



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

**For the six months ended June 30, 2010**

**Dated August 5, 2010**

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

**(905) 738-7877**

**[www.epsilonenergy ltd.com](http://www.epsilonenergy ltd.com)**

# **EPSILON ENERGY LTD.**

## **MANAGEMENT'S DISCUSSION AND ANALYSIS FOR THE SIX MONTHS ENDED JUNE 30, 2010**

### **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 periods presented. The MD&A has been prepared by management as at July 28, 2010 in accordance with Canadian Generally Accepted Accounting Principles ("GAAP") and should be read in conjunction with the unaudited interim consolidated financial statements (as at June 30, 2010 and for the six months ended June 30, 2010 and 2009), 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](http://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;
- incorrect assessments of the value of acquisitions;

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## **MANAGEMENT'S DISCUSSION AND ANALYSIS FOR THE SIX MONTHS ENDED JUNE 30, 2010**

### **Cautionary Statement Regarding Forward Looking Information and Statements (continued)**

- 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 and Africa. Established in 2005, the Corporation has been a producer of natural gas and oil since 2006. 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 and 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.

### **Overall Performance**

During the first six months of 2010, the Corporation generated a net income of approximately \$1.0 million as compared to \$11.7 million net loss for the first six months of 2009. At June 30, 2010, the Corporation had surplus working capital (inclusive of restricted cash) of approximately \$17.5 million, as compared to \$14.2 million of surplus working capital (inclusive of restricted cash) at December 31, 2009. The Corporation has net cash flows provided by operations of \$3.1 million compared to net cash flows used in operation of \$4.2 million for the six months ended June 30, 2009. Epsilon has no debt.

### **Operational Outlook and Property Overview**

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

#### ***United States***

##### ***Pennsylvania Marcellus Shale***

As of June 30, 2010, the Corporation had approximately 11,500 gross (5,750 net) leasehold acres in Pennsylvania where Chesapeake is the operator. 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 exceeding 9.1 Mmcft per day, with two compressors in operation with total capacity of 12 Mmcft per day.

##### ***New York***

In New York, where the Corporation holds an interest in approximately 29,000 gross (13,500 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 play). As of the date of this report the Corporation had drilled four wells in New York.

##### ***NY Marcellus Shale***

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## **MANAGEMENT'S DISCUSSION AND ANALYSIS**

### **FOR THE SIX MONTHS ENDED JUNE 30, 2010**

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%.

During the first six months of 2010, net production from Trenton-Black River formation was approximately 0.3 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.

#### *Ohio*

The Bailey's Mill project is located in Belmont and Monroe counties and consists of approximately 29,300 gross (7,300 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.

#### *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.

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. The first well, the Torquay, was drilled horizontally, fractured and is currently in production. As of June 30, 2010 the Corporation had paid CDN \$2.3 million (US \$ 2.2) for the cost to drill and complete the first of the two aforementioned earning wells. The second well obligation of \$2.4 million will be partially substituted for a 3D seismic program, at a cost of CDN \$1.3 million (US \$1.2). This amount was paid in full in June 2010.

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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 Gaspé Peninsula (covering Silurian and Devonian targets). Within Gastem Inc.'s St. Lawrence Lowlands leasehold acreage, Forest Oil Corporation recently spent CDN\$10.0 million 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.

### *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 82,500 square kilometers (31,853 square miles) in northwest Ethiopia. Terms of the PSA include an initial three-year exploration period that includes a minimum financial commitment of \$3.0 million 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.

### TOTAL REVENUES

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
<i>(in thousands of dollars, except per unit and production values)</i>				
<b>Total Revenues</b>	<b>\$ 3,869</b>	<b>\$ 671</b>	<b>\$ 7,865</b>	<b>\$ 2,307</b>
Net natural gas production (Mcf)	768,355	172,540	1,533,258	374,247
Average natural gas price (\$/Mcf)	\$ 5.03	\$ 6.52	\$5.12	\$3.86
End of period net production exit rate (Mcf/d)	8,259	1,040	8,259	1,040
Net oil production (bbls)	80	60	219	(182)
Average oil price (\$/bbl)	\$ 65.81	\$ 108.43	\$ 84.95	\$ 57.06

### Three months ended June 30 2010 and June 30 2009

Total revenues increased by \$3.2 million compared to second quarter of 2009 due to an increase in volume of 595,815 Mcf as a result of seven additional Pennsylvania wells operating at the end of June 2010 compared to one in June 2009.

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**Six months ended June 30 2010 and June 30 2009**

Total revenues increased by \$5.6 million compared to the six months ended June 30, 2009 due to an increase in volume of 1,159,011 Mcf as a result of seven additional Pennsylvania wells operating at the end of June 2010 compared to one in June 2009. The increase was partially offset by a decrease in the average natural gas price received. Furthermore, 50% of the Corporation's pro-rata production was subject to hedges, in effect to June 30, 2010, with higher than market gas prices. In 2009, these hedges were in effect to the end of April and following their expiry the natural gas production was sold at spot market rate at substantially lower natural gas prices.

**PROJECT OPERATING COSTS**

<i>(in thousands of dollars)</i>	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
	Project operating costs	\$441	\$385	\$867

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. These expenses vary directly with the level of oil and natural gas production and related expenses.

In 2009, the project operating costs included lease operating costs for Pennsylvania, where the Corporation was the operator and West Virginia, where the Corporation held interests as a non-operator. These costs were eliminated as a result of sale of the West Virginia interest in June 2009 and due to the farmout agreement with Chesapeake in February 2010 in Pennsylvania. In 2010, the lease operating costs have declined as percentage of total production due to the farmout agreement with Chesapeake but the reduction is offset by a one-time increase in repairs and maintenance costs to bring the well sites to the Chesapeake specifications. These expenses are not expected to reoccur in future periods. In 2010, there was a further reduction in production taxes due to the sale of the West Virginia interests. There are no production taxes in Pennsylvania or New York.

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

<i>(in thousands of dollars)</i>	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
	Depletion, depreciation and accretion	\$1,356	\$612	\$2,933

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.

**Three months ended June 30 2010 and June 30 2009**

The Depletion, Depreciation and Accretion ("DD&A") expense increased by \$0.7 million compared to the second quarter of 2009 due to the increase in proved reserves from 16.0 Bcf as of December 31, 2008 to 72.7 Bcf as of December 31, 2009.

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## MANAGEMENT'S DISCUSSION AND ANALYSIS FOR THE SIX MONTHS ENDED JUNE 30, 2010

### Six months ended June 30 2010 and June 30 2009

The Depletion, Depreciation and Accretion (“DD&A”) expense increased by \$1.6 million compared to the six months ended June 30, 2009 due to the increase in proved reserves from 16.0 Bcf as of December 31, 2008 to 72.7 Bcf as of December 31, 2009.

### GENERAL AND ADMINISTRATIVE

<i>(in thousands of dollars)</i>	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
<b>General and administrative</b>	\$1,105	\$1,166	\$3,065	\$2,472

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.

### Three months ended June 30 2010 and June 30 2009

The G&A expense decreased by approximately \$0.1 million in the second quarter of 2010 due to continued cost containment measures.

### Six months ended June 30 2010 and June 30 2009

The G&A expense increased by approximately \$0.6 million in the first six months of 2010 primarily due to a \$1.0 million transaction fee that was incurred at the closing of the joint venture agreement with Chesapeake. Excluding the impact of this one-time expenditure, general corporate expenses decreased by \$0.6 million as a result of continuation of cost containment measures that were implemented during the second half of 2009.

### OTHER INCOME (EXPENSE)

<i>(in thousands of dollars)</i>	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
<b>Other income (expense)</b>	\$23	(\$9,843)	\$40	(\$9,915)

Other income (expense) mainly consists of interest income or expense and purchase discounts.

### Three months ended June 30 2010 and June 30 2009

During the second quarter of 2009, the Corporation recorded a net loss of \$9.7 million on the sale of its oil and natural gas property interests in West Virginia and incurred a net amount of \$0.1 of interest expense.

### Six months ended June 30 2010 and June 30 2009

During the six months of 2009, the Corporation recorded a net loss of \$9.7 million on the sale of its oil and natural gas property interests in West Virginia and incurred a net amount of \$0.2 of interest expense.

### NET INCOME (LOSS)

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<i>(in thousands of dollars except per share amounts)</i>	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
	<b>Net income (loss)</b>	\$990	(\$10,845)	\$1,041
<b>Net income (loss) per share, basic</b>	\$0.02	(\$0.02)	\$0.02	(\$0.23)
<b>Net income (loss) per share, diluted</b>	\$ 0.02	(\$0.22)	\$ 0.02	\$ (0.23)

**Three months ended June 30 2010 and June 30 2009**

The net income for the second quarter ended June 30, 2010 of approximately \$1.0 million (\$0.02 per share) as compared to a net loss of \$10.8 million (\$0.21 per share) for the same period in 2009 was primarily attributable to a combination of following factors, all of which were discussed earlier:

- \$3.1 million attributable to higher revenue and;
- \$2.1 million reduction in impairment of unproved properties
- \$9.7 million loss on sale of the West Virginia properties in June 2009
- Partially offset by \$0.7 million higher DD&A costs

**Six months ended June 30 2010 and June 30 2009**

The net income for the six months ended June 30, 2010 of approximately \$1.0 million (\$0.02 per share) as compared to a net loss of \$11.7 million (\$0.23 per share) for the same period in 2009 was primarily attributable to a combination of following factors, all of which were discussed earlier:

- \$5.4 million attributable to higher revenue and;
- \$2.1 million reduction in impairment of unproved properties
- \$9.7 million loss on sale of the West Virginia properties in June 2009
- Partially offset by \$1.6 million higher DD&A costs

**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.

**EPSILON ENERGY LTD.**  
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(in thousands of dollars, except shares outstanding and per share amounts)	<b>Sept 30, 2008</b>	<b>Dec 31, 2008</b>	<b>Mar 31, 2009</b>	<b>June 30, 2009</b>	<b>Sept 30, 2009</b>	<b>Dec 31, 2009</b>	<b>Mar 31, 2010</b>	<b>June 30, 2010</b>
<b>Revenues:</b>								
Gas	1,986	1,855	1,650	665	607	2,374	3,983	3,864
Oil	490	(229)	(15)	6	-	19	13	6
Gathering fees, net	-	287	72	61	-	-	-	-
<b>Total revenues</b>	<b>2,476</b>	<b>1,913</b>	<b>1,707</b>	<b>732</b>	<b>607</b>	<b>2,393</b>	<b>3,996</b>	<b>3,870</b>
Operating costs	671	453	467	385	188	300	427	441
Impairment of unproved properties	-	34,099	-	2,172	581	16,031	33	-
DD&A	737	327	697	612	1,212	937	1,544	1,356
G&A	1,524	1,820	1,306	1,166	1,369	770	1,960	1,105
<b>Cost of</b>	<b>2,932</b>	<b>36,699</b>	<b>2,470</b>	<b>4,335</b>	<b>3,350</b>	<b>18,038</b>	<b>3,964</b>	<b>2,902</b>
Operating income (loss)	(456)	(34,786)	(763)	(3,603)	(2,743)	(15,645)	32	968
Gain (loss) on sale of assets	-	(72)	-	(7,128)	(14)	9,893	-	-
Other income (loss)	308	43	(72)	(114)	(55)	16	18	22
<b>Net income (loss) before income taxes</b>	<b>(148)</b>	<b>(34,815)</b>	<b>(835)</b>	<b>(10,845)</b>	<b>(2,812)</b>	<b>(5,736)</b>	<b>50</b>	<b>990</b>
Income tax expense	-	2,600	-	-	-	-	-	-
<b>Net income (loss)</b>	<b>(148)</b>	<b>(32,215)</b>	<b>(835)</b>	<b>(10,845)</b>	<b>(2,812)</b>	<b>(5,736)</b>	<b>50</b>	<b>990</b>
Weighted average number of shares outstanding, basic	51,315,323	51,315,323	51,315,323	51,315,323	51,315,323	50,325,998	50,550,998	49,840,185
Weighted average number of shares outstanding, diluted	51,315,323	51,315,323	51,315,323	51,315,323	51,315,323	50,325,998	50,550,998	51,175,431
Net income (loss) per share, basic	0.00	(0.79)	(0.02)	(0.27)	(0.05)	(0.06)	0.00	0.02
Net income (loss) per share, diluted	0.00	(0.79)	(0.02)	(0.27)	(0.05)	(0.06)	0.00	0.02

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## MANAGEMENT'S DISCUSSION AND ANALYSIS FOR THE SIX MONTHS ENDED JUNE 30, 2010

### LIQUIDITY AND CAPITAL RESOURCES

#### *Working Capital*

At June 30, 2010, the Corporation had a working capital surplus (inclusive of restricted cash) of \$17.5 million, as compared to \$14.2 million of surplus working capital (inclusive of restricted cash) at December 31, 2009. The \$3.3 million increase in working capital at June 30, 2010, as compared to December 31, 2009 is primarily attributable to \$1.4 million increase in accounts receivable due to higher gas revenues and two months of revenue accrued at June 30, 2010 compared to lower gas revenues and only one month at June 30, 2009. The two-month accrual results from a practice by the operator of the wells to remit payment for two months of production. Further increase is due to a \$1.5 million decrease in accounts payable as a result of paying off outstanding balances more promptly and to an increase in restricted cash due to a road bond with the Department of Environmental Protection.

As of June 30, 2010, the Corporation is debt free. 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 Africa.

#### *Cash Flow from Operations*

##### **Three months ended June 30 2010 and June 30 2009**

During the second quarter of 2010, \$1.7 million was provided by the Corporation's operating activities, a decrease of \$0.4 million compared to the second quarter of 2009. This is mainly attributable to the negative changes in non-cash working capital due to higher accounts receivable balance and a lower accounts payable balance. The increase in accounts receivable is due to two months of gas revenue accrued at June 30, 2010 compared to only one month at June 30, 2009. The two-month accrual results from a practice by the operator of the wells to remit payment for two months of production. The decrease in accounts payable is due to the payments to vendors being made more promptly in the second quarter of 2010 compared to second quarter of 2009.

##### **Six months ended June 30 2010 and June 30 2009**

During the first six months of 2010, \$3.1 million was provided by the Corporation's operating activities, an increase of \$7.3 million as compared to the first six months of 2009. This is mainly attributable to the \$5.0 million cash received pursuant to the Chesapeake farm-out agreement and to positive non-cash add-backs covering amortization, depletion and accretion and stock based compensation.

#### *Outstanding Share Capital*

The following table summarizes the components of share capital for the six months ended June 30, 2010 and the year ended December 31, 2009:

	<b>Number of Shares Issued</b>	<b>Amount</b>
<b>Balance at December 31, 2008</b>	50,315,323	\$ 138,259
Issuance costs for Bought Deal	-	-
Exercise of stock options	10,675	13
<b>Balance at December 31, 2009</b>	50,325,998	138,272
Exercise of stock options	300,000	498
<b>Balance at March 31, 2010</b>	50,625,998	\$ 138,770
Buy back of shares	(1,000,000)	(2,741)
Exercise of stock options	21,349	26
<b>Balance at June 30, 2010</b>	49,647,347	\$ 136,055

# EPSILON ENERGY LTD.

## MANAGEMENT'S DISCUSSION AND ANALYSIS FOR THE SIX MONTHS ENDED JUNE 30, 2010

On April 20, 2010, the Corporation signed an agreement with a former director and officer to purchase 1,000,000 or approximately 2% of the 50,625,998 common shares that were then issued and outstanding for \$2.5 million CDN (\$2.47 US) or \$2.50 CDN (\$2.47 US) per share. The shares purchased by Epsilon were cancelled. The purchase and cancellation was made as an exempt issuer bid pursuant to section 4.7 Multilateral Instrument 62-104 Take-Over Bids and Issuer Bids ("**MI 62-104**"). The price per share was calculated to comply with the requirements of section 1.11 of MI 62-104.

### *Stock Options*

Subsequent to June 30, 2010, 75,000 options were granted to a senior officer of the company. The options are exercisable at \$2.42 per option, have a 3-year term and shall vest 33 1/3% per annum, beginning one year from the date of grant.

Also subsequent to June 30, 2010, 21,349 stock options with an exercise price of \$0.85 and a fair market value of \$9,491, 75,000 options with an exercise price of \$1.00 and a fair market value of \$49,396 were exercised and 94,270 options were forfeited.

### *Property and Equipment*

<i>(in thousands of dollars)</i>	<b>Six Months Ended June 30, 2010</b>	<b>Year Ended December 31, 2009</b>
Property and equipment	\$62,867	\$66,691

Total property and equipment decreased by \$3.8 million from December 31, 2009 primarily due to:

- A reduction in the property and equipment balance of \$5.0 million as a result of the \$5.0 million consideration received for the Chesapeake farm-out agreement that was applied against the agreed-upon carry amount.
- New drilling activities in New York, capital expenditures in Pennsylvania and completion costs of the first well in the Bakken shale offset by the DD&A costs.

### *Farmout Agreement with Joint Venture Partner*

On April 1, 2010, the Company was advised by joint venture partner that there were title defects with respect to some of the Company's leases totaling \$19.7 million. This amount was reduced to \$10.8 million as of July 30, 2010. The Company continues to work on curing the remaining balance.

### **Reportable Geographical Operating Segments**

As at June 30, 2010, the Corporation's operations by geographical area included the United States, Canada, Yemen, and Ethiopia. See Note 4 "*Property and Equipment*". Summarized reportable geographical segment data follows:

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## MANAGEMENT'S DISCUSSION AND ANALYSIS FOR THE SIX MONTHS ENDED JUNE 30, 2010

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
Reportable Segments:	2010	2009	2010	2009
United States:				
Revenues	\$ 3,864	\$ 732	\$ 7,847	\$ 2,440
Operating costs	437	385	865	852
Capital expenditures	1,170	7,163	2,520	14,223
Canada:				
Revenues	5		18	-
Operating costs	3		2	-
Capital expenditures	1,289	40	1,390	50
Yemen:				
Revenues	-			-
Operating costs	-		-	-
Capital expenditures	-	300	-	2,172
Ethiopia:				
Revenues	-		-	-
Operating costs	-		-	-
Capital expenditures	176	644	179	230
Other International:				
Revenues	-	-	-	-
Operating costs	-	-	-	-
Capital expenditures	6	128	17	2,737
<b>Total Reportable Segments</b>				
Revenues	\$ 3,869	\$ 732	\$ 7,865	\$ 2,440
Operating costs	\$ 440	\$ 385	\$ 867	\$ 852
Capital expenditures	\$ 2,641	\$ 8,275	\$ 4,106	\$ 19,412

### COMMITMENTS AND CONTINGENCIES

#### *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 CDN\$2.3 million (US \$2.2) for the cost to drill the first of the two aforementioned earning wells. The second well obligation of CDN\$2.4 million will be partially substituted for a 3D seismic program, at a cost of CDN \$1.3 million (US \$1.2). This amount was paid in full in June 2010.

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 Talisman Energy Inc. (formerly 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

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## MANAGEMENT'S DISCUSSION AND ANALYSIS FOR THE SIX MONTHS ENDED JUNE 30, 2010

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 June 30, 2010, 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 at June 30, 2010, the Corporation had received a favorable decision on its F Andrews well appeal from the NY DEC commissioner. The decision was not appealed by Talisman Energy Inc. (formerly 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 \$3.0 million 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 June 30, 2010, the Corporation had incurred \$2.3 million under the terms of this agreement.

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
<b>Future Commitments:</b>				
Accounts payable and accrued liabilities	\$ 1,926	\$ 1,920	\$ 6	\$ -
Operating leases	266	76	152	38
Purchase obligations (1)	1,622	1,622	-	-
Other long-term obligations (2)	4,196	1,196	3,000	-
<b>Total future commitments</b>	<b>\$ 8,010</b>	<b>\$ 4,814</b>	<b>\$ 3,158</b>	<b>\$ 38</b>

Notes:

(1) Saskatchewan - Bakken Shale Drilling Commitment.

(2) Estimated remaining costs pertaining to the Production Sharing Agreement in Ethiopia and additional Bakken wells.

### *Litigation*

The Company is involved in litigation and claims arising in the normal course of operations. Management is of the opinion that any pending litigation is without merit and would not have a material adverse impact on the Company's financial position or results of operations.

# **EPSILON ENERGY LTD.**

## **MANAGEMENT'S DISCUSSION AND ANALYSIS FOR THE SIX MONTHS ENDED JUNE 30, 2010**

### **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;
- 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 bullet points 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 for more details.

- *Full Cost Accounting*
- *Crude Oil and Natural Gas Reserves*
- *Asset Retirement Obligations (“ARO”)*
- *Stock-Based Compensation*
- *Income Taxes*

### **International Financial Reporting Standards (“IFRS”)**

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.

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## **MANAGEMENT'S DISCUSSION AND ANALYSIS FOR THE SIX MONTHS ENDED JUNE 30, 2010**

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 is currently in the process of quantifying the impact of adopting IFRS on the opening balance sheet as of the transition date. This process is expected to be completed at the end of third quarter 2010.

In addition, due to anticipated changes to IFRS and International Accounting Standards prior to the Corporation's adoption of IFRS, Management's plan is continually evolving based on new facts and circumstances as they arise.

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
- 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

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## **MANAGEMENT'S DISCUSSION AND ANALYSIS FOR THE SIX MONTHS ENDED JUNE 30, 2010**

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 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

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## **MANAGEMENT'S DISCUSSION AND ANALYSIS FOR THE SIX MONTHS ENDED JUNE 30, 2010**

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**

#### *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.

#### *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.

As of March 31, 2010, the Corporation has identified a material weakness in ICFR. In the second quarter of June 2010, the Corporation has made substantial improvements in its ICFR framework. Specifically, a CFO with 12 years of experience in financial reporting and internal controls has been appointed. An Approval

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## **MANAGEMENT'S DISCUSSION AND ANALYSIS FOR THE SIX MONTHS ENDED JUNE 30, 2010**

Authority Matrix was adopted which outlines authority for entering into transactions for all major cycles of the Corporation.

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 concluded that the Corporation does not have sufficient history of controls to remove the deficiency disclosure in its June 30, 2010 reporting. The deficiency is expected to be removed by the end of third quarter 2010.

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.

### **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.

# EPSILON ENERGY LTD.

## MANAGEMENT'S DISCUSSION AND ANALYSIS FOR THE SIX MONTHS ENDED JUNE 30, 2010

### 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. In addition, the Corporation utilizes financial services provided by Capital Z Corporation, a company owned by the Executive Chairman. The Corporation shares office space with Capital Z Corporation at no charge.

The following transactions arose in the normal course of business and have been accounted for at the exchange amount being the amount agreed to by the related parties, which approximates the arms length equivalent value:

<i>(in thousands of dollars)</i>	<b>Six Months Ended June 30, 2010</b>	<b>Year Ended December 31, 2009</b>
706147 Ontario, Inc.	\$ 21	\$ 48
Capital Z Corporation	37	2
Rockefeller Hughes	(8)	-

The following balances are included in accounts payable and advances payable and are unsecured, non-interest bearing and due on demand:

<i>(in thousands of dollars)</i>	<b>Six Months Ended June 30, 2010</b>	<b>Year Ended December 31, 2009</b>
706147 Ontario, Inc.	\$ 4	\$ 4
Capital Z Corporation	2	2

#### *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 oil and natural gas property Gastem Inc. may acquire in Quebec. Raymond Savoie, Gastem Inc.'s President became a director of the Corporation on July 16, 2007. A summary of related party transactions between the Corporation and Gastem Inc. follows:

<i>(in thousands of dollars)</i>	<b>Six months June 30, 2010</b>	<b>Year ended December 31, 2009</b>
<b>Gastem Inc.</b>		
Joint venture costs	\$ 76	\$ 341
Joint venture revenues	-	112
Accounts payable	93	297
Proceeds from sale of assets	-	780

# EPSILON ENERGY LTD.

## MANAGEMENT'S DISCUSSION AND ANALYSIS FOR THE SIX MONTHS ENDED JUNE 30, 2010

These transactions arose in the normal course of business and have been accounted for at the exchange amount being the amount agreed to by the related parties, which approximates the arms length equivalent. The balances are unsecured, non-interest bearing and due on demand.

### ***Former Director and former President and CEO***

Austin Exploration LLC, a company owned by a former Director (resigned January 2010) 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, used to provide oil and natural gas lease brokerage services to the Corporation in accordance with a Project Services Agreement between Western Land Services and the Corporation. The agreement with Western Land Services was terminated as of quarter end.

<i>(in thousands of dollars)</i>	<b>June 30, 2010</b>	<b>December 31, 2009</b>
<b>Austin Exploration LLC:</b>		
Accounts receivable	\$ -	\$ 37
Joint venture costs	-	409
Joint venture revenues	-	564
<b>Western Land Services:</b>		
Lease brokerage services	-	441
Accounts payable	-	86

## **12. Subsequent Event**

By agreement dated January 2, 2010, the Corporation agreed to sell all of the issued and outstanding shares in Epsilon Energy Yemen Ltd. ("Epsilon Yemen"). This agreement was amended on July 14, 2010 and further amended on July 15, 2010; the total amended purchase price is \$656,000 of which \$100,000 was received on August 3, 2010.

## **OUTLOOK**

In NY, the Corporation is exploring opportunities in various formations including the Marcellus and Oriskany.

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](http://www.sedar.com)

Zoran Arandjelovic  
President and CEO  
Epsilon Energy Ltd.  
150 Jardin Drive, Suite 9

**EPSILON ENERGY LTD.**  
**MANAGEMENT'S DISCUSSION AND ANALYSIS**  
**FOR THE SIX MONTHS ENDED JUNE 30, 2010**

Concord, ON, Canada L4K 3P9

(905) 738-7877

[www.epsilonenergyltd.com](http://www.epsilonenergyltd.com)