

**Montello Resources Ltd.**

**Financial Statements**

**For the Three Months Ended January 31, 2007**

**(Unaudited)**

**Date Submitted: March 31, 2007**

**P.O. Box 1757, Station M  
Calgary, Alberta  
T2P 2L8**

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**Montello Resources Ltd.  
PO. Box 1757, Station M  
Calgary, Alberta T2P 2L8**

**NOTICE OF NO AUDITOR REVIEW**

The accompanying unaudited interim financial statements have been prepared by management and approved by the Audit Committee and Board of Directors.

The Company's independent auditors have not performed a review of these financial statements in accordance with the standards established by the Canadian Institute of Chartered Accountants for a review of interim financial statements by an entity's auditors.

**March 31, 2007**

# Montello Resources Ltd.

## Consolidated Balance Sheets

(Unaudited)

Canadian Funds

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	<b>ASSETS</b>	<b>January 31, 2007</b>	<b>July 31, 2006</b>
<b>Current</b>			
Cash		\$ 3,724,289	\$ 100,523
Marketable securities		18,617	18,617
Accounts receivable and prepaid expenses		566,709	351,015
		<u>4,309,615</u>	<u>470,241</u>
<b>Property &amp; equipment</b> (Note 3)		<u>2,004,685</u>	<u>2,307,281</u>
		<u>\$ 6,314,300</u>	<u>\$ 2,777,522</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>			
<b>Current</b>			
Accounts payable and accrued liabilities		\$ 272,821	\$ 1,107,076
Advances from joint venture partners		1,968,819	
Convertible loan payable (Note 4)		-	870,562
		<u>2,241,640</u>	<u>1,977,638</u>
<b>Advances from affiliated company</b> (Note 5)		-	272,696
<b>Asset retirement obligation</b>		<u>228,129</u>	<u>224,129</u>
		<u>2,469,769</u>	<u>2,474,463</u>
<b>Shareholders' equity</b>			
Share capital (Note 6)		22,430,404	17,980,440
Contributed surplus		989,929	749,294
Deficit		<u>(19,575,802)</u>	<u>(18,426,675)</u>
		<u>3,844,531</u>	<u>303,059</u>
		<u>\$ 6,314,300</u>	<u>\$ 2,777,522</u>

Approved by the directors:

"William R. Cawker"

Director – William R. Cawker

"Dwayne Tyrkalo"

Director – Dwayne S. Tyrkalo

*See accompanying notes.*

# Montello Resources Ltd.

## Consolidated Statements of Operations and Deficit

For the Six Months Ended January 31, 2007

(Unaudited)

Canadian Funds

	For the Three Months Ended January 31,		For the Six Months Ended January 31,	
	2007	2006	2007	2006
<b>Revenue</b>				
Oil and gas sales	\$ 24,611	\$ -	\$ 326,911	\$ 109,314
Royalty expense	(6,157)	-	(33,639)	-
Interest income	6,364	97	6,364	241
Gain on securities	-	-	-	25,199
	<u>24,818</u>	<u>97</u>	<u>299,636</u>	<u>134,754</u>
<b>Expenses</b>				
Production	(16,698)	-	139,779	-
General & administration	15,780	171,849	355,041	410,565
Interest	19,035	499	40,000	22,705
Depletion, depreciation & accretion	162,795	413	387,810	27,265
Stock based compensation	306,099	363,005	531,316	363,005
Foreign exchange (gain) loss	(5,636)	8,374	(5,446)	6,889
	<u>481,375</u>	<u>544,140</u>	<u>1,448,764</u>	<u>830,429</u>
<b>Loss for the period</b>	456,557	544,043	1,149,128	695,675
<b>Deficit, beginning of period</b>	19,119,245	16,166,932	18,426,674	16,015,300
<b>Deficit, end of period</b>	<u>\$ 19,575,802</u>	<u>\$ 16,710,975</u>	<u>\$ 19,575,802</u>	<u>\$ 16,710,975</u>

*See accompanying notes.*

**Montello Resources Ltd.**  
**Consolidated Statements of Cash Flows**  
**For the Six Months Ended January 31, 2007**  
(Unaudited)  
Canadian Funds

	For the Three Months Ended January 31,		For the Six Months Ended January 31,	
	2007	2006	2007	2006
<b>Cash provided by (used in)</b>				
<b>Operating activities</b>				
Loss for the period	\$ (456,557)	\$ (544,043)	\$ (1,149,128)	\$ (695,675)
Items not affecting cash:				
Depletion, depreciation & accretion	162,795	413	387,810	27,265
Stock based compensation	306,099	363,005	531,316	363,005
	12,337	(180,625)	(230,002)	(305,405)
Changes in non-cash working capital items, net	908,752	50,353	918,870	6,906
	921,089	(130,272)	688,868	(298,499)
<b>Investing activities</b>				
Additions to property & equipment	2,068	(2,167,097)	(81,127)	(2,634,487)
	2,068	(2,167,097)	(81,127)	(2,634,487)
<b>Financing activities</b>				
Issuance of shares, net of issue costs	3,086,221	1,069,150	3,288,721	1,673,725
Proceeds from convertible loan	-	944,444	-	944,444
Advances from (to) affiliated company	(379,772)	138,005	(272,696)	138,332
	2,706,449	2,151,599	3,016,025	2,756,501
<b>Increase (decrease) in cash during the period</b>	3,629,606	(145,770)	3,623,766	(176,485)
<b>Cash, beginning of period</b>	94,683	49,143	100,523	79,858
<b>Cash, end of period</b>	\$ 3,724,289	\$ (96,627)	\$ 3,724,289	\$ (96,627)

*See accompanying notes.*

**Montello Resources Ltd.**  
**Notes to the Consolidated Financial Statements**  
**January 31, 2007**  
(Unaudited)  
Canadian Funds

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**1. BASIS OF PRESENTATION**

These unaudited interim financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles and on a basis consistent with the audited July 31, 2006 financial statements. Accordingly these unaudited interim statements should be read in conjunction with the notes contained in the Company's audited July 31, 2006 financial statements. Because a precise determination of many assets and liabilities is dependent upon future events, the preparation of periodic financial statements necessarily involves the use of estimates and approximations. Accordingly, actual results could differ from those estimates. The financial statements have, in management's opinion, been properly prepared using careful judgment within reasonable limits of materiality and within the framework of the significant accounting policies.

These consolidated financial statements include the accounts of the Company and its 100% interest in Montello Resources USA Ltd. Corp., which was incorporated in Delaware, USA on March 2, 2005.

Certain prior period comparative figures have been reclassified to conform to the presentation used in the current period.

**2. NATURE OF OPERATIONS**

The Company's principal business activities include the evaluation, acquisition, exploration and development of oil and gas properties in Western Canada and Tennessee, USA.

**3. PROPERTY & EQUIPMENT**

	<b>January 31, 2007</b>		<b>July 31, 2006</b>	
	<u>Cost</u>	<u>Accumulated Amortization</u>	<u>Net Carrying Amount</u>	<u>Net Carrying Amount</u>
Petroleum & natural gas properties	\$ 2,647,160	\$ 654,475	\$ 1,992,685	\$ 2,294,081
Office equipment	<u>18,253</u>	<u>6,253</u>	<u>12,000</u>	<u>13,200</u>
	<u>\$ 2,665,413</u>	<u>\$ 660,728</u>	<u>\$ 2,004,685</u>	<u>\$ 2,307,281</u>

# Montello Resources Ltd.

## Notes to the Consolidated Financial Statements

January 31, 2007

(Unaudited)

Canadian Funds

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### 4. CONVERTIBLE LOAN PAYABLE

During the first quarter ended October 31, 2006, the Company extinguished the \$870,562 convertible loan payable by issuing 7,914,209 Units under a debt restructuring agreement. Each Unit consists of one common share and one common share purchase warrant entitling the holder to purchase one additional common share of the Company at a price of \$0.11 per share for a period of two years expiring September 20, 2008.

### 5. ADVANCES FROM AFFILIATED COMPANY

During the first six months of this fiscal period, Companies that were previously considered affiliated with Montello Resources Ltd. no longer met the conditions under which they considered affiliated. As a result, any monies owed to these companies have been reclassified under accounts payable.

### 6. SHARE CAPITAL

a. Authorized:

Unlimited Common shares without  
par value

b. Issued:

	Number of shares	Value
Balance as at July 31, 2006	103,438,343	\$ 17,980,440
Issued for cash	12,720,000	1,272,000
Issued for cash pursuant to a flow through share private placement	6,419,000	898,600
Issued for cash on exercise of warrants	7,700,000	770,000
Issued for cash on exercise of stock options	4,172,000	428,200
Fair value transfer on exercise of stock options	-	290,681
Issued for settlement of convertible debenture	7,914,209	870,562
Share issue costs		(80,079)
	<u>142,363,552</u>	<u>\$ 22,430,404</u>

# Montello Resources Ltd.

## Notes to the Consolidated Financial Statements

January 31, 2007

(Unaudited)

Canadian Funds

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- c. Share capital transactions during the six months ended January 31, 2007:
- i. In December 2006 the Company completed a private placement of 12,720,000 units @ \$0.10 per share for gross proceeds of \$1,272,000. The units consist of one common share and a share purchase warrant to purchase a share @ \$0.13.
  - ii. In December 2006 the Company issued 6,419,000 units pursuant to a flow through arrangement @ \$0.14 per unit for gross proceeds of \$898,600. Each unit consists of one common share and one share purchase warrants exercisable at \$0.20 per share.
  - iii. During the six months ended January 31, 2007 the company issued 7,700,000 common shares on exercise of share purchase warrants at \$0.10 per share for total cash proceeds of \$770,000.
  - iv. During the six months ended January 31, 2007 the company issued 4,172,000 common shares on exercise of stock options at various prices ranging from \$0.10 to \$0.11 for total cash proceeds of \$428,200. The fair value assigned to these options exercised of \$290,681 has been transferred to share capital from contributed surplus.
  - v. In September of 2006 the Company settled a convertible debenture with the issuance of 7,914,209 shares and an equal number of share purchase warrants exercisable at \$0.11. At the time of settlement the debenture was valued at \$870,562.
- d. Stock option plan

The Company has a stock option plan for the benefit of directors, officers, employees and consultants administered by the Board of Directors, in which up to 10% of the issued and outstanding common shares are reserved for issuance. All share options granted vest immediately.

A summary of the status of the stock option plan as of January 31, 2007 and changes during the period then ended is presented below:

	<b>Number of Options</b>	<b>Average Exercise Price</b>
Balance, July 31, 2006	9,216,834	\$0.11
Exercised	(2,672,000)	\$0.10
Exercised	(700,000)	\$0.11
Exercised	(800,000)	\$0.105
Granted	1,677,000	\$0.105
Granted	5,955,621	\$0.11
Balance, October 31, 2006	<u>12,677,455</u>	<u>\$0.11</u>

**Montello Resources Ltd.**  
**Notes to the Consolidated Financial Statements**  
**January 31, 2007**  
(Unaudited)  
Canadian Funds

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d. options continued

The following table summarizes information about options outstanding at January 31, 2007:

<u>Number of Shares</u>	<u>Exercise Price</u>	<u>Expiry Date</u>
250,000	\$0.10	December 29, 2009
1,900,000	\$0.13	September 16, 2010
1,050,000	\$0.11	January 6, 2011
2,794,834	\$0.10	June 7, 2011
877,000	\$0.105	August 15 to 16, 2011
1,475,000	\$0.11	September 14, 2011
700,000	\$0.11	November 9, 2011
<u>3,630,621</u>	<u>\$0.11</u>	<u>December 21, 2011</u>
<u>12,677,455</u>		

The Company has recorded stock-based compensation expense of \$ 531,316 for the six months ended January 31, 2007. The compensation expense is determined based on the fair value of the options at the grant date. The fair value of each option granted is estimated on the date of granting the options using the Black-Scholes Option Pricing Model with the following weighted average assumptions:

	<u>January 31, 2007</u>
Risk free rate	6.0%
Expected volatility	50.0%
Annual dividend yield	0.0%
Expected life of options	5 years

# Montello Resources Ltd.

## Notes to the Consolidated Financial Statements

January 31, 2007

(Unaudited)

Canadian Funds

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e. Warrants

A summary of the status of warrants issued and outstanding at January 31, 2007 and changes during the period then ended, is presented below:

	<u>Number of Warrants</u>	<u>Average Exercise Price</u>	<u>Expiry Date</u>
Balance, July 31, 2006	16,155,577	\$0.10-\$0.20	December 16, 2006 to November 18, 2007
Exercised	(7,700,000)	\$0.10	December 16, 2006
Granted	7,914,209	\$0.11	September 30, 2008
Granted	6,419,000	\$0.20	March 21, 2008
Granted	12,720,000	\$0.13	December 13, 2008
Cancelled	(116,667)	\$0.10	December 16, 2006
Balance, January 31, 2006	<u>35,392,119</u>	<u>\$0.11</u>	

The Company has the following share common share purchase warrants outstanding at January 31, 2007:

<u>Number of Warrants</u>	<u>Exercise Price</u>	<u>Expiry Date</u>
3,650,461	\$0.20	May 6, 2007
820,000	\$0.20	June 8, 2007
2,039,565	\$0.20	September 15, 2007
1,828,884	\$0.20	November 18, 2007
7,914,209	\$0.11	September 30, 2008
6,419,000	\$0.20	March 21, 2008
12,720,000	\$0.13	December 13, 2008
<u>35,392,119</u>		

## 7. RELATED PARTY TRANSACTIONS

- (a) During the six month period ended January 31, 2007, the Company incurred management fees and consulting fees of \$ 90,000 with directors and officers of the Company.

# Montello Resources Ltd.

## Notes to the Consolidated Financial Statements

January 31, 2007

(Unaudited)

Canadian Funds

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### 8. SUPPLEMENTAL DISCLOSURE OF NON-CASH OPERATING, INVESTING AND FINANCING ACTIVITIES

Significant non-cash transactions during the six months ended October 31, 2006

The Company extinguished the \$870,562 convertible loan payable by issuing 7,914,209 units under a debt restructuring agreement.

### 9. SUBSEQUENT EVENTS

Subsequent to January 31, 2007

- (a) 500,000 options were granted to directors, officers at an exercise price of \$0.135 per share until March 6, 2012.
- (b) 558,900 options were granted to consultants at an exercise price of \$0.15 per share until February 9, 2012.

**Montello Resources Ltd.**  
**(the “Company”)**  
**Form 51-102F1**

**Management Discussion and Analysis**

**For the Three Months Ended January 31, 2007**

<b>ISSUER DETAILS</b>		FOR QUARTER ENDED	DATE OF REPORT
NAME OF ISSUER		Y    M    D	Y    M    D
MONTELLO RESOURCES LTD.		07   01   31	07   03   31
ISSUER ADDRESS			
P.O. BOX 1757, STATION M			
PROVINCE	POSTAL CODE	ISSUER FAX NO.	ISSUER TELEPHONE NO.
CALGARY                    AB	T2P 2L8	(403) 241-9197	(403) 241-9197
CONTACT PERSON		CONTACT'S POSITION	
BILL CAWKER		CEO, CHAIRMAN, DIRECTOR	
CONTACT TELEPHONE NO.		CONTACT TELEPHONE NO.	
(604) 649-0080		(604) 649-0080	
CONTACT EMAIL ADDRESS		WEB SITE ADDRESS	
ir@montello.com		<a href="http://www.montello.com">www.montello.com</a>	
DIRECTOR'S SIGNATURE		PRINT FULL NAME	
<b>‘DWAYNE TYRKALO’</b>		DWAYNE TYRKALO	
DATE SIGNED		DATE SIGNED	
Y    M    D		Y    M    D	
07   03   31		07   03   31	
DIRECTOR'S SIGNATURE		PRINT FULL NAME	
<b>‘RANDY MARSHALL’</b>		RANDY MARSHALL	
DATE SIGNED		DATE SIGNED	
Y    M    D		Y    M    D	
07   03   31		07   03   31	

**Web page [www.montello.com](http://www.montello.com)**  
**Email [ir@montello.com](mailto:ir@montello.com)**

**DATE OF REPORT: March 31, 2007**

## **OVERALL PERFORMANCE**

### **GENERAL**

This Management Discussion and Analysis (“MD&A”) of Montello Resources Limited (the “Company”) provides analysis of the Company’s financial results for the second quarter of fiscal 2007 commencing November 1, 2006 and ending January 31, 2007. All amounts are stated in Canadian dollars unless otherwise indicated.

Production information is commonly reported in units of barrel of oil equivalent (“boe”). For purposes of computing such units, natural gas is converted to equivalent barrels of oil using a conversion factor of six thousand cubic feet to one barrel of oil. This conversion ratio of 6.1 is based on an energy equivalent wellhead value for the individual products. Such disclosure of boes may be misleading, particularly if used in isolation. Readers should be aware that historical results are not necessarily indicative of future performance.

### **NON-GAPP MEASURES**

All financial information in this MD&A is prepared in accordance with Canadian generally accepted accounting principles (“GAAP”), as an indicator of the Company’s performance. All financial information is presented in Canadian dollars unless otherwise indicated.

The Company is incorporated in the Province of British Columbia (extra-provincially registered in the Province of Alberta).

### **FORWARD-LOOKING STATEMENTS**

Certain information regarding Montello set forth in this report, including management’s assessment of Montello’s future plans and operations, contains forward-looking statements that involve substantial known and unknown risks and uncertainties. These risks and uncertainties, many of which are beyond Montello’s control, include the impact of general economic conditions and specific industry conditions, volatility of commodity prices, currency fluctuations, imprecision of reserve estimates, environmental risks, and competition from other producers, the lack of available qualified personnel or management, stock market volatility and ability to access sufficient capital from internal and external sources. The Company believes the expectations reflected in these forward-looking statements and information are reasonable, but no assurance can be given that these expectations will prove to be correct, and such forward-looking statements and information included in this discussion should not be unduly relied upon. Such forward-looking statements and information speak only as of the date of this discussion, and the Company does not undertake any obligation to publicly update or revise any forward-looking statements or information, except as required by applicable laws.

In particular, this discussion may contain forward-looking statements and information pertaining to the following:

- The quality of and future net revenues from our reserves;
- Oil, NLG’s and natural gas production levels;
- Commodity prices, foreign currency exchange rates and interest rates;
- Capital expenditure programs and other expenditures;

- Supply and demand for oil, NLG's and natural gas;
- Expectations regarding the Company's ability to raise capital and to continually add to reserves through acquisitions and development;
- Schedules and timing of certain projects and the Company's strategy for growth;
- The Company's future operating and financial results; and
- Treatment under governmental and other regulatory regimes and tax, environmental and other laws.

The Company's actual results could differ materially from those anticipated in these forward-looking statements and information as a result of both known and unknown risks, in this discussion and those set forth below:

- Volatility in market prices for oil, NLG's and natural gas;
- Changes or fluctuation in oil, NGL's and natural gas production levels;
- Changes in foreign currency exchange rates and interest rates;
- Changes in capital and other expenditure requirements and debt service requirements;
- Liabilities and unexpected events inherent in oil and gas operations, including geological, technical, drilling and processing problems;
- Uncertainties associated with estimating reserves;
- Competition for, amongst other things, capital, acquisition of reserves, undeveloped lands and skilled personnel;
- Incorrect assessment of the value of acquisitions;
- The Company's success at acquisition, exploration and development of reserves;
- Changes in general economic, market and business conditions in Canada and North America;
- Actions by governmental or regulatory authorities including changes in income tax laws or changes in tax laws and incentive programs relating to the oil and gas industry; and
- Changes in environmental or other legislation applicable to the Company's operations, and the Company's ability to comply with current and future environmental and other laws.

Many of the risk factors and other specific risks and uncertainties are discussed in further detail throughout this discussion and analysis.

Additional information related to the Company, is available through the internet on the Company's SEDAR profile at [www.sedar.com](http://www.sedar.com). Readers are also referred to the risk factors described in other documents the Company files from time to time with securities regulatory authorities. Copies of these documents are available on the TSX Venture website as well as the Company's website, [www.montello.com](http://www.montello.com).

## **BUSINESS OVERVIEW**

Montello Resources Limited (the "Company") is a junior natural resource company engaged in the acquisition, exploration, and development of oil and gas properties. The Company is a reporting issuer in British Columbia and Alberta and trades on the TSX Venture Exchange under the symbol MEO.

It has been the objective of the Montello Resources' Board to reduce debt, improve the debt to equity ratio for the Company, evaluate all of Montello's investments, develop, abandon, and/or acquire investments to maximize returns by the Company and to improve its working capital position.

## **Current Operations**

During the year, the Company commenced receiving revenues from its Moonshine Oil and Gas properties. The Company has limited operating income and cash flow and its continued existence has relied almost exclusively upon equity financing activities to date. An increase in cash flow and operating income therefore must come from acquisitions and by the drill bit, otherwise only slow progress could be expected in the immediate future. Setting up the foundations to achieve this goal was the priority for the first two quarters of fiscal 2007, which encompassed the period from August 1, 2006 through to January 31, 2007. This continues to be the focus for the third quarter ending April 30, 2007.

On October 10, 2006, the Company announced the signing of a mineral lease on 253-acres referred to as "the Blowout Property" located in Morgan County, Tennessee in conjunction with its joint venture partner Austin Developments (TSX Venture Exchange symbol, AUL). The joint ventured property initially referred to as "The Blowout Property", now called the "Morgan Highpoint Project", borders beside the well-known Pryor Oil Company property, which was drilled in the Elmer Howard-White Unit #1, Permit 9893, and experienced a blow-out in July of 2002.

Initially, a late January spud date had been planned, however it was subsequently determined that a larger drill rig was required due to a new strategic focus on directional drilling. This development precipitated the need for extending the time required for the pre-drill phase of the "Morgan Highpoint Project" as Engineering and Operations personnel reviewed logistics including a greater need for specialized drilling technology and equipment, meticulous site preparation and most importantly, recruitment of more qualified personnel for Morgan Highpoint than was originally anticipated. Montello Management believes that extending the pre-drill period has been prudent due to the technically challenging nature of this prospectively high-impact exploration well.

In the interim, Montello has been successful in negotiating equipment and more importantly, additional land agreements in the immediate area. A final spud date will be announced shortly. As per Montello's news releases, Montello's Joint Venture Partners for Morgan Highpoint are participating on a two for one basis. Austin Developments Ltd. and any additional Joint Venture Partners are required to spend a minimum of \$3,000,000 USD in order to earn their working interest.

Montello funded on a timely basis for activity in 2007. November 1, 2006, was the start of the second quarter of fiscal 2007. The company raised funds in excess of three million dollars, paid off all current oil and gas operations liabilities and is executing its business plan in Tennessee and Alberta. Many ongoing negotiations on both sides of the border, are now coming to a close. The Company will soon be relieved from restraints that have limited its ability to provide more timely detailed updates regarding Tennessee. \$898,600.00 of Flow Through funding completed on December 29, 2006, will be used to advance various Peace River Arch, Alberta Projects. Drilling details will be announced in the summer.

## **PROPERTY EXPLORATION PLANS AND WORK PROGRAMS STATUS**

The Company plans to continue exploration work on its currently held resource properties, subject to availability and timing of financing (including, where applicable, the ability to meet cash calls from the project operator) and data analysis from work programs.

For properties in which the Company is the operator, results of exploration programs, including technical disclosure are prepared by or under the supervision of a qualified person. For properties in which the Company is not the operator, results of exploration programs are provided to the Company by the project operator.

The Company is the project operator for the Mulligan Property and in Tennessee. The operator of the Sarcee was C1 Energy Ltd. and is now Arapahoe Energy. Technical reports and news releases discussing progress in the Company's properties can be viewed on the SEDAR website at [www.sedar.com](http://www.sedar.com).

## **OIL AND GAS PROPERTIES**

### **Morgan and Scott County Properties, Tennessee**

The Company owns oil and gas wells located primarily in Morgan and Scott Counties in Tennessee. At the end of June 2006, the Company focused on reworking the "Tex Flora Well" (officially known as the John Bowen #1). Upon re-completing and commencing evaluation for economic potential, Management felt it was prudent to immediately commence negotiations on the "Blowout Project Lands". It was anticipated that negotiations would take two to three weeks but successful completion of this acquisition was not announced until October 10, 2006. "Tex Flora" was shut-in during the prolonged negotiation period and remains shut-in until after completion of the "Blowout Project" when it will be re-evaluated.

Both the "Tex Flora Well" and the Brooks property are owned jointly with Austin Developments ("Austin") wherein Austin has earned a 50% participating interest in each well and associated contiguous land package by reimbursing Montello for \$176,386.22 CDN on December 27, 2006 for a total equalization payment of approximately \$788,151.00 USD for 100 per cent of all costs involved in the acquisition, drilling, completion, stimulation, and equipping to production stage of all Tennessee operations. This makes Montello and Austin 50-50 Joint Venture Partners in these existing Tennessee operations.

Austin also made an advance of approximately 1.68 million USD in mid January 2007 towards earning their Working Interest in the "Morgan Highpoint Project" on a two for one basis (which has a farm-out agreement and an AMI). Austin is in the final stages of closing their approved funding expenditure ("AFE"). Should Austin decide to or not be able to fund 100%, the Company will be speaking to other interested parties.

The Company continues to focus its efforts on the Blowout Project in Morgan County, Tennessee, which the Company anticipates as being one of the most significant drilling projects in the Southeast Region. Montello has completed a detailed drilling program involving drilling specialists in Canada and the U.S.

### **Mulligan (Peace River Arch), Alberta**

The Company owns various working interests in 6,720 acres of land in the Mulligan area in Northern Alberta. At present this area contains four producing oil wells, one producing gas well,

four shut-in gas wells; one shut-in oil well and two identified drilling locations. The production is subject to new Crown royalties and various gross overriding royalties. The Company's lands in this area are from the Upper Mississippian Stoddart Group (Kiskatinaw), and the lower Cretaceous (Gething formation). The Company acquired the Mulligan properties in September 15, 2005.

The Company continues to work on enhancing the Mulligan properties. The Company has successfully used water flooding as a technique to increase production in the Charlie Lake Zone in Section 23-81-8 W6M and is investigating the use of the same procedure in offsetting operated properties. The focus is to drill two wells and workover two. With the water-flood enhancement program in place, a re-work of the injection well is required (6-23-81-8-W6). This is scheduled to start in late July and will allow Montello to ramp up water injection to increase oil production as high as two fold.

### **Sarcee, Alberta**

The Company, under a farm-out agreement, owns a 2.50 percent working interest in 2,560 acres on four sections of land in this area by paying 5.00 percent of the gross capital development expenditures. These lands contain one well and one identified drilling location.

Production will be subject to Indian Royalties, which are equivalent to Alberta New Crown Royalties plus 6.5 percent Gross Overriding Royalty (*GORR*). The unit of interest is the Mississippian (Visean) age Turner Valley Formation of the Rundle Group.

As of late, the Company has elected not to spend any time related to this project as the original operator, C1 Energy, was replaced with Arapahoe Energy. With the re-organization of the corporations and the First Nations; there has not been any activity and Montello awaits updated plans with regards to going forward.

### **SELECTED FINANCIAL INFORMATION**

The Company's second quarter ends on January 31, of each year. The following is a summary of certain selected audited financial information for the last three completed fiscal years of the Company.

#### **Operating Results**

After acquiring Moonshine Resource Ltd., the Company became an active oil and gas operator. The Company has started generating oil & gas revenue since then. That explains why oil & gas sales and direct operating expenses for the first two quarters in 2007 has increased compared to same period in 2006.

Amortization & depletion expenses has increased from January 31, 2006 (second quarter fiscal 2006) 3 months ended \$26,852.00 and 6 months. ended \$27,265.00, as compared to 3 months ended \$162,795.00 and 6 months ended \$387,810.00, for January 31, 2007 (second quarter fiscal 2007). This is due to wells generating revenue since the acquisition of Moonshine Resources Ltd.

In November of 2005, the Company obtained a convertible debenture in the amount of \$1,000,000.00 with annual interest rate of 12%. The principal debt outstanding as of September 15, 2006 was \$870,563.00. The debenture holder agreed to convert into equity at a conversion

rate of 7,914,209 legended shares at \$0.11 per share also with a two year warrant exercisable at \$0.11 expiring September 20, 2008. The hold period of four months expired on January 22, 2007.

Old management has been replaced by the new management team, which directly runs the oil & gas operations. Management and consulting fees in the first quarter of 2006 were \$81,160.00 for three months ended and \$135,350.00 and for the six months ended respectively. In the second quarter of 2007, management and consulting fees were \$45,000.00 for the three months ended January 31, 2007 and \$90,000.00 for the six months ended January 31, 2007.

## SUMMARY OF ANNUAL RESULTS

	2007 to date	2006	2005
Revenues	\$ 326,911	\$ 353,351	-
Operation Costs and Royalties	173,418	49,854	-
Property write-downs	Zero	1,144,465	-
Current and Administrative Expenses	355,041	1,580,406	948,817
Net Income (Loss)	(2,014,548)	(2,422,374)	(942,756)

## LIQUIDITY

The Company has a positive working capital of \$2,067,975 as of January 31, 2007 whereas it had a negative working capital of \$668,235.00 as of October 31, 2006; compared to a negative working capital of \$1,522,840.00 on July 31, 2006. The Company had cash and cash equivalents of \$3,724,289 as on January 31, 2007 as compared to \$94,683.00 on October 31, 2006 compared to \$89,292.00 on July 31, 2006.

On September 27, 2006 the Company eliminated \$870,562.00 in debt with an equity issue. Montello issued 7,914,209 units with a hold period of four months until January 22, 2007. Each unit consists of one common share purchase warrant entitling the holder to purchase an additional share of Montello at \$0.11 per share for 2 years expiring September 20, 2008.

The Company raised \$22,500.00 through the exercise of warrants between August 1 and October 31, 2006. There was no money raised via private placements or share subscriptions during this time. The Company issued 2,422,000 common shares for proceeds of \$247,700.00 on the exercise of stock options. The Company also issued 7,475,000 common shares for proceeds of \$747,500.00 on the exercise of warrants expiring December 16, 2006. \$2,848,320.00 net of finder's fees was subsequently raised between November 1 and December 31, 2006 through Warrants, Flow Through and Non Flow Through Private Placements.

On December 19, 2006 the TSX Venture Exchange accepted for filing documentation with respect to a Non-Brokered Private Placement announced November 9, 2006 and November 14, 2006. Gross Proceeds of \$1,272,000.00 was raised via the sale of 12,720,000 units priced at \$0.10 per unit. The company initially announced this Non-Brokered Private Placement financing for \$695,000.00. The unit offering consisted of 12,720,000 shares and 12,720,000 share purchase warrants to purchase 12,720,000 shares at \$0.13 for a two year period. There is a 4 month hold applicable for the shares and finder's fees of 6% totaling \$69,780.00 were payable on the placement in accordance to the policies of the TSX Venture Exchange. The proceeds of the private placement will be used for general working capital purposes and for further potential oil and natural gas mineral lease acquisitions.

On December 29, 2006 the TSX Venture Exchange accepted for filing documentation with respect to a Non-Brokered Flow-Through Private Placement announced December 19, 2006. Gross Proceeds of \$898,600.00 were raised via the sale of 6,419,000 Flow-Through units consisting of 6,419,000 shares at \$0.14 per share and 6,419,000 share purchase warrants to purchase 6,419,000 shares at \$0.20 for a period of 15 months from the date of issuance. The common shares issued pursuant to the Private Placement will be subject to a four-month hold period expiring April 23, 2007. The proceeds from the Private Placement will be used to drill on the Company's Northwestern Alberta Properties.

Since incorporation, Montello's capital resources have been limited. In addition to having to rely upon cash generated from operations, the Company has had to rely upon the sale of equity and debt securities for cash required for administration, acquisition(s) and exploration program(s). While there are presently no known specific trends, events or uncertainties that are likely to result in Montello's liquidity decreasing in any material way over the next year, it is unlikely that significant cash would be generated from operations if Management didn't continue to pursue significant projects like the Blowout Lease in Tennessee. The Company intends to strongly pursue its goals of engaging in the acquisition, exploration and development of oil and gas properties.

While there can be no assurance that financing, whether debt or equity, will always be available in the amount(s) required at any particular time or for any particular period or, if available, that it can be obtained on satisfactory terms. The Company is currently interested in looking at agreements to acquire interests in additional projects or Oil and Gas Properties. The availability of equity capital to junior resource companies is affected by commodity prices, global economic conditions, and economic conditions and government policies in the countries of operation, among other things. These conditions are beyond the control of the management of the Company and have a direct effect on the Company's ability to raise equity capital.

The Company's working capital and liquidity fluctuate in proportion to ongoing project commitments or debt - equity financing activities. The Company requires a certain amount of liquid capital in order to sustain its operations and in order to meet various obligations as specified under the Company's resource property acquisition agreements.

Should the Company fail to obtain future equity financing due to reasons as described above, it will not be able to meet these obligations and may lose its interests in properties covered by an agreement. Further, should the Company be unable to obtain sufficient equity financing for working capital, it may be unable to take on or meet ongoing operational commitments.

Exploration and development of natural resources involve substantial expenditures and a high degree of risk. Few properties which are explored are ultimately developed into producing properties. Accordingly, the Company has no material revenue, writes off its natural resource properties from time to time, and operates at a loss.

## **DIVIDEND RECORD AND POLICY**

The Company has not declared any dividends since incorporation and does not intend to declare dividends in the foreseeable future. As the Company generates earnings, it expects that they will be retained to finance future growth.

## **CAPITAL RESOURCES**

The Company is presently entering contractual obligations and commitments in conjunction with its Joint Venture Partners for material expenditures at Morgan Highpoint in Tennessee.

## **CRITICAL ACCOUNTING ESTIMATES**

Management is often required to make judgments, assumptions and estimates in the application of generally accepted accounting principles that have a significant impact on the financial results of the Company.

## **OFF-BALANCE SHEET ARRANGEMENT**

The Company does not have any off-balance sheet arrangements.

## **PROPOSED TRANSACTIONS**

There were no proposed transactions.

## **CRITICAL ACCOUNTING ESTIMATES**

Not applicable to venture issuers.

## **CHANGES IN ACCOUNTING POLICIES**

The Company has not changed any of its accounting policies as compared to those disclosed in its unaudited financial statements for the First Quarter ended October 31, 2005.

## **FINANCIAL INSTRUMENTS AND OTHER INSTRUMENTS**

It is management's opinion that the fair value of the Company's cash, reclamation deposit, marketable securities, accounts receivable, accounts payable and accrued liabilities, and advances approximate their carrying value due to the relatively short periods to the maturity of the instruments.

The maximum credit risks exposure for all financial assets is the carrying value of those assets. None of the Company's financial instruments are denominated in U.S. dollars, and the Company does not use derivative instruments or foreign exchange contracts to hedge against gains or losses arising from foreign exchange fluctuations.

## **OUTSTANDING SHARE DATA**

The Company's authorized share capital consists of unlimited common shares without par value.

The Company has only one kind and class of shares and there are no unusual rights or restrictions attached to that class.

As at January 31, 2007, Montello had a total of 142,363,552 common shares issued and outstanding as compared to February 3, 2006 when the company had 100,438,343 according to records provided by the Company's Transfer Agent, Computershare.

## **SUBSEQUENT EVENTS**

**MONTELLO RESOURCES LTD.** ("Montello") (TSX Venture: MEO) is pleased to announce that in accordance with National Instrument 51-101 "Standards of Disclosure for Oil and Gas Activities of the Canadian Securities Administrators", the Company has filed its reserves data and other oil and gas information (51-101F1, F2 and F3) for the year ended July 31, 2006. Copies may be obtained on [www.sedar.com](http://www.sedar.com).

February 10, 2007, Montello Resources has also granted 558,900 incentive stock options to consultants at an exercise price of \$0.15 cents per share expiring February 10th, 2012, subject to the approval of the TSX Venture Exchange.

March 12, 2007, the Board of Directors formally announced the appointment of an Acting Controller effective Friday, March 9, 2007. 150,000 options were granted on March 9, 2007 at an exercise price of \$0.135 per share expiring on March 6, 2012, subject to the approval of the TSX Venture Exchange.

March 12, 2007, the Board of Directors formally announced a new Board appointment effective Friday, March 9, as well as this individual being appointed to the Audit Committee. 350,000 options were granted effective March 9, 2007 at an exercise price of \$0.135 per share expiring on March 6, 2012, subject to the approval of the TSX Venture Exchange

