items identified in the scope and planning phase are addressed according to the priority levels assigned to them. This phase involves analysis of policy choices allowed under IFRS and their impact on the financial statements. The conclusion of the impact analysis and evaluation phase might potentially require the audit committee of the Board of Directors to review and approve all accounting policy choices as proposed by management.
- (iii) Implementation and Review - involves implementation of all changes approved in the impact analysis phase and might include changes to information systems, business processes, modification of agreements and training of all staff who are impacted by the conversion.

The Corporation has completed the scope and plan phase and has prepared draft analysis for the impact analysis and evaluation phase. Management has not yet finalized its accounting policies and as such is unable to quantify the impact of adopting IFRS on the financial statements. In addition, due to anticipated changes to IFRS and International Accounting Standards prior to the Corporation's adoption of IFRS, Management's plan is subject to change based on new facts and circumstances that arise after the date of this MD&A.

The Corporation is evaluating the impact of implementing IFRS on the Corporation's consolidated financial statements as there are a number of differences between Canadian GAAP and IFRS applicable to the Corporation.

The Corporation has concluded that the following key issues are expected to have the most significant impact on the Corporation's results of operations, financial position and disclosures:

- IFRS 1 – First-time adoption of International Financial Reporting Standards
- IFRS 6 – Exploration and evaluation of mineral resources

EPSILON ENERGY LTD.
MD&A FOR THE YEAR ENDED DECEMBER 31, 2009

- IAS 16 – Property, plant and equipment
- IAS 36 – Impairment of assets
- IAS 37 – Provisions, contingent liabilities and contingent assets

First-Time Adoption of IFRS

IFRS 1, “First-Time Adoption of International Financial Reporting Standards” (“IFRS 1”), provides entities adopting IFRS for the first time with a number of optional exemptions and mandatory exceptions in certain areas to the general requirement for full retrospective application of IFRS. Management is analyzing the various accounting policy choices available and will implement those determined to be the most appropriate for the Corporation, which at this time are summarized as follows:

- Business Combinations – IFRS 1 would allow the Corporation to use the IFRS rules for business combinations on a prospective basis rather than re-stating all business combinations. The IFRS business combination rules converge with the new CICA Handbook section 1582 that is also effective for the Corporation on January 1, 2011; however, early adoption is permitted.
- Property, Plant and Equipment (“PP&E”) – IFRS 1 provides the option to value the PP&E assets at their deemed cost being the Canadian GAAP net book value assigned to these assets as at the date of transition, January 1, 2010. This amendment is permissible for entities, such as the Corporation, who currently follow the full cost accounting guideline under Canadian GAAP that accumulates all oil and gas assets into one cost centre. Under IFRS, the Corporation’s PP&E assets must be divided into smaller cost centers. The net book value of the assets on the date of transition will be allocated to the new cost centers on the basis of the Corporation’s reserve volumes or values at that point in time.
- Share-Based Payments – IFRS 1 allows the Corporation an exemption on IFRS 2, “Share-Based Payments” to equity instruments which vested before the Corporation’s transition date to IFRS.

The transition from Canadian GAAP to IFRS is a significant undertaking that may materially affect our reported financial position and results of operations. At this time, the Corporation has identified key differences that will impact the financial statements as follows:

- Re-classification of Exploration and Evaluation (“E&E”) expenditures from PP&E – Upon transition to IFRS, the Corporation will re-classify all E&E expenditures that are currently included in the PP&E balance on the Consolidated Balance Sheet. This will consist of the book value for the Corporation’s undeveloped land that relates to exploration properties. E&E assets will not be depleted and must be assessed for impairment when indicators suggest the possibility of impairment.
- Calculation of depletion expense for PP&E assets – Upon transition to IFRS, the Corporation has the option to calculate depletion using a reserve base of proved reserves or both proved and probable reserves, as compared to the Canadian GAAP method of calculating depletion using only proved reserves. The Corporation has not concluded at this time which method for calculating depletion will be used.
- Impairment of PP&E assets – Under IFRS, impairment of PP&E must be calculated at a more granular level than what is currently required under Canadian GAAP. Impairment calculations will be performed at the cash generating unit level using either total proved or proved plus probable reserves.
- Due to the recent withdrawal of the exposure draft on IAS 12 Income Taxes in November 2009 and the issuance of the exposure draft on IAS 37 Provisions, Contingent Liabilities and Contingent Assets in January 2010. Management is still determining the impact of these revised standards on its IFRS transition and expects to have all additional potential material impact areas identified during the first quarter of 2010 and approved by the audit committee during the second quarter of 2010.

In addition to accounting policy differences, Epsilon’s transition to IFRS will impact the internal controls over financial reporting, the disclosure controls and procedures, Epsilon’s business activities and IT systems as follows:

- Internal Controls over Financial Reporting (“ICFR”) – As the review of Epsilon’s accounting policies is completed, an assessment will be made to determine changes required for ICFR. As an

EPSILON ENERGY LTD.

MD&A FOR THE YEAR ENDED DECEMBER 31, 2009

example, additional controls will be implemented for the IFRS 1 changes such as the allocation of Epsilon's PP&E as well as the process for re-classifying Epsilon's E&E expenditures from PP&E. This will be an ongoing process through 2010 to ensure that all changes in accounting policies include the appropriate additional controls and procedures for future IFRS reporting requirements.

- Disclosure controls and procedures – Throughout the transition process, Epsilon will be assessing stakeholders' information requirements and will ensure that adequate and timely information is provided so that all stakeholders are kept apprised. Management anticipates delivering investor presentations during the fourth quarter of 2011 to explain the differences between the historical Canadian GAAP statements and the IFRS statements.
- Business activities – Based on the expected changes to Epsilon's accounting policies at this time, there are no foreseen issues as a result of the conversion to IFRS. Management will continue to monitor business activities closely as final policy choices are made.
- IT systems – Epsilon is evaluating system updates required (if any) in order to ready the company for IFRS reporting. The modifications (if any) are not expected to be significant, however, if required will be critical in order to allow for reporting of both Canadian GAAP and IFRS statements in 2010 as well as the modifications required to track PP&E costs and E&E costs with a more granular level of detail for IFRS reporting. Additional system modifications may be required based on final policy choices.

CHANGES IN ACCOUNTING POLICIES, INCLUDING INITIAL ADOPTION

Goodwill and Intangible Assets

Effective January 1, 2009, the Corporation adopted Section 3064, "Goodwill and Intangible Assets" issued by the Canadian Institute of Chartered Accountants ("CICA"). Section 3064 establishes standards for the recognition, measurement, presentation and disclosure of goodwill and intangible assets subsequent to its initial recognition. This new section has no current impact on the Corporation or its Consolidated Financial Statements.

Financial Instruments – Disclosures

In May 2009, the CICA amended Section 3862, Financial Instruments – Disclosures, to include additional disclosure requirements about fair value measurement for financial instruments and liquidity risk disclosures. These amendments require a three level hierarchy that reflects the significance of the inputs used in making the fair value measurements. Fair values of assets and liabilities included in Level 1 are determined by reference to quoted prices in active markets for identical assets and liabilities. Assets and liabilities in Level 2 include valuations using inputs other than quoted prices for which all significant outputs are observable, either directly or indirectly. Level 3 valuations are based on inputs that are unobservable and significant to the overall fair value measurement. These amendments are effective for the Corporation on December 31, 2009. The amendments are consistent with recent amendments to financial instrument disclosure standards in IFRS and have been included in those financial statements as incremental disclosure.

Business Combinations

The CICA issued Handbook Section 1582 "Business Combinations" that replaces the previous business combinations standard. Under this guidance, the purchase price used in a business combination is based on the fair value of shares exchanged at the market price at acquisition date. Under the current standard, the purchase price used is based on the market price of shares for a reasonable period before and after the date the acquisition is agreed upon and announced. In addition, the guidance generally requires all acquisition costs to be expensed. Current standards allow for the capitalization of these costs as part of the purchase price. This new Section also addresses contingent liabilities, which will be required to be recognized at fair value on acquisition, and subsequently re-measured at each reporting period until settled. Currently, standards require only contingent liabilities that are payable to be recognized. The new guidance requires negative goodwill to be recognized in earnings rather than the current standard of deducting from non-current assets in the purchase price allocation. This standard applies prospectively to business combinations on or after January 1, 2011 with earlier application permitted. The Corporation is currently assessing the impact of the standard.

EPSILON ENERGY LTD.
MD&A FOR THE YEAR ENDED DECEMBER 31, 2009

Consolidated Financial Statements and Non-controlling Interest

The CICA issued Handbook Sections 1601 “Consolidated Financial Statements”, and 1602 “Non-controlling Interests”, which replaces existing guidance under Section 1600 “Consolidated Financial Statements”. Section 1601 establishes standards for the preparation of Consolidated Financial Statements. Section 1602 provides guidance on accounting for a non-controlling interest in a subsidiary in Consolidated Financial Statements subsequent to a business combination. These standards will be effective for the Corporation for business combinations occurring on or after January 1, 2011 with early application permitted. The Corporation is currently assessing the impact of the standard.

Disclosure Controls and Procedures and Internal Controls over Financial Reporting

Management is responsible for establishing and maintaining adequate Internal Controls over Financial Reporting (“**ICFR**”). ICFR means a process designed by or under the supervision of the Chief Executive Officer and Chief Financial Officer, and effected by the Board of Directors, management and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP.

Disclosure controls and procedures are designed to provide reasonable assurance that material information is gathered and reported to senior management, including the Chief Executive Officer and Chief Financial Officer, as appropriate to permit timely decisions regarding public disclosure. The Corporation has evaluated the effectiveness of its disclosure controls and procedures and has concluded based on this evaluation that the disclosure controls and procedures are not effective due to the material weakness in ICFR as described below.

Management completed an assessment of the design of ICFR. The Corporation used the Committee of Sponsoring Organizations of the Treadway Commission (“**COSO**”) framework and guidance for smaller public companies for the design of the Corporation’s ICFR. All internal control systems have inherent limitations and therefore our ICFR can only provide reasonable assurance and may not prevent or detect misstatements due to error or fraud.

The Chief Executive Officer, acting also in the capacity of the Chief Financial Officer, having designed ICFR to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial reporting in accordance with GAAP, has identified that ICFR is not effective due to the material weakness in ICFR as described below.

As of December 31, 2009, and as of the date of this MD&A the Corporation did not have a Chief Financial Officer. During the process of management's assessment, it was determined that a deficiency existed in the ICFR. Segregation of duties was identified as an area where a deficiency exists.

Segregation of duties is a basic, key internal control and one of the most difficult to achieve in a small company. It is used to ensure that errors or irregularities are prevented or detected on a timely basis by employees in the normal course of business. Due to the Corporation’s small size and limited resources, a complete segregation of duties cannot be fully achieved. The result is that the Corporation is highly reliant on the performance of mitigating procedures during the process of closing its financial statements in order to gain a higher level of assurance that the financial statements are presented fairly in all material respects.

The risk of a material misstatement is mitigated by direct involvement of senior management in the day to day operations of the Corporation and review of the financial statements and disclosures by senior management and the Board of Directors. This weakness and its related risks are not uncommon in an entity of the size of the Corporation. As the Corporation grows, it plans to expand the number of individuals involved in the accounting function.

Management is in the process of making changes to its ICFR and identifying and hiring additional accounting resources including a CFO.

EPSILON ENERGY LTD.
MD&A FOR THE YEAR ENDED DECEMBER 31, 2009

Environmental Issues

Compliance with Environmental and Safety Regulations

All phases of the oil and natural gas business present environmental risks and hazards and are subject to environmental regulation pursuant to a variety of federal, provincial and local laws and regulations. Environmental legislation provides for, among other things, restrictions and prohibitions on spills and releases or emissions of various substances produced in association with oil and natural gas operations. The legislation also requires that wells and facility sites be operated, maintained, abandoned and reclaimed to the satisfaction of applicable regulatory authorities. Compliance with such legislation can require significant expenditures and a breach may result in the imposition of fines and penalties, some of which may be material. Environmental legislation is evolving in a manner expected to result in stricter standards and enforcement, larger fines and liabilities, and potentially increased capital expenditures and operating costs. The discharge of oil, natural gas or other pollutants into the air, soil or water may give rise to liabilities to governments and third parties and may require the Corporation to incur costs to remedy such discharge. Although the Corporation believes that it is in material compliance with current applicable environmental regulations, no assurance can be given that environmental laws will not result in a curtailment of production or a material increase in the costs of production, development or exploration activities or otherwise adversely affect the Corporation's financial condition, results of operations or prospects. The Corporation must also conduct its operations in accordance with various laws and regulations concerning occupational safety and health. Currently, the Corporation does not foresee expending material amounts to comply with occupational safety and health laws and regulations. However, since such laws and regulations are frequently changed, the Corporation is unable to predict the future effect of these laws and regulations.

The Corporation's activities are subject to numerous federal, provincial and state laws and regulations concerning the storage, use and discharge of materials into the environment, the remediation of environmental impacts and other matters relating to environmental protection, all of which may adversely affect the Corporation's operations and the costs of doing business. Federal, provincial and state regulatory authorities also have established rules and regulations requiring permits for drilling, drilling bonds and reports concerning drilling and producing activities. Such regulations also cover the location of wells, the method of drilling and casing wells, the surface use and restoration of well locations, the plugging and abandoning of wells, and other matters. There can be no assurance that future legislation or administrative regulations or interpretations will not impose stricter requirements that could have an adverse impact on the operating costs of the Corporation and the oil and natural gas industry in general. The Corporation believes it is in material compliance with existing environmental laws and regulations and does not currently believe that it will be required to expend material amounts to comply with existing environmental laws and regulations in the future.

OFF-BALANCE SHEET ARRANGEMENTS

The Corporation has no off-balance sheet arrangements.

TRANSACTIONS WITH RELATED PARTIES

The Corporation reports its related party transactions on an exchange amount basis in equivalent US dollars. 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. Administrative service expenses for the years ended December 31, 2009 and 2008 were \$39 and \$57, respectively. In addition, the Corporation shares office space with Capital Z Corporation, a company owned by the Executive Chairman, at no charge.

Former Director, President and CEO

Austin Exploration LLC, a company owned by a former Director who was also the former President and CEO of the Corporation, was also a participant in the Corporation's Empire project. Western Land

**EPSILON ENERGY LTD.
MD&A FOR THE YEAR ENDED DECEMBER 31, 2009**

Services Inc., a company owned by the same person, provided 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 were capitalized with oil and natural gas properties. Related party transactions with the former Director, President and CEO were conducted in US dollars. A summary of related party transactions follows:

	Years Ended December 31,	
	2009	2008
Austin Exploration LLC:		
Accounts receivable.....	\$ 37	\$ 110
Joint venture costs	\$ 409	\$ 2,655
Joint venture revenues	\$ 564	\$ 902
Accounts payable.....	\$ -	\$ 75
 Western Land Services:		
Lease brokerage services.....	\$ 440	\$ 1,902
Accounts payable.....	\$ 86	\$ 139

OUTLOOK

In the United States, the Corporation is continuing to proceed with its drilling activities in its Marcellus shale prospect in NY.

In Pennsylvania, Chesapeake is now the operator. The leasehold acquisition, drilling, completing, equipping and gathering activities are expected to continue as stipulated in the Corporation's Farmout agreement with Chesapeake.

In Canada, as per the joint venture agreements signed with Spartan and Gastem Inc. the Corporation will continue to participate in Bakken Shale in Saskatchewan and in the St. Lawrence Lowlands and Gaspé Peninsula in Quebec.

In Ethiopia, in 2010, the Corporation is planning to conduct a second aero gravity/magnetic survey, that, when combined with the Corporation's earlier survey, will cover the entire block in the PSA.

Additional Information:

Additional information relating to the Corporation can be found on SEDAR at www.sedar.com

Zoran Arandjelovic
President and CEO
Epsilon Energy Ltd.
150 Jardin Drive, Suite 9
Concord, ON, Canada L4K 3P9
(905) 738-7877
www.epsilonenergyltd.com