



**Interim Unaudited
Consolidated Financial Statements
For the three and nine months ended
September 30, 2010**

EPSILON ENERGY LTD.

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EPSILON ENERGY LTD.
Interim Unaudited Consolidated Balance Sheets
(All amounts stated in US\$)

	September 30, 2010	December 31, 2009
	<u>2010</u>	<u>2009</u>
ASSETS		
Current assets:		
Cash	\$ 17,518,799	\$ 15,288,547
Accounts receivable	2,152,092	1,488,429
Assets held for sale (Note 3)	-	100,000
Other current assets	168,873	62,382
Total current assets	<u>19,839,764</u>	<u>16,939,358</u>
Property and equipment:		
Net property and equipment (Note 3)	62,325,740	66,691,074
Other assets:		
Restricted cash (Note 4)	848,140	732,240
Other deferred charges and miscellaneous assets	8,010	18,504
Total other assets	<u>856,150</u>	<u>750,744</u>
Total assets	<u>\$ 83,021,654</u>	<u>\$ 84,381,176</u>
 LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 1,601,759	\$ 3,460,740
Total current liabilities	<u>1,601,759</u>	<u>3,460,740</u>
Other liabilities:		
Asset retirement obligations	170,989	214,393
Total other liabilities	<u>170,989</u>	<u>214,393</u>
Total liabilities	<u>1,772,748</u>	<u>3,675,133</u>
 Commitments and contingencies (Note 6)		
Related party transactions (Note 8)		
Subsequent event (Note 11)		
 Shareholders' equity:		
Share capital (Note 5)	136,219,791	138,272,250
Contributed surplus (Note 5)	6,338,228	6,098,296
Deficit	(54,763,480)	(56,787,577)
Accumulated other comprehensive loss	(6,545,633)	(6,876,926)
Total shareholders' equity	<u>81,248,906</u>	<u>80,706,043</u>
Total liabilities and shareholders' equity	<u>\$ 83,021,654</u>	<u>\$ 84,381,176</u>

(signed) Nick Orlando

(signed) Raymond Savoie

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Revenues:				
Oil & gas revenues	\$ 2,690,203	\$ 606,563	\$ 10,555,753	\$ 2,913,112
Other revenues	-	-	-	133,248
Total revenues	<u>2,690,203</u>	<u>606,563</u>	<u>10,555,753</u>	<u>3,046,360</u>
Operating costs and expenses:				
Project operating costs	75,103	187,787	942,475	1,040,180
Impairment of unproved properties	263,168	580,754	296,423	2,753,030
Amortization, depletion and accretion	1,152,920	1,212,468	4,052,765	2,520,662
General and administrative	243,376	1,368,497	3,308,251	3,840,879
Total operating costs and expenses	<u>1,734,567</u>	<u>3,349,506</u>	<u>8,599,914</u>	<u>10,154,751</u>
Operating income (loss)	<u>955,636</u>	<u>(2,742,943)</u>	<u>1,955,839</u>	<u>(7,108,391)</u>
Other income (expense):				
Other income (expense)	24,675	(54,525)	68,258	(240,786)
Gain (loss) on sale of assets	3,133	(14,178)	-	(9,742,665)
Net income (loss) before income taxes	<u>983,444</u>	<u>(2,811,646)</u>	<u>2,024,097</u>	<u>(17,091,840)</u>
Income taxes:				
Income tax recovery	-	-	-	2,600,000
Net income (loss)	983,444	(2,811,646)	2,024,097	(14,491,840)
Deficit, beginning of period	<u>(55,746,924)</u>	<u>(48,239,153)</u>	<u>(56,787,577)</u>	<u>(36,558,958)</u>
Deficit, end of period	<u>\$ (54,763,480)</u>	<u>\$ (51,050,799)</u>	<u>\$ (54,763,480)</u>	<u>\$ (51,050,799)</u>
Basic net income (loss) per share	\$ 0.02	\$ (0.06)	\$ 0.04	\$ (0.29)
Basic weighted average number of shares outstanding	49,756,506	50,315,323	49,756,506	50,315,323
Diluted net income (loss) per share	0.02	\$ (0.06)	0.04	\$ (0.29)

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

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

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2010	2009	2010	2009
Cash flows from operating activities:				
Net income (loss) for the period	\$ 983,444	\$ (2,811,646)	\$ 2,024,097	\$(14,491,840)
Items not involving cash:				
Amortization, depletion and accretion	1,152,920	1,212,468	4,052,765	2,520,662
Impairment of unproved properties	263,168	580,754	296,423	2,753,030
Stock-based (recovery) compensation (Note 5)	(263,192)	229,686	239,759	724,706
(Gain) Loss on sale of assets	(3,133)	14,178	(3,133)	9,742,665
Future income tax expense (recovery)	-	-		(2,600,000)
Changes in non-cash balances related to operations	519,473	23,646	(835,158)	(3,631,810)
Net cash provided by (used in) operating activities	<u>2,652,680</u>	<u>(750,914)</u>	<u>5,774,753</u>	<u>(4,982,587)</u>
Cash flows from investing activities:				
Additions to oil and natural gas properties	(971,397)	(6,717,610)	(6,663,950)	(25,907,987)
Additions to other property and equipment	(2,343)	(11,083)	(1,809)	(53,961)
Cash received on farmout with joint venture partner	-	-	5,000,000	-
Proceeds from assets sold	17,000	(14,178)	17,000	12,932,272
Change in restricted cash (Note 4)	84,800	(538,920)	(115,900)	31,558,538
Changes in other assets and other liabilities	-	379,992	-	358,733
Net cash provided by investing activities	<u>(871,940)</u>	<u>(6,901,799)</u>	<u>(1,764,659)</u>	<u>18,887,595</u>
Cash flows from financing activities:				
Proceeds from the issuance of common shares	99,879	-	416,964	(280)
Changes in lines of credit	-	(1,134,500)		(11,684,134)
Buy back of common stock	-		(2,469,250)	
Change in long-term liabilities	(2,080)	(5,908)	(7,638)	(1,743)
Net cash provided by financing activities	<u>97,799</u>	<u>(1,140,408)</u>	<u>(2,059,924)</u>	<u>(11,686,158)</u>
Effect of currency rates on cash and cash equivalents	<u>117,696</u>	<u>977,357</u>	<u>280,082</u>	<u>2,202,898</u>
Increase (decrease) in cash	1,996,235	(7,815,764)	2,230,252	4,421,749
Cash, beginning of period	<u>15,522,564</u>	<u>20,470,955</u>	<u>15,288,547</u>	<u>8,233,442</u>
Cash, end of period	<u>\$17,518,799</u>	<u>\$12,655,191</u>	<u>\$17,518,799</u>	<u>\$ 12,655,191</u>
Supplementary cash flow information				
Interest received	20,336	21,764	57,144	244,552
Interest paid	413	76,289	4,733	442,886
Income taxes paid	-	-	-	-

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

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

	<u>Three Months Ended September 30,</u>		<u>Nine Months Ended September 30,</u>	
	<u>2010</u>	<u>2009</u>	<u>2010</u>	<u>2009</u>
Comprehensive income (loss):				
Net income (loss)	\$ 983,444	\$ (2,811,646)	\$ 2,024,097	\$ (14,491,840)
Other comprehensive income:				
Currency translation adjustments	<u>202,924</u>	<u>977,357</u>	<u>331,293</u>	<u>2,202,898</u>
Comprehensive income (loss)	<u>\$ 1,186,368</u>	<u>\$ (1,834,289)</u>	<u>\$ 2,355,390</u>	<u>\$ (12,288,942)</u>
Accumulated other comprehensive loss:				
Balance, beginning of period	\$ (6,748,557)	\$ (8,581,495)	\$ (6,876,926)	\$ (9,807,036)
Currency translation adjustments	<u>202,924</u>	<u>977,357</u>	<u>331,293</u>	<u>2,202,898</u>
Accumulated other comprehensive loss	<u>\$ (6,545,633)</u>	<u>\$ (7,604,138)</u>	<u>\$ (6,545,633)</u>	<u>\$ (7,604,138)</u>

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

Epsilon Energy Ltd.
Notes to the Unaudited Interim Consolidated Financial Statements
For the three and nine months ended September 30, 2010

1. Description of Business

Epsilon Energy Ltd. (the “Corporation”) was incorporated under the laws of the Province of Alberta on March 14, 2005. On October 24, 2007, the Corporation became a publicly traded entity on the Toronto Stock Exchange under the trading symbol “EPS”. The Corporation is engaged in the acquisition, exploration, development and production of natural gas and oil reserves. Such activities are concentrated in the following geographic areas:

- Marcellus Shale (“Pennsylvania” and “New York”) and Trenton-Black River in the United States;
- Bakken Shale (“Saskatchewan”) and Utica Shale (“Quebec”) Canada; and
- the Federal Democratic Republic of Ethiopia (“Ethiopia”).

2. Significant accounting policies

The Corporation’s unaudited interim consolidated financial statements for the period ended September 30, 2010 and 2009 include the accounts of the Corporation and its wholly owned subsidiaries Epsilon Energy USA, Inc. and Epsilon Energy International Ltd. and its wholly owned subsidiaries. All material intercompany transactions have been eliminated.

The unaudited interim consolidated financial statements have been prepared by management in US dollars and in accordance with Canadian generally accepted accounting policies and follow the same accounting policies as the most recent annual audited consolidated financial statements. The interim consolidated financial statement note disclosures do not include all of those required by Canadian generally accepted accounting principles (“GAAP”) applicable for annual consolidated financial statements. Accordingly, these interim consolidated financial statements should be read in conjunction with the Corporation’s audited consolidated financial statements for the years ended December 31, 2009 and 2008. In the opinion of management, all adjustments, consisting only of normal recurring adjustments, considered necessary for a fair presentation have been included. Operating results for the period ended September 30, 2010 are not indicative of the results that may be expected for the year ended December 31, 2010.

Future Accounting Changes

(a) International Financial Reporting Standards (“IFRS”)

In February 2008, the Accounting Standards Board (“AcSB”) confirmed that January 1, 2011 is the changeover date for publicly-listed companies to use IFRS, replacing Canada’s own GAAP. The date is for the interim and annual financial statements relating to fiscal years 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 its year ended December 31, 2010, and of the opening balance sheet as at January 1, 2010. Management is currently assessing the impact of adoption of IFRS.

Epsilon Energy Ltd.
Notes to the Unaudited Interim Consolidated Financial Statements
For the three and nine months ended September 30, 2010

3. Property and Equipment

The following table summarizes the Corporation's oil and natural gas property and other equipment as at September 30, 2010 and December 31, 2009:

	<u>Gross Cost</u>	<u>Accumulated Depletion, Depreciation and Impairment</u>	<u>Net Book Value</u>
As at September 30, 2010:			
Oil and natural gas properties			
United States ⁽¹⁾	\$ 65,703,906	\$ (10,094,462)	\$ 55,609,444
Canada	4,810,736	(634,095)	4,176,641
Yemen	50,413,721	(50,413,720)	1
Ethiopia	2,351,413	-	2,351,413
Oman	929,127	(929,127)	-
Other	284,444	(284,444)	-
	<u>\$ 124,493,347</u>	<u>\$ (62,355,848)</u>	<u>\$ 62,137,499</u>
Other property and equipment	<u>585,395</u>	<u>(397,154)</u>	<u>188,241</u>
Total property and equipment	<u><u>\$ 125,078,742</u></u>	<u><u>\$ (62,753,002)</u></u>	<u><u>\$ 62,325,740</u></u>

Notes:

- (1) During the first quarter of 2010, \$5,000,000 was received from the joint venture partner for the farm-out agreement, which was booked as a reduction in property and equipment.

	<u>Gross Cost</u>	<u>Accumulated Depletion, Depreciation and Impairment</u>	<u>Net Book Value</u>
As at December 31, 2009:			
Oil and natural gas properties			
United States	\$ 67,483,813	\$ (6,746,650)	\$ 60,737,163
Canada	3,312,075	(1,390)	3,310,685
Yemen	50,413,720	(50,413,720)	-
Ethiopia	2,094,037	-	2,094,037
Oman	929,127	(929,127)	-
Other property	268,196	(21,276)	246,920
	<u>\$ 124,500,968</u>	<u>\$ (58,112,163)</u>	<u>\$ 66,388,805</u>
Other property and equipment	<u>583,591</u>	<u>(281,322)</u>	<u>302,269</u>
Total property and equipment	<u><u>\$ 125,084,559</u></u>	<u><u>\$ (58,393,485)</u></u>	<u><u>\$ 66,691,074</u></u>

Costs excluded from the depletion calculation include \$14,968,818 (2009: \$7,369,526) in the United States and \$2,508,085 (2009: \$1,009,423) in Canada. Capitalized costs in Ethiopia are in the pre-production stage and have not been depleted and recoverability is dependent upon achieving commercial production and profitability.

Epsilon Energy Ltd.
Notes to the Unaudited Interim Consolidated Financial Statements
For the three and nine months ended September 30, 2010

3. Property and Equipment (continued)

Farmout Agreement with Joint Venture Partner

During the first quarter of 2010, \$5,000,000 was received as a cash payment from a joint venture partner pursuant to a farmout agreement whereby the joint venture partner will earn a 50% interest in the Marcellus Shale property by paying a further \$95,000,000 over time and by carrying the first \$95,000,000 of Epsilon's 50% share of costs attributable to the property. No gain or loss on the transaction was recorded as the depletion rate did not change by greater than 20%.

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 approximately \$5.5 million as of September 30, 2010. The Company continues to work on curing the remaining balance.

Assets Held for Sale - Sale of Epsilon Energy Yemen ltd.

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 most recently amended on July 15, 2010 and is expected to close December 31, 2010. The Corporation received \$100,000 on August 3, 2010 pursuant to the agreement.

Capitalized General and Administrative Costs ("G&A")

Capitalized G&A costs consist of wages, travel and other G&A costs directly associated with specific capital projects. Capitalized G&A costs for each country cost center for the three and nine months ended September 30, 2010 and 2009 were as follows:

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2010	2009	2010	2009
Capitalized general and administrative costs:				
United States	\$ 141,670	\$ 203,626	\$ 433,078	\$ 494,527
Canada	20,381	8,038	37,677	10,411
Yemen	-	10,500	-	63,819
Oman	-	118,220	-	361,135
Ethiopia	20,774	12,148	34,916	86,943
Other	-	21,022	17,117	49,224
Total capitalized general and administrative costs	\$ 182,825	\$ 373,554	\$ 522,788	\$ 1,066,059

4. Restricted Cash

	At September 30,	At December 31,
	2010	2009
Restricted Cash:		
Amegy Bank - US letter of credit	\$ 265,000	\$ -
Northwestern Bank - US letter of credit	-	65,000
TD Bank - Yemen letter of credit	390,418	378,233
TD Bank - Ethiopia letter of credit and other	192,722	289,007
Total restricted cash	\$ 848,140	\$ 732,240

Epsilon Energy Ltd.
Notes to the Unaudited Interim Consolidated Financial Statements
For the three and nine months ended September 30, 2010

5. Shareholders' Equity

(a) Authorized shares

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

(b) Issued

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

	Number of Shares Issued	Amount
Balance at December 31, 2008	50,315,323	\$ 138,259,259
Issuance costs for Bought Deal	-	(280)
Exercise of stock options	10,675	13,271
Balance at December 31, 2009	50,325,998	\$ 138,272,250
Exercise of stock options	300,000	497,582
Balance at March 31, 2010	50,625,998	\$ 138,769,832
Buy back of shares	(1,000,000)	(2,741,078)
Exercise of stock options	21,349	26,576
Balance at June 30, 2010	49,647,347	\$ 136,055,330
Exercise of stock options	109,159	164,461
Balance at September 30, 2010	49,756,506	\$ 136,219,791

Buy Back of Common Shares

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 (\$2,469,250 US) or \$2.50 CDN (\$2.47 US) per share. The shares purchased by Epsilon were cancelled.

Epsilon Energy Ltd.
Notes to the Unaudited Interim Consolidated Financial Statements
For the three and nine months ended September 30, 2010

5. Shareholders' Equity (continued)

(c) Stock Options

The following table summarizes stock option activity for the nine months ended September 30, 2010 and the year ended December 31, 2009:

	As at September 30, 2010		As at December 31, 2009	
	Number of Options	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price
Stock Options Outstanding:				
Balance at beginning of period	3,017,727	\$ 2.35	3,317,449	\$ 2.60
Granted	625,000	\$ 2.84	360,000	\$ 2.41
Exercised	(430,508)	\$ 0.98	(10,675)	\$ 0.85
Forfeited	(1,031,982)	\$ 3.12	(649,047)	\$ 3.72
Balance at end of period	<u>2,180,237</u>	<u>\$ 2.39</u>	<u>3,017,727</u>	<u>\$ 2.35</u>
Exercisable at period-end	<u>1,342,437</u>	<u>\$ 1.91</u>	<u>2,117,127</u>	<u>\$ 1.81</u>

The following table summarizes information about stock options outstanding at September 30, 2010 and December 31, 2009:

Exercise Price	Number of Options Outstanding	Number of Options Exercisable	Black-Scholes Option Pricing Model Valuation	Weighted Average Remaining Contractual Life (in years)
As at September 30, 2010:				
\$ 0.85	95,421	95,421	\$ 62,343	3.20
\$ 1.00	481,000	481,000	310,790	5.13
\$ 1.34	100,000	50,000	53,494	1.92
\$ 1.45	65,000	32,500	58,966	8.87
\$ 1.97	50,000	25,000	50,892	2.06
\$ 2.00	240,000	240,000	242,808	1.12
\$ 2.42	75,000	-	14,822	2.80
\$ 2.50	227,316	224,916	785,535	6.73
\$ 2.60	50,000	-	7,384	1.88
\$ 2.93	50,000	-	34,309	4.42
\$ 3.04	250,000	-	212,266	9.32
\$ 4.00	461,500	184,600	997,243	7.32
\$ 6.10	35,000	9,000	154,672	7.70
Total	<u>2,180,237</u>	<u>1,342,437</u>	<u>\$ 2,985,524</u>	<u>6.05</u>

Epsilon Energy Ltd.
Notes to the Unaudited Interim Consolidated Financial Statements
For the three and nine months ended September 30, 2010

5. Shareholders' Equity (continued)

(c) Stock Options (continued)

Exercise Price	Number of Options Outstanding	Number of Options Exercisable	Black-Scholes Option Pricing Model Valuation	Weighted Average Remaining Contractual Life (in years)
As at December 31, 2009:				
\$ 0.85	240,595	240,595	\$ 108,339	3.95
\$ 1.00	856,000	856,000	557,768	5.88
\$ 1.34	100,000	-	17,350	2.67
\$ 1.45	80,000	-	28,647	9.61
\$ 1.97	50,000	25,000	30,978	2.81
\$ 2.00	340,000	340,000	335,403	1.84
\$ 2.50	413,632	410,032	784,540	7.48
\$ 4.00	825,000	223,000	1,474,514	8.34
\$ 5.60	50,000	10,000	126,924	8.63
\$ 6.10	62,500	12,500	340,177	8.45
Total	<u>3,017,727</u>	<u>2,117,127</u>	<u>\$ 3,804,640</u>	<u>6.20</u>

The weighted average fair value of options granted during the period ended September 30, 2010 was \$2.02 per option calculated using a risk-free rate of 4.3%, dividend yield of 0%, volatility factor of 84%, and expected life ranging from 2.0 to 9.3 years. The value of the options was recorded as stock based compensation expense, with an offsetting amount to contributed surplus based on the vesting terms.

Subsequent to September 30, 2010, 200,000 options granted to a former officer expired on October 1, 2010.

(d) Contributed Surplus

The following table summarizes contributed surplus for the nine months ended September 30, 2010 and the year ended December 31, 2009:

Epsilon Energy Ltd.
Notes to the Unaudited Interim Consolidated Financial Statements
For the three and nine months ended September 30, 2010

5. Shareholders' Equity (continued)
(d) Contributed Surplus (continued)

	Nine Months Ended September 30, 2010	Year Ended December 31, 2009
Contributed surplus:		
Balance, beginning of period	\$ 6,098,296	\$ 5,401,361
Stock options exercised and forfeited	(783,444)	-
Buy back of shares	271,828	-
Stock options amortized and granted	751,548	696,935
Balance, end of period	<u>\$ 6,338,228</u>	<u>\$ 6,098,296</u>

6. Commitments and Contingencies

Saskatchewan - Bakken Shale Drilling Commitment

The Corporation entered into an agreement with an unrelated public 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 public company. During the nine months ended September 30, 2010, the Corporation paid \$1,109,795 (2009: \$2,213,680) for the cost to drill and complete the first of the two aforementioned earning wells. The second well obligation of \$2.4 million has been partially substituted for a 3D seismic program, which resulted in expenditures to the Corporation of \$1.3 million. 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 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 September 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. In 2009 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.

Epsilon Energy Ltd.
Notes to the Unaudited Interim Consolidated Financial Statements
For the three and nine months ended September 30, 2010

6. Commitments and Contingencies (continued)

Ethiopia

On May 14, 2009, the Corporation announced that it had signed a Production Sharing Agreement (“PSA”) with the Ministry of Mines and Energy in Democratic Republic of Ethiopia. Terms of the PSA include an initial three-year exploration period that includes a minimum financial commitment of \$3,000,000 to drill one exploratory well and to acquire a minimum of 200 kilometers of 2D seismic. In the event the 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 September 30, 2010, the Corporation had incurred \$2,351,413 under the terms of this agreement mainly for a high resolution airborne gravity and magnetic survey.

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	\$ 1,608,446	\$ 1,604,872	\$ 3,574	\$ -
Operating leases	247,535	76,165	152,329	19,041
Purchase obligations - Canada	2,593,300	2,593,300	\$ -	\$ -
Purchase obligations - US	10,000,000	-	10,000,000	-
Other long-term obligations - International	3,182,925	182,925	3,000,000	\$ -
Total future commitments	\$ 17,632,206	\$ 4,457,262	\$ 13,155,903	\$ 19,041

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.

7. Financial Instruments

Risk Management

The Corporation has the following risks related to financial assets and liabilities:

- *Liquidity Risk*
- *Commodity Price Risk*
- *Interest Rate Risk*
- *Foreign Currency Risk*
- *Credit Risk*

There have been no significant changes to objectives, policies or risks that the Corporation is subject to since December 31, 2009.

Epsilon Energy Ltd.
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8. Related Party Transactions

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. The Corporation utilizes consultation services provided by Capital Z Corporation, a company owned by the Executive Chairman and the Corporation shares office space with Capital Z Corporation at no charge. The Executive Chairman is the Chairman and CEO of Rockefeller Hughes, a company that rents office space from the Corporation. The following G&A 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:

	Nine Months Ended September 30, 2010	Year Ended December 31, 2009
706147 Ontario, Inc.	\$ 31,061	\$ 48,618
Capital Z Corporation	39,375	2,181
Rockefeller Hughes	(12,800)	-

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

	Nine Months Ended September 30, 2010	Year Ended December 31, 2009
706147 Ontario, Inc.	\$ 165	\$ 3,597
Capital Z Corporation	-	1,546

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. In return, the Corporation granted Gastem Inc. the right to participate for 25% of the Corporation's interest in certain future wells to be drilled in the Corporation's Amber Bank project in West Virginia by spending up to \$1.05 million. The Corporation's carrying value of the portion of its Amber Bank project's leasehold attributable to Gastem Inc.'s participation was nominal. The agreement was consummated with the expectation that Raymond Savoie, Gastem Inc.'s President, would become a director of the Corporation. Mr. Savoie became a director of the Corporation on July 16, 2007. On June 16, 2009, the Corporation, along with Gastem Inc., sold all of its oil and natural gas property interests in West Virginia to an unrelated third party for a gross amount of \$14,000,000 (\$779,802 net to Gastem Inc.). Related party transactions with Gastem Inc. were conducted in US

Epsilon Energy Ltd.**Notes to the Unaudited Interim Consolidated Financial Statements***For the three and nine months ended September 30, 2010***8. Related Party Transactions (continued)**

dollars. A summary of Gastem's joint venture share of related party transactions between the Corporation and Gastem Inc. follows:

	Nine months September 30, 2010	Year ended December 31, 2009
Gastem Inc.		
Joint venture costs	\$ 92,709	\$ 341,164
Joint venture revenues	-	111,502
Accounts payable	103,755	296,678
Proceeds from sale of assets	-	779,802

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 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 during second quarter of 2010.

	Nine months September 30, 2010	Year ended December 31, 2009
Austin Exploration LLC:		
Accounts receivable	\$ -	\$ 36,819
Joint venture costs	-	\$ 408,873
Joint venture revenues	-	\$ 563,835
Western Land Services:		
Lease brokerage services	\$ -	\$ 440,092
Accounts payable	-	\$ 86,320

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9. Reportable Geographical Segments

As at September 30, 2010, the Corporation's operations by geographical area included the United States, Canada, Yemen and Ethiopia. See Note 3 "Property and Equipment". Summarized reportable geographical segment data follows:

Reportable Segments:	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
United States:				
Revenues	\$ 2,684,771	\$ 606,563	\$ 10,532,514	\$ 3,046,360
Operating costs	72,750	187,787	938,578	1,040,180
Capital expenditures	694,628	2,919,646	3,215,274	17,142,155
Canada:				
Revenues	5,432	-	23,238	-
Operating costs	2,350	-	3,894	-
Capital expenditures	113,246	2,257,176	1,503,478	2,307,147
Yemen:				
Revenues	-	-	-	-
Operating costs	-	-	-	-
Capital expenditures	-	580,754	-	2,753,030
Ethiopia:				
Revenues	-	-	-	-
Operating costs	-	-	-	-
Capital expenditures	77,572	13,148	257,376	242,709
Oman:				
Revenues				
Operating costs				
Capital expenditures		119,866		2,878,258
Other International:				
Revenues	-	-	-	-
Operating costs	-	-	-	-
Capital expenditures	(876)	21,393	16,247	64,065
Total Reportable Segments				
Revenues	\$ 2,690,203	\$ 606,563	\$10,555,752	\$ 3,046,360
Operating costs	\$ 75,100	\$ 187,787	\$ 942,472	\$ 1,040,180
Capital expenditures	\$ 884,570	\$ 5,911,983	\$ 4,992,375	\$ 25,387,364

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10. Changes in Non-Cash Balances Related to Cash Flows

Changes in non-cash balances were comprised of the following:

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2010	2009	2010	2009
Changes in non-cash balances:				
Accounts receivable, net	\$ 680,635	\$ 3,799,052	\$ (663,663)	\$ 6,032,223
Assets held for sale	100,000	-	100,000	-
Long-term receivable	-	(4,448,683)	-	(4,448,683)
Other current assets	(113,303)	166,158	(95,997)	163,803
Accounts payable and accrued liabilities	(147,859)	507,119	(175,498)	(5,379,153)
	<hr/>	<hr/>	<hr/>	<hr/>
Total changes to non-cash balances	\$ 519,473	\$ 23,646	\$ (835,158)	\$ (3,631,810)

Non-cash changes relating to the *Additions to Oil and Natural Gas Properties* component of cash used in investing activities for the three and nine months ended September 30, 2010 and 2009, respectively, were comprised of the following:

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2010	2009	2010	2009
Additions to Oil and Natural Gas Properties				
Change in gross property for the period	\$ 872,738	\$ 5,911,983	\$ 4,982,048	\$ 2,712,428
Non-cash changes:				
Assets held for sale	-	1,138,042	-	1,138,042
Asset retirement obligations	(4,085)	-	42,590	134,370
Cost of assets sold	13,866	-	13,866	22,674,937
Accrued liabilities	174,105	(332,415)	1,676,658	(751,790)
Currency translation effect	(85,227)	-	(51,212)	-
	<hr/>	<hr/>	<hr/>	<hr/>
Total cash additions to oil and natural gas properties	\$ 971,397	\$ 6,717,610	\$ 6,663,950	\$ 25,907,987

The Corporation did not have any material non-cash changes pertaining to its financing activities for the presented periods.

Epsilon Energy Ltd.
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11. Capital Disclosures

The Corporation as at September 30, 2010 defines its capital as follows:

- Cash
- Restricted cash
- Shareholders' equity

The amounts included in the Corporation's capital are as follows:

	September 30, 2010	December 31, 2009
Capital:		
Cash and short-term investments	\$ 17,518,799	\$ 15,288,547
Restricted cash	\$ 848,140	\$ 732,240
Shareholders' equity	\$ 81,505,387	\$ 80,706,043

The Corporation's strategy is designed and formulated to maintain a flexible capital structure to allow the Corporation the ability to respond to changes in economic conditions, additional capital requirements, and the risk characteristics of the underlying assets of the Corporation. The Corporation considers the cash flows from the underlying assets and future capital needs when assessing the need for additional capital, if any. Depending on future liquidity requirements, the Corporation may invest its excess cash in short or long-term financial instruments.

12. Subsequent event

Signing of a Participation Agreement

On October 1, 2010, the Corporation signed a Participation Agreement (the "Agreement") for the development of an oil resource play in the southern U.S. with a large US-based private land owner. Under the principal terms of the Agreement, the Corporation is committed to drill a minimum of two wells at an estimated cost of \$10,000,000 in return for a lease of 60% of land owner's available mineral interests in the approximate 15,800 gross (13,600 net) acres it owns or controls.