



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

**For the three and nine months ended  
September 30, 2010**

**Dated November 4, 2010**

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# **EPSILON ENERGY LTD.**

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

### **FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 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 November 4, 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 September 30, 2010 and for the three and nine months ended 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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#### **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.

#### **Recent Events**

##### ***Signing of a Participation Agreement***

On October 1, 2010, the Corporation signed a Participation Agreement (the "Agreement") with Black Stone Minerals Company, L.P. ("Black Stone") for the development of an oil resource play in Clarke and Wayne Counties, Mississippi.

Under the principal terms of the Agreement, Epsilon is committed to drill a minimum of two wells at an estimated cost of US\$10 million in return for a lease of 60% of Black Stone's available mineral interests in the approximate 15,800 gross/13,600 net acres it owns or controls. The acreage subject to the proposed joint operating agreement is in the immediate proximity of an existing producing oil fairway. The expenditures on this project are scheduled to commence in the second quarter of 2011.

##### ***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.

##### ***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 canceled. 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.

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#### ***Farmout Agreement with Chesapeake***

On February 3, 2010, the Corporation closed a Farmout Agreement with Chesapeake Energy Corporation (“**Chesapeake**”). At closing Chesapeake paid to the joint venture \$5.0 million in cash and will earn a 50% interest in the Corporation’s upstream Marcellus Shale assets by paying a further \$95.0 million over time by carrying the first \$95.0 million of the Corporation's share of leasehold, drilling, completing, equipping and gathering costs attributable to the prospect.

#### **Overall Performance**

During the first nine months of 2010, the Corporation generated a net income of approximately \$2.02 million as compared to \$14.5 million net loss for the first nine months of 2009. At September 30, 2010, the Corporation had surplus working capital (inclusive of restricted cash) of approximately \$19.1 million, as compared to \$14.2 million of surplus working capital (inclusive of restricted cash) at December 31, 2009, an increase of 34.50%. The Corporation has net cash flows provided by operations of \$5.77 million compared to net cash flows used in operation of \$4.98 million for the nine months ended September 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 September 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 8 Mmcf per day, with two compressors in operation with total capacity of 10 Mmcf per day. By the end of the third quarter, seven additional wells have been drilled by the joint venture partners in which the Corporation has an average working interest of approximately 20%. The anticipated production date for these wells is first quarter of 2011.

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

In New York, where the Corporation holds an interest in approximately 27,300 gross (12,700 net) acres, the Corporation’s acreage is prospective for natural gas production in both the Marcellus shale, (shallow unconventional natural gas play) and the Trenton-Black River formation (deep conventional natural gas play).

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

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

###### ***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%.

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During the first nine 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 24,800 gross (6,200 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 an unrelated public 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 public 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 public company.

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 September 30, 2010 the Corporation had paid CDN \$1.1 million 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, at a cost of CDN \$1.3 million (US \$1.2). This amount was paid in full in June 2010 and the drilling on the well will commence in the fourth quarter of 2010.

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 public 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 at a total cost of approximately \$1.0 million. The drilling on the first well is scheduled to commence during the fourth quarter of 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

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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**

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>
<i>(in thousands of dollars, except per unit and production values)</i>				
<b>Total Revenues</b>	<b>\$ 2,690</b>	<b>\$ 607</b>	<b>\$ 10,556</b>	<b>\$ 3,046</b>
Net natural gas production (Mcf)	620,293	182,086	2,153,557	557,423
Average natural gas price (\$/Mcf)	\$ 4.31	\$ 3.33	\$ 4.89	\$ 5.48
End of period net production exit rate (Mcf/d)	6,046	2,891	6,046	2,891
Net oil production (bbls)	78	2	296	(180)
Average oil price (\$/bbl)	\$ 69.92	\$ 53.54	\$ 81.01	\$ 49.50

**Three months ended September 30, 2010 and 2009**

Total revenues increased by \$2.1 million compared to third quarter of 2009 due to an increase in gas production of 438,207 Mcf as a result of six additional Pennsylvania wells operating at the end of September 2010 compared to two in September 2009. The increase in revenues also resulted from the increase in the average natural gas price.

**Nine months ended September 30, 2010 and 2009**

Total revenues increased by \$7.5 million compared to the nine months ended September 30, 2009 due to an increase in gas production of 1,596,134 Mcf as a result of six additional Pennsylvania wells operating at the end of September 2010 compared to two in September 2009. 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**

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<i>(in thousands of dollars)</i>	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>
<b>Project operating costs</b>	<b>75</b>	<b>188</b>	<b>942</b>	<b>1,040</b>

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 which carries Epsilon's share of lease operating expenses. In 2010, there was a further reduction in production taxes that are included in project operating costs due to the sale of the West Virginia interests. There are no production taxes in Pennsylvania or New York.

***IMPAIRMENT OF UNPROVED PROPERTY***

<i>(in thousands of dollars)</i>	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>
<b>Impairment of unproved property</b>	<b>263</b>	<b>581</b>	<b>296</b>	<b>2,753</b>

**Three and nine months ended September 30, 2010 and 2009**

During the three months ended September 30, 2010, the Corporation recorded an unproved property impairment on interests in Uruguay, Syria and Iraq. During the same quarter of 2009, the Corporation recorded an unproved property impairment pertaining to Block 41 in Yemen.

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

<i>(in thousands of dollars)</i>	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>
<b>Depletion, depreciation and accretion</b>	<b>1,153</b>	<b>1,212</b>	<b>4,053</b>	<b>2,521</b>

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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.

Substantially all depreciation expense amounts pertained to the Corporation's office furniture and fixtures, computer hardware and software, while all accretion expense amounts pertain to the amortization of the Corporation's asset retirement obligations.

**Three months ended September 30, 2010 and 2009**

The Depletion, Depreciation and Accretion ("DD&A") expense is lower in 2010 despite higher reserves because the current reserves are being depleted at a lower rate compared to the third quarter of 2009.

**Nine months ended September 30, 2010 and 2009**

The Depletion, Depreciation and Accretion ("DD&A") expense increased by \$1.5 million compared to the nine months ended September 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>	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>
<b>General and administrative</b>	<b>243</b>	<b>1,369</b>	<b>3,308</b>	<b>3,841</b>

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

**Three months ended September 30, 2010 and 2009**

The G&A expense decreased by approximately \$1.1 million in the third quarter of 2010 due to continued cost containment measures, and reversal of unvested stock options on forfeitures.

**Nine months ended September 30, 2010 and 2009**

The G&A expense decreased by approximately \$0.5 million in the first nine months of 2010 as a result of continuation of cost containment measures that were implemented during the second half of 2009, reversal of unvested stock options on forfeitures and the reversal of the Ontario capital tax discontinued in 2010.

In the first quarter of 2010, the Corporation incurred a one-time \$1.0 million transaction fee on the closing of the joint venture agreement with Chesapeake. Excluding the impact of this expenditure, general and administrative expenses decreased by \$1.5 million.

**OTHER INCOME (EXPENSE)**

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<i>(in thousands of dollars)</i>	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>
<b>Other income (expense)</b>	<b>25</b>	<b>(55)</b>	<b>65</b>	<b>(241)</b>

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

**Three and nine months ended September 30, 2010 and 2009**

In 2010, Epsilon had higher interest income compared to 2009 since the Corporation had higher cash balance and no debt.

**GAIN (LOSS) ON SALE OF ASSETS**

<i>(in thousands of dollars)</i>	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>
<b>Gain (loss) on sale of assets</b>	<b>3</b>	<b>(14)</b>	<b>3</b>	<b>(9,743)</b>

**Three months ended September 30, 2010 and 2009**

During the third quarter of 2009, Epsilon incurred \$0.01 million loss on sale of assets, reflecting an adjustment to the sale of West Virginia properties that were sold in the second quarter of 2009; there was a small gain related to the disposition of fixed assets during the third quarter of 2010.

**Nine months ended September 30, 2010 and 2009**

During the first nine months of 2009, the Corporation recorded a net loss of \$9.74 million on the sale of its oil and natural gas property interests in West Virginia; there was a small gain related to the disposition of fixed assets during the third quarter of 2010.

**INCOME TAXES**

<i>(in thousands of dollars)</i>	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>
<b>Income tax expense (recovery)</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>(2,600)</b>

**Three and nine months ended September 30, 2010 and 2009**

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

During the first nine months of 2009 the Corporation recorded a future income tax recovery of \$2.6 million. This amount represents the Corporation's recognition of deductible temporary differences (mainly

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pertaining to the sale of its oil and natural gas property interests in West Virginia) to the extent to offset the taxable temporary differences and record a valuation allowance for any remaining deductible temporary differences. Deferred tax assets were not booked as they were not assessed by the management to be more likely than not to be realized as assets. There was no income tax recovery for the three and nine months ended September 30, 2010.

Determination of the Corporation's income tax and other tax liabilities requires the interpretation of complex laws and regulations. All tax filings are subject to audit and potential reassessment after the lapse of considerable time. Accordingly, the actual income tax liability may differ from that estimated and recorded by the Corporation's management.

#### **NET INCOME (LOSS)**

<i>(in thousands of dollars except per share amounts)</i>	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>
<b>Net income (loss)</b>	<b>984</b>	<b>(2,812)</b>	<b>2,024</b>	<b>(14,492)</b>
<b>Net income (loss) per share, basic</b>	<b>0.02</b>	<b>(0.06)</b>	<b>0.04</b>	<b>(0.29)</b>
<b>Net income (loss) per share, diluted</b>	<b>0.02</b>	<b>(0.06)</b>	<b>0.04</b>	<b>(0.29)</b>

#### **Three months ended September 30, 2010 and 2009**

The net income for the third quarter ended September 30, 2010 of approximately \$0.98 million (\$0.02 per share) as compared to a net loss of \$2.8 million (\$0.06 per share) for the same period in 2009 was primarily attributable to a combination of following factors, all of which were discussed earlier:

- \$2.1 million attributable to higher revenue
- \$1.1 million reduction in general and administrative expenses
- \$0.3 million reduction in impairment of unproved properties

#### **Nine months ended September 30, 2010 and 2009**

The net income for the nine months ended September 30, 2010 of approximately \$2.02 million (\$0.04 per share) as compared to a net loss of \$14.5 million (\$0.29 per share) for the same period in 2009 was primarily attributable to a combination of following factors, all of which were discussed earlier:

- \$7.5 million attributable to higher revenue
- \$2.5 million reduction in impairment of unproved properties
- \$9.7 million loss on sale of the West Virginia properties in June 2009
- Partially offset by \$1.5 million higher DD&A costs and a nil income tax recovery compared to a \$2.6 million recovery in 2009

#### **SUMMARY OF QUARTERLY RESULTS**

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

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(in thousands of dollars, except shares outstanding and per share amounts)	<b>Dec 31, 2008</b>	<b>Mar 31, 2009</b>	<b>Jun 30, 2009</b>	<b>Sep 30, 2009</b>	<b>Dec 31, 2009</b>	<b>Mar 31, 2010</b>	<b>June 30, 2010</b>	<b>Sep 30, 2010</b>
<b>Revenues:</b>								
Gas	1,855	1,650	665	607	2,374	3,983	3,864	2,685
Oil	(229)	(15)	6	-	19	13	6	5
Gathering fees, net	287	72	61	-	-	-	-	-
<b>Total revenues</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>	<b>2,690</b>
Operating costs	453	467	385	188	300	427	441	75
Impairment of unproved properties	34,099	-	2,172	581	16,031	33	-	263
DD&A	327	697	612	1,212	937	1,544	1,356	1,153
G&A	1,820	1,306	1,166	1,369	770	1,960	1,105	243
<b>Cost of operations</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>	<b>1,734</b>
Operating income (loss)	(34,786)	(763)	(3,603)	(2,743)	(15,645)	32	968	956
Gain (loss) on sale of assets	(72)	-	(9,728)	(14)	9,893	-	-	-
Other income (loss)	43	(72)	(114)	(55)	16	18	22	28
<b>Net income (loss) before income taxes</b>	<b>(34,815)</b>	<b>(835)</b>	<b>(13,445)</b>	<b>(2,812)</b>	<b>(5,736)</b>	<b>50</b>	<b>990</b>	<b>984</b>
Income tax expense (recovery)	2,600	-	(2,600)	-	-	-	-	-
<b>Net income (loss)</b>	<b>(37,415)</b>	<b>(835)</b>	<b>(10,845)</b>	<b>(2,812)</b>	<b>(5,736)</b>	<b>50</b>	<b>990</b>	<b>984</b>
Weighted average number of shares outstanding, basic	51,315,323	51,315,323	51,315,323	51,315,323	50,325,998	50,550,998	49,840,185	49,756,506
Weighted average number of shares outstanding, diluted	51,315,323	51,315,323	51,315,323	51,315,323	50,325,998	50,550,998	51,175,431	50,719,276
Net income (loss) per share, basic	(0.79)	(0.02)	(0.27)	(0.05)	(0.06)	0.00	0.02	0.02
Net income (loss) per share, diluted	(0.79)	(0.02)	(0.27)	(0.05)	(0.06)	0.00	0.02	0.02

# EPSILON ENERGY LTD.

## MANAGEMENT'S DISCUSSION AND ANALYSIS

### FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2010

#### LIQUIDITY AND CAPITAL RESOURCES

##### *Working Capital*

At September 30, 2010, the Corporation had a working capital surplus (inclusive of restricted cash) of \$19.1 million, as compared to \$14.2 million of surplus working capital (inclusive of restricted cash) at December 31, 2009. The \$4.9 million increase in working capital at September 30, 2010, as compared to December 31, 2009 is primarily attributable to \$0.7 million increase in accounts receivable due to higher gas revenues and a \$1.9 million decrease in accounts payable as a result of paying off outstanding balances more promptly. There has also been an increase in cash from higher revenues and lower operating costs pursuant to the farmout agreement, and to an increase in restricted cash due to a road bond with the Department of Environmental Protection.

As of September 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 farmout 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 US and Africa.

##### *Cash Flow from Operations*

##### **Three months ended September 30, 2010 and 2009**

During the third quarter of 2010, \$2.7 million was provided by the Corporation's operating activities, an increase of \$3.45 million compared to the third quarter of 2009 due to net income of \$0.98 million in 2010 compared to a net loss of \$2.81 in 2009.

##### **Nine months ended September 30 2010 and 2009**

During the first nine months of 2010, \$5.8 million was provided by the Corporation's operating activities, an increase of \$10.8 million as compared to the first nine months of 2009. This is mainly attributable to the net income of \$2.02 million generated in 2010 compared to a net loss of \$14.5 million in 2009, and to \$5.0 million cash received pursuant to the farmout agreement.

##### *Outstanding Share Capital*

The following table summarizes the development of share capital from December 31, 2008 to September 30, 2010:

*(in thousands of dollars, except for the number of shares)*

	<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
Exercise of stock options	109,159	164
<b>Balance at September 30, 2010</b>	49,756,506	\$ 136,219

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**Stock options**

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.

**Property and Equipment**

<i>(in thousands of dollars)</i>	<u>Nine Months Ended</u> <u>September 30,</u> <u>2010</u>	<u>Year Ended</u> <u>December 31,</u> <u>2009</u>
<b>Property and equipment</b>	<u>\$62,326</u>	<u>\$66,691</u>

Total property and equipment decreased by \$4.4 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 farmout agreement that was applied against the agreed-upon carry amount.
- Drilling activities in New York, capital expenditures in Pennsylvania, completion costs of the first well in the Bakken shale and exploratory costs in Ethiopia, offset by the DD&A costs.

**Reportable Geographical Operating 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:

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*(in thousands of dollars)*

<b>Reportable Segments:</b>	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>
United States:				
Revenues	\$ 2,685	\$ 606	\$ 10,532	\$ 3,046
Operating costs	73	188	938	1,040
Capital expenditures	695	2,920	3,215	17,142
Canada:				
Revenues	5	-	23	-
Operating costs	2	-	4	-
Capital expenditures	113	2,257	1,503	2,307
Yemen:				
Revenues	-	-	-	-
Operating costs	-	-	-	-
Capital expenditures	-	581	-	2,753
Ethiopia:				
Revenues	-	-	-	-
Operating costs	-	-	-	-
Capital expenditures	78	13	257	243
Oman:				
Revenues				
Operating costs				
Capital expenditures		120		2,878
Other International:				
Revenues	-	-	-	-
Operating costs	-	-	-	-
Capital expenditures	(1)	21	17	64
<b>Total Reportable Segments</b>				
<b>Revenues</b>	<b>\$ 2,690</b>	<b>\$ 606</b>	<b>\$ 10,555</b>	<b>\$ 3,046</b>
<b>Operating costs</b>	<b>\$ 75</b>	<b>\$ 188</b>	<b>\$ 942</b>	<b>\$ 1,040</b>
<b>Capital expenditures</b>	<b>\$ 885</b>	<b>\$ 5,912</b>	<b>\$ 4,992</b>	<b>\$ 25,387</b>

**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 \$1.1 million (2009: \$2.2 million) 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 (US \$1.2 million). The remaining balance after

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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.

***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 September 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:

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*(in thousands of dollars)*

	<b>Payments Due by Period</b>			
	<b>Total</b>	<b>Less than 1 Year</b>	<b>1 – 3 Years</b>	<b>4 Years and After</b>
<b>Future Commitments:</b>				
Accounts payable and accrued liabilities	\$ 1,609	\$ 1,605	\$ 4	\$ -
Operating leases	247	76	152	19
Purchase obligations - Canada	2,593	2,593	-	-
Purchase obligations - US	10,000		10,000	
Purchase obligations - International	3,183	183	3,000	-
<b>Total future commitments</b>	<b>\$ 17,632</b>	<b>\$ 4,457</b>	<b>\$ 13,156</b>	<b>\$ 19</b>

***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.

**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*

# **EPSILON ENERGY LTD.**

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

### **FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2010**

#### **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 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'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 and Impact Analysis and Evaluation phases and has completed the opening balance sheet as at January 1, 2010.

The Corporation has considered the following key issues that were 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 has considered the following optional exemptions:

- **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. This election had no impact on the Corporation's opening balance sheet

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- 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. The Corporation has elected to carry the PP&E forward at net book value on the date of transition. Further, under IFRS, the Corporation’s PP&E assets must be divided into smaller cost centers. The net book value of the assets on the date of transition has been 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. There will be no impact on the Corporation on the adoption of IFRS 2 because the Corporation has been using the graded vesting method from inception.
- The Effects of Changes in Foreign Exchange Rates – IAS 21 allows an entity to deem all cumulative translation differences related to investments in foreign operations to zero at the transition date to avoid retrospective application. Epsilon will use this election at transition date.

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 re-classified 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.
- 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 have been performed at the cash generating unit level and no material impairment was determined to exist on transition date.
- 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 will continue to calculate depletion using proved reserves.
- The Effects of Changes in Foreign Exchange Rates – a cumulative translation adjustment related to investments in foreign operations totaling \$6.9 million was deemed nil by netting it against the deficit. This reclassification resulted in a nil adjustment to shareholders’ equity on transition date.

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”) – This has been 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 has assessed 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.

# **EPSILON ENERGY LTD.**

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

### **FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2010**

- 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.
- IT systems – The modifications are not expected to be significant,

#### **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 effective for the third quarter ended September 30, 2010.

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.

# **EPSILON ENERGY LTD.**

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

### **FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2010**

As of March 31, 2010, the Corporation has identified a material weakness in ICFR. In the second and third quarters of 2010, the Corporation has made substantial improvements in its ICFR framework. Specifically, a CFO with over 12 years of experience in financial reporting and internal controls has been appointed. An Approval 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 been closely monitoring the effectiveness of the Corporation's internal controls during the second and third quarters and noted that they have been operating effectively. The CFO also noted that, as at September 30, 2010, there is sufficient history of effective functioning of internal controls to remove the deficiency disclosure in current quarter reporting.

#### **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.

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**OFF-BALANCE SHEET ARRANGEMENTS**

The Corporation has no off-balance sheet arrangements.

**TRANSACTIONS WITH RELATED PARTIES**

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

***Executive Chairman***

The Corporation utilizes administrative services provided by 706147 Ontario, Inc., a company owned by the Executive Chairman's spouse. 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:

*(in thousands of dollars)*

	<b>Nine Months Ended September 30, 2010</b>	<b>Year Ended December 31, 2009</b>
	<hr/>	<hr/>
706147 Ontario, Inc.	\$ 31	49
Capital Z Corporation	39	2
Rockefeller Hughes	(13)	-

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

*(in thousands of dollars)*

	<b>Nine Months Ended September 30, 2010</b>	<b>Year Ended December 31, 2009</b>
	<hr/>	<hr/>
706147 Ontario, Inc.	\$ -	\$ 4
Capital Z Corporation	-	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. 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

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\$14,000,000 (\$779,802 net to Gastem Inc.). Related party transactions with Gastem Inc. were conducted in US dollars. A summary of Gastem's joint venture share of related party transactions between the Corporation and Gastem Inc. follows:

*(in thousands of dollars)*

	<b>Nine months September 30, 2010</b>	<b>Year ended December 31, 2009</b>
<b>Gastem Inc.</b>		
Joint venture costs	\$ 93	\$ 341
Joint venture revenues	-	112
Accounts payable	104	297
Proceeds from sale of assets	-	780

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.

*(in thousands of dollars)*

	<b>Nine months September 30, 2010</b>	<b>Year ended 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	\$ -	\$ 440
Accounts payable	-	\$ 86

**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

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**MANAGEMENT'S DISCUSSION AND ANALYSIS**  
**FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2010**

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.

**OUTLOOK**

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)

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