

**Montello Resources Ltd.**  
**Management's Discussion and Analysis**  
**For the Three Months Ended October 31, 2010**

**Report Date: January 24, 2011**

The following is a discussion and analysis ("MD&A") of the operations, results, and financial position of the Montello Resources Ltd. (the "Company" or "Montello") as at October 31, 2010 and for the three months ended October 31, 2010, and should be read in conjunction with the unaudited consolidated financial statements for the three months ended October 31, 2010. The consolidated financial statements and related notes are presented in accordance with Canadian generally accepted accounting principles.

**Forward Looking Information**

In addition to historical information, this MD&A contains forward-looking statements that are generally identifiable as any statements that express, or involve discussions as to, expectations, beliefs, plans, objectives, assumptions or future events of performance (often, but not always, through the use of words or phrases such as "will likely result," "expected," "is anticipated," "believes," "estimated," "intends," "plans," "projection" and "outlook"), are not historical facts and may be forward-looking and may involve estimates, assumptions and uncertainties which could cause actual results or outcomes to differ materially from those expressed in such forward-looking statements.

Actual results achieved during the forecast period will vary from the information provided herein as a result of numerous known and unknown risks and uncertainties and other factors. Such factors include, but are not limited to: risks associated with the Company's stage of development; competitive conditions; share price volatility; risks associated with crude oil and natural gas exploration and development; risks related to the inherent uncertainty of reserves and resources estimates; possible imperfections in title to properties; the volatility of crude oil and natural gas prices and markets; environmental regulation and associated risks; loss of key personnel; operating and insurance risks; the inability to add reserves; risks associated with industry conditions; the ability to obtain additional financing on acceptable terms if at all; non operator activities; the inability of investors in certain jurisdictions to bring actions to enforce judgments; equipment unavailability; potential conflicts of interest; risks related to operations through subsidiaries; risks related to foreign operations; currency exchange rate risks and other factors, many of which are beyond the control of the Company. Accordingly, there is no representation by Montello that actual results achieved during the forecast period will be the same in whole or in part as that forecast. Further, Montello undertakes no obligation to update or revise any forward-looking statement or statements to reflect events or circumstances after the date on which such statement is made or to reflect the occurrence of unanticipated events, except as required by applicable securities laws.

Financial outlook information contained in this MD&A about prospective results of operations, financial position or cash flows is based on assumptions about future events, including economic conditions and proposed courses of action, based on management's assessment of the relevant information currently available. Readers are cautioned that such financial outlook information contained in this MD&A should not be used for purposes other than for which it is disclosed herein.

**Note Regarding Production Information, Boe and Mcfe**

In this MD&A, Boes are derived by converting gas to oil in the ratio of six thousand cubic feet of gas to one barrel of oil (6 Mcf:1 bbl) and Mcfes are derived by converting oil to gas in the ratio of one barrel of oil to six thousand cubic feet of gas (1 bbl:6 Mcf). Per barrel oil equivalent amounts ("boe") and one thousand cubic feet of gas equivalent ("Mcfe") amounts may be misleading, particularly if used in isolation. A boe conversion of 6 Mcf of natural gas to 1 bbl of oil, or a Mcfe conversion ratio of 1 bbl of oil to 6 Mcf of natural gas is based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the well head. When it comes to Production Information, readers should be aware that historical results are not necessarily indicative of future performance.

**Montello Resources Ltd.**  
**Management's Discussion and Analysis**  
**For the Three Months Ended October 31, 2010**

**DESCRIPTION OF BUSINESS**

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The Company is a reporting issuer in British Columbia and Alberta. The Company is a junior natural resource company engaged in the acquisition, exploration and development of oil and gas properties in Canada and the U.S.A. The Company is listed on the TSX Venture Exchange ("TSX-V") under the symbol *MEO*, and classified as a junior resource company.

As a junior resource company, Montello's primary business is to identify, explore and develop opportunities in the oil and gas resource sector through acquisition or joint venture. The Company currently holds a 25% working interest in the 1-11-4-29W4 discovery well in the Pincher Creek field and also an option on over 10,000 acres within the same focus area. In Tennessee, Montello is a partner in 5 wells - 48% interest in two wells in John Bowen property and 35% interest in three wells in Morgan Highpoint property.

With consideration given to depressed natural gas prices, the Company is assessing its plan to either development its remaining assets, sell them, identify new partners or farm-out the properties to others to maximize value for the shareholders.

**HIGHLIGHTS**

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**Pincher Creek, Alberta**

During the year ended July 31, 2010 Montello settled its claim against Pennine Petroleum Corporation ("Pennine"). As a result of the settlement, Pennine novated Montello's 25% interest in Pincher Creek. Montello's claim against Pennine filed on October 26, 2009 for damages of \$2,500,000 primarily related to lost revenues due to Pennine's inability to bring the well to production in a timely manner. As part of the settlement agreement Montello is not able to disclose the terms of the settlement.

On June 8, 2010 Montello entered into a Letter of Intent with Tosca Capital Corp. ("Tosca") of Vancouver, British Columbia to sell a 5% working interest in its Pincher Creek property for \$250,000. During the year ended July 31, 2010, \$100,000 was received by way of promissory note. A further \$13,000 was received during the three months ended October 31, 2010 and \$62,500 was received subsequent to October 31, 2010 with the balance expected in January 2011 at which time a full agreement on the same terms as the Letter of Intent will be executed.

On December 8, 2010 the Company entered into an option agreement to sell up to 10% working interest in its Pincher Creek property to the future operator of the property (the "Optionee"). Consideration for the first 5% working interest is \$260,000, payable \$185,000 in cash and \$75,000 in costs related to the Company's full portion of future pipeline and surface facilities required to put the well into production, carried by the Optionee. Upon signing the option agreement the Company received a non-refundable deposit of \$13,000 from the Optionee. The remaining cash consideration of \$172,000 was due and payable by December 31, 2010. An option to purchase a further 5% working interest for consideration of \$260,000 was to be granted on January 1, 2011, which required a nonrefundable deposit of \$15,000 upon signing the option agreement and the remaining \$245,000 payable on or before February 28, 2011. This option was not exercised and no payment was received. The payment for \$172,000 regarding the first 5% option was not received and the option on the second 5% has expired, thus the offer to sell has been revoked.

**Montello Resources Ltd.**  
**Management's Discussion and Analysis**  
**For the Three Months Ended October 31, 2010**

**Regulatory matters**

On January 29, 2010, the Alberta Securities Commission issued a general Cease Trade Order against the Company for failure to file its audited financial statements, management's discussion and analysis, and related CEO and CFO certifications for the year ended July 31, 2009 and its interim unaudited financial statements and interim management's discussion and analysis for the quarter ended October 31, 2009. In turn, the Company's securities were suspended from trading on the TSX Venture Exchange until such time as the Cease Trade Order has been revoked and the Company meets TSX Venture Exchange requirements in relation to reinstatement of trading, including meeting Tier Maintenance Requirements. Management continues to work on meeting all requirements for the reinstatement, including raising funds for the procedures. At the date of this report, the process for re-instatement has commenced.

**OIL AND GAS PROPERTIES – ALBERTA, CANADA**

**Pincher Creek**

Montello entered into a farm-in agreement to participate in the recompletion of the Pincher Creek 1-11-4-29W4 well. By farming into the petroleum and natural gas rights in the lands which were held by Pennine Petroleum Corporation ("Pennine") at the time, the Company earned a 25% interest before payout, 15% after payout in a discovery well that is capable of producing high grade condensate and associated gas from two zones. By paying an additional fee Montello earned a 25% in the remainder of the interests at Pincher Creek.

The recompletion of the well was initiated on August 30, 2007 and resulted in completions in the Cadomin and Brown Sand with initial swabbing rates of up to 337 barrels of condensate and 500 Mcf. per day of natural gas. The success of this well enhanced the prospectivity of the group's lands in the area.

Pincher Creek has been one of the most prolific fields in Alberta. It is a structurally controlled, over-thrusted imbricate stack that has been producing since 1947 and has produced some 600 Bcf. of gas and over one million barrels of associated liquids from the Mississippian-age carbonates of the Turner Valley (Rundle) formation.

On January 28, 2009 a public hearing was held in Pincher Creek by the Energy Resources Conservation Board ("ERCB") to review the application by the Operator of the property to obtain access for the construction of a pipeline to tie into the Waterton Gas Plant. The result of this meeting was to have Pennine granted the pipeline license. However, Pennine was unsuccessful in securing right of entry with the landowners and also unsuccessful in applying for an extension to the license as the company was on Global Refer at the time. Pennine is no longer on Global Refer and Montello has been informed that the Pipeline License will be reapplied for in the third quarter of 2010. On August 19, 2009, Pennine sold its interest to a private company, later identified as Highwood Oil and Gas, but operatorship has not been transferred at this time. It is understood that the ERCB has been reviewing both the pipeline license and the license transfers. To Montello's knowledge, Pennine will not remain the operator of record.

As a result of the delay of novating Montello interest in Pincher Creek and Pennine's inability to bring the well to production in a timely manner, on October 26, 2009 Montello initiated a statement of claim against Pennine for \$2,500,000 primarily due to lost revenues. Pennine responded to the claim on October 28, 2009. During September 2010 Montello entered into an agreement with Pennine to settle all Montello's claims against Pennine and its president Desmond Smith. This settlement agreement included non-disclosure and confidentiality provisions and does not reflect any admission by either Pennine or Montello, their affiliates, directors or officers. The settlement was entered into on the basis that it best serves the interests of both companies and their shareholders.

**Montello Resources Ltd.**  
**Management's Discussion and Analysis**  
**For the Three Months Ended October 31, 2010**

**Grouard**

In December 2007, Montello, under a farm-in agreement, participated in the drilling of two exploratory wells in the Grouard area of northwestern Alberta. Under the farm-in agreement the company paid 50% of the drilling, completion and equipping costs to earn a 35% interest. By participating in the wells Montello earned a 35% interest in 1,470 gross acres of P&NG rights with additional drilling locations. Both of the earning wells were production tested and deemed capable of gas production of 150 Mcf. Per day. A gathering system is required to place the wells on production.

During the three months ended October 31, 2010 and the years ended July 31, 2010 and 2009, no capital costs were incurred at Grouard, Alberta. Due to the operator's poor financial condition Montello does not contemplate participating in any optimization programs, or facility construction until the condition is sufficiently improved.

**Sarcee**

Montello, under a farm-out agreement held a 2.5% interest in 2,560 acres of petroleum and natural gas rights on lands in the T'suu Tina Reserve. In November 2007, the Company increased its interest to 8.5% by issuing 11,663,333 shares at \$0.30 per share to Vanguard Exploration Corp. for an additional 6% working interest. Due to the lack of activity on the property and management's unwillingness to accept the new terms for continuance (which were not deemed to be economic) the lands were returned to the T'sui Tina Band in May 2009.

A Quit Claim was signed on September 10, 2009, in connection with the transfer of all assets and liabilities related to the Sarcee Property to Canadian Phoenix Resources Corp. on July 22, 2009.

**OIL AND GAS PROPERTIES – TENNESSEE, USA**

Montello and its joint venture partners Austin Developments Ltd., Nexgen Petroleum Corp., signed a letter dated July 5, 2008 formally confirming Farm-out and Participation agreements dated March 10 and April 11, 2008, whereby Nexgen Petroleum Corp was confirmed to have earned 30% undivided working interests in the said test wells and farm out lands for the Lavender #1, Southeast #1, and Southeast #2 Wells (otherwise known as the Morgan Highpoint Project Wells #5, #3, and #4). This letter also stated that from and after July 1, 2008 all operations on these Farm-out lands and test wells would be governed by CAPL Operating Procedure including the Accounting Procedure.

On July 7, 2008, a Joint Operating and Equalization Agreement was formally signed by the Morgan Highpoint joint venture partners with regards to operations to be carried out in the Bowen Block / Bowen Lands. Also subject to specific terms, for example, based on economic viability of John Bowen #2 Well, Nexgen could elect to earn an additional undivided 5% working interest in the Bowen Block from Montello. During the year ended July 31, 2009 Nexgen purchased the additional 5% interest for gross proceeds of US\$446,000.

**John Bowen**

During the year ended July 31, 2009, the Company and its joint venture partners sold 107 acres of land and associated buildings for gross proceeds of US\$248,000 netting US\$98,648 after deducting liabilities and for costs incurred on the sale. Montello and its partners retain a 3.7 acre parcel around the two Bowen well bores and the access road to the well sites, along with all mineral rights.

No work was performed on the property in the three months ended October 31, 2010 or the year ended July 31, 2010. A pump jack that was not suitable for the expected depth of well on the property was sold in the prior. Instead of attempting to operate the Tennessee property, the management intends to cede its operatorship in all its properties to a farm-in partner.

**Montello Resources Ltd.**  
**Management's Discussion and Analysis**  
**For the Three Months Ended October 31, 2010**

**Morgan Highpoint**

During the year ended July 31, 2009 Montello was exploring the potential of the shallower zones such as the Chattanooga Shales in the surrounding area. Due to the current wellhead price for gas the Company has no immediate plans to exploit and test these shallower gas zones. Instead Montello had decided to try to stimulate and clean up the Morgan Highpoint #3. In late 2009 Montello began work on this well in the 500 foot open section at the base of the wellbore, from where oil had previously flowed. The results of this work proved that rather than the oil emulsifying the zone though fractured was tight and largely impermeable and not conducive to flow without a large fracture program over the whole of the 500 feet of open wellbore. Montello did not deem this process to be economic at this time and has been working with local companies with the view to farming out its interests.

Attempts were made during the year ended July 31, 2010 to produce from the Morgan Highpoint #3 well. The tubing and rods were removed and examined for damage and wax build up. No damage or wax was found and the tubing and rods were run back into the hole. The well bore was then treated with chemicals with a hope of stimulating flow. This did not happen and it was decided that the 500 feet of open hole needed a very large "frac" to stimulate flow. This was deemed to too expensive a procedure in the present economic environment and it is not agreed to by all partners.

With regard to all its projects in Tennessee, Montello is in the process of looking for alternative farm-in partners. At the time of this report no partners have been identified.

**SELECTED ANNUAL INFORMATION**

The Company's fiscal year ends on July 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:

**Summary of Annual Results**

	<b>2010</b>	<b>2009</b>	<b>2008 (restated)</b>
	<b>\$</b>	<b>\$</b>	<b>\$</b>
Revenues	7,521	197,515	552,613
Net loss	(484,256)	(3,823,148)	(4,274,858)
Loss per share, basic and diluted	(0.00)	(0.02)	(0.02)
Total assets	6,489,548	6,803,590	11,040,819

**RESULTS OF OPERATIONS**

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**Revenues**

The company had revenues of \$7,521 for the year ended July 31, 2010 compared to \$197,515 in the prior year. The significant decrease is due primarily to the Mulligan wells being shut in for the construction of a water pipeline and for overhaul of the compressor station at the 14-23-81-8W6 Battery. In year ended July 31, 2009 the Mulligan properties were transferred to Texokcan. These wells made up the bulk of the company's production.

**Production costs**

Production costs were \$910 in the year ended July 31, 2010 compared to \$254,127 in the prior year. Despite a reduction in revenue for the year ended July 31, 2009, production costs were similar to those in the year ended July 31, 2008 primarily due to the construction of the water pipeline on the 14-23 to resolve the voidage problem in the Mulligan Area in order to be compliant with the ERCB regulations. Shut downs and repairs as noted above were also responsible for the decreased production costs as well.

**Montello Resources Ltd.**  
**Management's Discussion and Analysis**  
**For the Three Months Ended October 31, 2010**

**General and Administrative Expenses**

General and administrative expenses in the year ended July 31, 2010 were \$451,205 compared to \$696,304 in the prior year, a decrease of approximately \$245,000. Approximately \$275,000 was incurred in legal, management and consulting fees in relation to efforts to reorganize the company, to review and improve financial reporting and disclosure processes and to protect the company's remaining asset, the Pincher Creek property. Among other cost saving measures audit and accounting fees were lower by \$65,000 and insurance expense was reduced to nil from \$35,000 in the prior year.

General and administrative expenses, not including stock-based compensation, for the year ended July 31, 2009 were approximately \$600,000 higher than in the year ended July 31, 2008 primarily due to \$474,000 recorded in allowances for bad debts as required under GAAP. The Company has engaged an experienced oil and gas accountant on a contract basis to assist in preparing all outstanding joint interest receivables and related supporting documentation to actively pursue collection of the amounts due from its partners. The balance of the increase is due to a legal and accounting expenses related to management changes, the AGM and continuous disclosure matters. Stock-based compensation included in the year ended July 31, 2008 was \$3,936,231 compared to nil for the 2009 year end.

**SUMMARY OF QUARTERLY RESULTS**

	<b>2010 Oct. 31</b>	<b>2010 July 31</b>	<b>2010 April 30</b>	<b>2010 Jan. 31</b>
Total revenues	\$Nil	\$579	Nil	Nil
Loss from operations	\$(47,088)	\$(145,133)	\$(56,110)	\$(143,630)
Loss per share, basic and diluted	\$(0.00)	\$(0.00)	\$(0.00)	\$(0.00)

	<b>2009 Oct. 31</b>	<b>2009 July 31</b>	<b>2009 April 30</b>	<b>2009 Jan. 31</b>
Total revenues	\$6,942	\$5,968	\$29,536	\$62,007
Loss from operations	\$(139,383)	\$(194,981)	\$(200,812)	\$(3,030,674)
Loss per share, basic and diluted	\$(0.00)	\$(0.00)	\$(0.00)	\$(0.02)

**Revenue**

Montello did not generate revenue during the three months ended October 31, 2010 as the pipeline for the Pincher Creek well has not been constructed and the company continues to identify farm-in partners for its Tennessee properties...

Revenue during the year ended July 31, 2010 was the result of adjustments and corrections made for revenue earned in prior periods. For all four quarters in the year there were no current revenues as the well in Tennessee is shut down, the Pincher Creek well is still not on-line due to the inability of the operator of record to obtain the permits to do so and the absence of revenues from the Mulligan wells which were sold in the prior year,

Revenue for the quarter ended July 31, 2009, April 30, 2009 and January 31, 2009 were much lower than previous quarters due to decreased production from Mulligan. The Mulligan wells which were responsible for the bulk of the company's production in prior periods were shut in for the construction of a water pipeline during the month of December 2008 and for overhaul of the compressor station at the 14-23-81-8W6 Battery. The lack of production from the 14-23 was due to repairs needed on the compressor. Other production interruptions were due to pump jack motor repairs carried out on the 6-9 and treator on the 14-4.

**Montello Resources Ltd.**  
**Management's Discussion and Analysis**  
**For the Three Months Ended October 31, 2010**

**General and Administrative Expenses**

General and administrative expense for the three months ended October 31, 2010 was \$47,088, which includes legal fees recovery of \$23,500 from the legal settlement with Pennine. Expenses decreased from \$94,247 in the three months ended October 31, 2009 to \$74,545 in the current period due to the management's continued efforts to streamline operations.

General and administrative expenses for the three months ended July 31, 2010 were approximately \$150,000, the same amount as those in the same quarter last year. Expenses for this period were approximately \$67,000 higher than in the quarter ended April 30, 2010 due primarily to increased legal and consulting expenses related to the Pennine matter. Overall general and administrative expenses for each quarter this year were lower than the same quarters last year due primarily to management's continued cost reduction measures and the absence of expenses relating to the Tennessee operations. General and administrative expenses were approximately \$42,000 higher in the quarter ended January 31, 2010 than the quarter ended April 30, 2010 due to higher consultant fees and legal fees relating to the Pennine matter.

General and administrative expenses for the October 31, 2009 quarter were approximately \$30,000 higher than the preceding four quarters due to management changes and additional expenses related to the Tennessee operations. Typical general and administrative expenses for those four quarters were approximately \$150,000 on average.

General and administrative expenses for the three months ended July 31, 2009 were approximately \$149,000, approximately \$35,000 higher than the quarter ended April 30, 2009 due to accrued audit fees, legal fees and additional expenses related to continuous disclosure matters and costs incurred to bringing the company back trading from the cease trade invoked by ASC on December 1, 2009.

Expenses for the three months ended January 31, 2009 included \$40,000 in audit fees, accounting expenses of \$30,000 (\$3,000 same quarter this year), consulting expenses of approximately \$90,000 (\$18,500 same quarter this year) and legal expenses of \$12,500.

**Production costs**

The Company did not incur production costs during the three months ended October 31, 2010, as the pipeline for the Pincher Creek well has not been constructed and the company continues to identify farm-in partners for its Tennessee properties.

Production costs were \$910 in the year ended July 31, 2010 and relate primarily to adjustments for prior periods. Production costs in the three months ended January 31, 2010, were primarily from additional expenses incurred in relation to the attempts to produce from the Morgan Highpoint #3 well. The USD\$35,000 bond relating to the Oneida wells that were transferred to a partner company of Montello's were retained by the government of Tennessee for work not performed by the new owners. This amount was included in production costs for the three months ended October 31, 2009 along with other costs related to work on Morgan Highpoint #3 well. Production costs for four quarters preceding October 31, 2009, exceeded revenue due to the production problems described above.

**Loss from operations**

Loss from operations in the three months ended October 31, 2010 was \$47,088, reduced from \$140,791 in the same period last year, largely due to the reduced general and administrative expenses mentioned above and the fact that Montello incurred production costs of \$45,194 last year, which is absent during the current period.

Loss from operations in the three months ended July 31, 2010 was approximately \$90,000 higher than the loss in the quarter ended April 30, 2010 primarily due to higher general and administrative costs.

**Montello Resources Ltd.**  
**Management's Discussion and Analysis**  
**For the Three Months Ended October 31, 2010**

**Loss from operations (continued)**

The loss from operations in the three months ended January 31, 2010 was lower by \$2,700,000 compared to the same period last year due to a \$3,515,546 write down of the Sarcee property during that period. The loss from operations in the three months ended October 31, 2009 was lower than the same period in the prior year due to lower general and administration costs, the absence of stock based compensation, a gain on foreign exchange of \$4,400 versus a loss of \$111,802 and lower depletion, depreciation and accretion. Loss from operations in the three months ended July 31, 2009 and April 30, 2009 are fairly consistent as they relate primarily to production costs, depreciation, depletion and accretion costs as well as production costs offset by very low revenue.

**LIQUIDITY AND CAPITAL RESOURCES**

As at October 31, 2010, the Company had a working capital deficit of \$1,065,018 (July 31, 2010 - \$1,032,821) and an accumulated deficit of \$30,394,587 (July 31, 2010 - \$30,347,499). During the period \$22,785 was used in operating activities while \$12,658 was raised from selling of equipment and \$13,000 was raised from a promissory note.

During the year ended July 31, 2010, significant cash flows were as follows: financing activities included proceeds from loans payable of \$100,000 (2009- Nil) and net proceeds from the issuance of common shares and flow through common shares Nil (2009- \$280,593). Investing activities included the return of restricted cash of \$30,343 (2009 - 316) and additions to oil and gas properties in 2010 of Nil (2009 - \$297,498) offset by in proceeds from oil and gas property dispositions of \$4,821 (2009 - \$889,302). Cash outflows used in operating activities were \$427,381 (2009 - \$1,165,411).

The Company has financed its operations to date primarily through the issuance of common shares for private placements and on the exercise of stock options and warrants and in the two most recent years from the sale of assets and related loans. The Company continues to seek capital through various means including the issuance of equity and/or debt.

The financial statements have been prepared on a going concern basis which assumes that the Company will be able to realize its assets and discharge its liabilities in the normal course of business for the foreseeable future. The continuing operations of the Company are dependent upon its ability to continue to raise adequate financing and to have profitable operations in the future.

The Company's future capital requirements will depend on many factors, including costs of exploration and development of the properties, cash flow from operations, costs to complete well production if warranted, competition and global market conditions. The Company's growing working capital needs may require it to obtain additional capital to operate its business.

The Company will depend partly on outside capital to complete the exploration and development of its resource properties. Such outside capital will include the sale of additional common shares and debt financing. There can be no assurance that capital will be available as necessary to meet these continuing exploration and development costs or, if the capital is available, that it will be on terms acceptable to the Company. The issuances of additional equity securities by the Company may result in a significant dilution in the equity interests of its current shareholders. If the Company is unable to obtain financing in the amounts and on terms deemed acceptable, the business and future success may be adversely affected.

**Montello Resources Ltd.**  
**Management's Discussion and Analysis**  
**For the Three Months Ended October 31, 2010**

**RELATED PARTY TRANSACTIONS**

During the three months ended October 31, 2010, the Company was involved in the following related party transactions:

- (a) Management fees of \$30,000 (2010 - \$30,000) were incurred to the President of the Company.
- (b) Management fees of \$22,500 (2010 - \$22,500) were incurred to a company controlled by the Chief Financial Officer of the Company.
- (c) As at October 31, 2010, the Company owes \$21,292 (July 31, 2010 - \$21,292) to the former Chief Financial Officer of the Company which is non-interest bearing, unsecured, and due on demand.
- (d) As at October 31, 2010, the Company owes \$37,453 (July 31, 2010 - \$6,126) to the President of the Company which is non-interest bearing, unsecured, and due on demand.
- (e) As at October 31, 2010, the Company owes \$41,807 (July 31, 2010 - \$22,451) to a company controlled by the Chief Financial Officer of the Company which is non-interest bearing, unsecured, and due on demand.

These transactions were in the normal course of operations and have been recorded at their exchange amounts, which are the amounts agreed upon by the transacting parties.

**OFF-BALANCE SHEET ARRANGEMENTS**

The Company has not entered into any off-balance sheet arrangements.

**OTHER MATTERS**

**Legal Proceedings**

On October 26, 2009, Montello Resources Ltd. filed with the Court of Queen's Bench of Alberta a statement of claim against Pennine and Desmond Smith. The statement of claim alleges that the defendants breached their obligations by failing to prepare and circulate assignment and conveyance documents for the Section 11 lands and Section 12 lands located near Pincher Creek, Alberta; failing to make payments to landowners required to enable the construction and operation of a .26 kilometre pipeline for the 1-11 Well; and failing to initiate drilling in the deep Rundle formation by 31 March 2009. In the statement of claim, Montello has sought various forms of relief, including but not limited to damages of \$2,500,000, an order that Pennine convey its interest in 11-4-29 W4M to Montello, and an order that Pennine be removed as operator.

On September 9, 2010 Montello entered into an agreement with Pennine Petroleum Corporation to settle all claims against Pennine and Desmond Smith. The settlement agreement included non-disclosure and confidentiality provisions and does not reflect any admission by either Pennine or Montello, their affiliates, directors or officers. The settlement has been entered into on the basis that it best serves the interests of both companies and their shareholders. As a result of the settlement Montello recovered legal cost of \$23,500 incurred during the legal proceedings.

**Montello Resources Ltd.**  
**Management's Discussion and Analysis**  
**For the Three Months Ended October 31, 2010**

**Legal Proceedings (continued)**

During the year ended July 31, 2009, the Company was sued for \$40,700 relating to a builders' lien for work performed on a minerals lease. A default judgment of \$40,700 was entered against the Company on May 12, 2010, of which \$25,217 was paid in May 2010 and \$15,483 was paid in September 2010.

There are no ongoing legal proceedings of any kind initiated by third parties against the company and there are no contingent liabilities and no default under debt or other contractual obligations. There were no special resolutions passed by shareholders.

**Material contracts**

The Company did not enter into any material contracts during the period.

**Disclosure of Outstanding Share Data**

As at January 24, 2011, the Company had 199,325,406 common shares issued and outstanding

As at January 24, 2011, the Company did not have any share purchase warrants or stock options outstanding.

**Investor Relations**

The Company did not enter into any investor relations contracts in the period.

**Regulatory Matters**

Montello had been subject to a voluntary management cease trade order issued by the Alberta Securities Commission (the "ASC") on December 1, 2009 related to the delay in its filing of the Annual Disclosure (the "MCTO") which was set to expire on January 29, 2010. After discussions with its auditors, Montello confirmed with the ASC that the Required Filings would not be ready prior to the expiry of the MCTO.

As a result, on January 29, 2010, the Alberta Securities Commission issued a general Cease Trade Order against the Company for failure to file its audited financial statements, management's discussion and analysis, and related CEO and CFO certifications for the year ended July 31, 2009 and its interim unaudited financial statements, interim management's discussion and analysis for the quarter ended October 31, 2009.

In turn, the Company's securities were suspended from trading on the TSX Venture Exchange until such time as the Cease Trade Order has been revoked and the Company meets TSX Venture Exchange requirements in relation to reinstatement of trading, including meeting Tier Maintenance Requirements.

Upon filing of the interim consolidated financial statements for the three months ended October 31, both the annual reporting requirements and the interim reporting requirements will have been completed. However until the filings are reviewed and accepted and additional documentation is filed, the cease trade order ("CTO") issued by the Alberta Securities Commission ("ASC") on January 29, 2010 will remain in effect.

The Company expects to apply for the revocation order immediately after filing the October 31, 2010 interim financial statements. Upon revocation of the cease trade order by the ASC, Montello will then apply for reinstatement of trading to the TSX Venture Exchange.

**Montello Resources Ltd.**  
**Management's Discussion and Analysis**  
**For the Three Months Ended October 31, 2010**

## **SUBSEQUENT EVENTS**

### *Promissory Notes*

On December 10, 2010, the Company issued a promissory note payable for proceeds of \$62,500 which bears interest at 10% per annum beginning on February 1, 2011, is unsecured, and due on April 30, 2011.

On January 24, 2011, the Company issued a promissory note payable for proceeds of \$62,000 which bears interest at 10% per annum beginning on February 1, 2011, is unsecured, and due on April 30, 2011.

### *Pincher Creek Option Agreement*

On December 8, 2010 the Company entered into an option agreement to sell up to 10% working interest in its Pincher Creek property to the future operator of the property (the "Optionee").

Consideration for the first 5% working interest is \$260,000, payable \$185,000 in cash and \$75,000 in costs related to the Company's full portion of future pipeline and surface facilities required to put the well into production, carried by the Optionee. Upon signing the option agreement the Company received a non-refundable deposit of \$13,000 from the Optionee. The remaining cash consideration of \$172,000 was due and payable by December 31, 2010 but was not received by the Company.

An option to purchase a further 5% working interest for consideration of \$260,000 was to be granted on January 1, 2011, which required a nonrefundable deposit of \$15,000 upon signing the option agreement and the remaining \$245,000 payable on or before February 28, 2011. This option was not exercised and no payment was received. The payment for \$172,000 regarding the first 5% option was not received and the option on the second 5% has expired, thus the offer to sell has been revoked.

## **Changes in accounting policies including initial adoption**

### **Newly Adopted Accounting Standards**

Effective August 1, 2009, the Company adopted CICA Handbook Section 3064, "Goodwill and Intangible Assets", which replaces Section 3062, "Goodwill and Intangible Assets", and Section 3450, "Research and Development Costs". This revision establishes standards for the recognition, measurement and disclosure of goodwill and intangible assets. The adoption of this standard did not have a material impact on the Company's consolidated financial statements.

In June 2009, the Accounting Standards Board ("AcSB") further amended CICA Handbook Section 3862, "Financial Instruments – Disclosures" to include additional disclosures about fair value measurements of financial instruments and to enhance risk disclosure. The additional fair value measurement disclosures include classification of financial instrument fair values in a fair value hierarchy comprising three levels reflecting the significance of the inputs used in making the measurements, described as follows:

- Level 1: Valuation based on quoted prices (unadjusted) in active markets for identical assets or liabilities;
- Level 2: Valuations based on directly or indirectly observable inputs in active markets for similar assets or liabilities, other than Level 1 prices, such as quoted interest or currency exchange rates; and
- Level 3: Valuations based on significant inputs that are not derived from observable market data, such as discounted cash flow methodologies based on internal cash flow forecasts.

**Montello Resources Ltd.**  
**Management's Discussion and Analysis**  
**For the Three Months Ended October 31, 2010**

These amendments were required to be adopted for the year ended July 31, 2010. The adoption of this section did not have a material effect on the Company's consolidated financial statements.

**Future Changes in Accounting Standards**

In August 2009, AcSB issued CICA Handbook Section 3251, "Equity" in response to issuing Section 1602, "Non-controlling Interests". The amendments require non-controlling interests to be recognized as a separate component of equity. The amendments apply only to entities that have adopted Section 1602. The adoption of this section is not expected to have a material impact on the Company's consolidated financial statements.

In January 2009, the AcSB issued CICA Handbook Sections 1582, "Business Combinations", 1601, "Consolidated Financial Statements" and 1602, "Non-controlling Interests" which replace CICA Handbook Sections 1581, "Business Combinations" and 1600, "Consolidated Financial Statements". Section 1582 establishes standards for the accounting for business combinations that is equivalent to the business combination accounting standard under IFRS. Section 1582 is applicable for the Company's business combinations with acquisition dates on or after August 1, 2011. Early adoption of this section is permitted. Section 1601 together with Section 1602 establishes standards for the preparation of consolidated financial statements. Section 1601 is applicable for the Company's interim and annual consolidated financial statements for its fiscal year beginning August 1, 2011. Early adoption of this section is permitted and all three sections must be adopted concurrently. The adoption of these sections is not expected to have a material effect on the Company's consolidated financial statements.

**International Financial Reporting Standards ("IFRS")**

In February 2008, the AcSB confirmed that public companies will be required to prepare interim and annual financial statements under International Financial Reporting Standards ("IFRS") for fiscal years beginning on or after January 1, 2011. The transition date of August 1, 2011 will require the restatement for comparative purposes of amounts reported by the Company for the year ended July 31, 2011. Management is currently assessing the impact of adopting IFRS and it has not yet determined its effect on the Company's financial statements.

The Chief Financial Officer will manage the conversion and report regularly to the Audit Committee. The implementation of IFRS consists of four phases:

- (i) Scoping and impact analysis – Project scoping and impact analysis will be completed by January 31, 2011, and will produce a high level view of potential differences to existing accounting and reporting policies and consequential changes to information systems and business processes.
- (ii) Evaluation and design phase – This phase involves specification of changes required to existing accounting policies, information systems and business processes, together with an analysis of policy alternatives allowed under IFRS and development of draft IFRS financial statement content. Expected to be completed by March 31, 2011.
- (iii) Implementation phase – The implementation and review includes training programs for all current and future finance staff, execution of changes to information systems and business processes, and completing formal authorization processes to approve recommended accounting policy changes. It will culminate in the collection of financial information necessary to compile IFRS compliant financial statements, embedding of IFRS in business processes, elimination of unnecessary data collection processes and Board approval of IFRS financial statements. Implementation also involves delivery of further training to staff as systems begin to take effect. Expected to be completed by May 31, 2011.

**Montello Resources Ltd.**  
**Management's Discussion and Analysis**  
**For the Three Months Ended October 31, 2010**

- (iv) Quantitative impact review phase – Final determination of accounting policies and the quantitative impact of adopting IFRS on key line items in the Company's financial statements. Expected to be completed by July 31, 2011.

**Impact of Adopting IFRS on the Company's Financial Statements**

The adoption of IFRS will result in some changes to the Company's accounting policies that are applied in the recognition, measurement and disclosure of balances and transactions in its financial statements.

The following provides a summary of the Company's evaluation to date of potential changes to accounting policies in key areas. This summary is intended only to highlight the areas the Company believes to be most significant based on its evaluations to date, and is not necessarily a complete list of changes that will result from adoption of IFRS.

In addition, the International Accounting Standards Board has significant ongoing projects related to potential changes to IFRS that could affect the potential for changes to the Company's current accounting policies on adoption of IFRS.

*Impairment of (Non-financial) Assets* — IFRS requires a write down of assets if the higher of the fair market value and the value in use of a group of assets is less than its carrying value. Value in use is determined using discounted estimated future cash flows. Current Canadian GAAP requires a write down to estimated fair value only if the undiscounted estimated future cash flows of a group of assets are less than its carrying value. The Company's accounting policies related to impairment of non-financial assets will be changed to reflect these differences, however the Company does not expect that this change will have an immediate impact to the carrying value of its assets. The Company will perform impairment assessments in accordance with IFRS at the transition date.

*Share-based Payments* — In certain circumstances, IFRS requires a different measurement of stock-based compensation related to stock options than current Canadian GAAP. The Company does not expect any changes to its accounting policies related to share-based payments that would result in a significant change to line items within its financial statements.

*Asset Retirement Obligations (Decommissioning Liabilities)* — IFRS requires the recognition of a decommissioning liability for legal or constructive obligations, while current Canadian GAAP only requires the recognition of such liabilities for legal obligations. A constructive obligation exists when an entity has created reasonable expectations that it will take certain actions. The Company's accounting policies related to decommissioning liabilities will be changed to reflect these differences, however the Company does not expect this change will have an immediate impact to the carrying value of its assets.

*Income Taxes* — IFRS contains some different guidance related to recognition and measurement of future (deferred) income taxes. One of those differences relates to accounting for "flow-through" common shares, for which IFRS does not include the same level of specific guidance provided under current Canadian GAAP. The Company has not completed its detailed evaluation of the differences between IFRS and current Canadian GAAP related to accounting for income taxes. These differences could require changes to accounting policies that may impact the Company's financial statements and require adjustments to future (deferred) income taxes and shareholders' equity.

**Financial Instruments and Other Instruments**

The Company classifies all financial instruments as either held-for-trading, available-for-sale, held-to-maturity, loans and receivables or other financial liabilities. Financial instruments are required to be measured at fair value on initial recognition. Measurement in subsequent periods depends on the financial instruments classification. Held-for-trading instruments are measured at fair value with unrealized gains and losses recognized in results of operations. Available-for-sale instruments are

**Montello Resources Ltd.**  
**Management's Discussion and Analysis**  
**For the Three Months Ended October 31, 2010**

measured at fair value with unrealized gains and losses recognized in other comprehensive income. Instruments held-to-maturity, loans and receivables and other financial liabilities are measured at amortized cost.

The Company has classified its cash and cash equivalents as held-for-trading. Receivables are classified as loans and receivables. Accounts payable, accrued liabilities and amounts due to related parties are classified as other financial liabilities.

(a) Fair Values

Assets and liabilities measured at fair value on a recurring basis were presented on the Company's balance sheet as at October 31, 2010 as follows:

Fair Value Measurements Using				
	Quoted prices in active markets for identical instruments (Level 1) \$	Significant other observable inputs (Level 2) \$	Significant unobservable inputs (Level 3) \$	Balance, October 31, 2010 \$
Cash	8,618	–	–	8,618

The fair values of other financial instruments, which include GST receivable, accounts payable and accrued liabilities, amounts due to related parties, and loan payable, approximate their carrying values due to the relatively short-term maturity of these instruments.

(b) Credit Risk

Financial instruments that potentially subject the Company to a concentration of credit risk consist primarily of cash and cash equivalents. The Company limits its exposure to credit loss by placing its cash and cash equivalents with high credit quality financial institutions. The carrying amount of financial assets represents the maximum credit exposure.

(c) Foreign Exchange Rate Risk

The Company operates in Canada and U.S. The Company is exposed to foreign exchange risk due to fluctuations in exchange rate of U.S. dollar. Foreign exchange risk arises from purchase transactions as well as financial assets and liabilities denominated in U.S. dollars.

(d) Interest Rate Risk

The Company's cash and cash equivalents and restricted cash contain highly liquid investments that earn interest at market rates. The Company manages its interest rate risk by maximizing the interest earned on excess funds while maintaining the liquidity necessary to fund daily operations. Fluctuations in market interest rates do not have a significant impact on the Company's results of operations due to the short term to maturity of the investments held.

(e) Liquidity Risk

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they fall due. The Company currently settles its financial obligations out of cash. The ability to do this relies on the Company raising equity financing in a timely manner and by maintaining sufficient cash in excess of anticipated needs.

(f) Price Risk

The Company is exposed to price risk with respect to commodity prices. The Company's ability to raise capital to fund exploration and production activities is subject to risks associated with fluctuations in the market price of commodities.

**Montello Resources Ltd.**  
**Management's Discussion and Analysis**  
**For the Three Months Ended October 31, 2010**

**RISK FACTORS**

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There are a number of risks facing participants in the Canadian oil and gas industry. Some of the risks are common to all businesses while others are specific to the sector. The following reviews the general and specific risks and includes the Company's approach to managing these risks.

**Risks in the Canadian Oil and Gas Industry**

**Exploration, Development and Production Risks**

Oil and natural gas exploration involves a high degree of risk, which even a combination of experience, knowledge and careful evaluation may not be able to overcome. There is no assurance that expenditures made on future exploration by the Company will result in new discoveries of oil or natural gas in commercial quantities.

It is difficult to project the costs of implementing an exploratory drilling program due to the inherent uncertainties of drilling in unknown formations, the costs associated with encountering various drilling conditions such as over pressured zones and tools lost in the hole, and changes in drilling plans and locations as a result of prior exploratory wells or additional seismic data and interpretations thereof. The long-term commercial success of the Company depends on its ability to find, acquire, develop and commercially produce oil and natural gas reserves. No assurance can be given that the Company will be able to locate satisfactory properties for acquisition or participation. Moreover, if such acquisitions or participations are identified, the Company may determine that current markets, terms of acquisition and participation or pricing conditions make such acquisitions or participations uneconomic.

Future oil and gas exploration may involve unprofitable efforts, not only from dry wells, but from wells that are productive but do not produce sufficient net revenues to return a profit after drilling, completion, and operating costs. Completion of a well does not ensure a profit on the investment or recovery of drilling, completion and operating costs. In addition, drilling hazards or environmental damage could greatly increase the cost of operations, and various field operating conditions may adversely affect the production from successful wells. These conditions include delays in obtaining governmental approvals or consents, shut-ins of connected wells resulting from extreme weather conditions, insufficient storage or transportation capacity or other geological and mechanical conditions. While diligent well supervision and effective maintenance operations can contribute to maximizing production rates over time, production delays and declines from normal field operating conditions cannot be eliminated and can be expected to adversely affect revenue and cash flow levels to varying degrees. Oil and gas exploration, development and production operations are subject to all the risks and hazards typically associated with such operations, including encountering unexpected formations or pressures, premature declines of reservoirs, blow-outs, cratering, sour gas releases, fires and spills. Losses resulting from the occurrence of any of these risks could have a materially adverse effect on future results of operations, liquidity and financial condition.

**Prices, Markets and Marketing**

Demand for crude oil and natural gas produced by the Company exists within North America, however, crude oil prices are affected by worldwide supply and demand fundamentals, while natural gas prices are affected by North American supply and demand fundamentals, all of which are beyond the control of the Company. World prices for oil and natural gas have fluctuated widely in recent years. Any material decline in prices could result in a reduction of net production revenue. Certain wells or other projects may become uneconomic as a result of a decline in world oil prices and natural gas prices, leading to a reduction in the volume of the Company's oil and gas reserves. The Company might also elect not to produce from certain wells at lower prices. All of these factors could result in a material decrease in the Company's future net production revenue, causing a reduction in its oil and gas acquisition and development activities.

**Montello Resources Ltd.**  
**Management's Discussion and Analysis**  
**For the Three Months Ended October 31, 2010**

In addition to establishing markets for its oil and natural gas, the Company must also successfully market its oil and natural gas to prospective buyers. The marketability and price of oil and natural gas which may be acquired or discovered by the Company will be affected by numerous factors beyond its control. The Company will be affected by the differential between the price paid by refiners for light quality oil and the grades of oil actually produced. The ability of the Company to market its natural gas may depend upon its ability to acquire space on pipelines which deliver natural gas to commercial markets. The Company will also likely be affected by deliverability uncertainties related to the proximity of its reserves to pipelines and processing facilities and related to operational problems with such pipelines and facilities and extensive government regulation relating to price, taxes, royalties, land tenure, allowable production, the export of oil and natural gas and many other aspects of the oil and natural gas business. The Company has limited direct experience in the marketing of oil and natural gas and utilizes the expertise of a marketing consultant.

**Inflation Risks**

Inflation risks subject the Company to potential erosion of product netbacks. For example, domestic prices for oil and natural gas production equipment and services can inflate the costs of operations.

**Substantial Capital Requirements**

The Company anticipates that it will make substantial capital expenditures for the acquisition, exploration, development and production of oil and natural gas reserves in the future. If the Company's revenues or reserves decline, it may have limited ability to expend the capital necessary to undertake or complete future drilling programs. There can be no assurance that debt or equity financing, or cash generated by operations will be available or sufficient to meet these requirements or for other corporate purposes or, if debt or equity financing is available, that it will be on terms acceptable to the Company. Future activities may require the Company to alter its capitalization significantly. The inability of the Company to access sufficient capital for its operations could have a material adverse effect on its financial condition, results of operations or prospects. Failure to obtain such financing on a timely basis could cause the Company to forfeit its interest in certain properties, miss certain acquisition opportunities and reduce or terminate its operations. If the Company's revenues from its reserves decrease as a result of lower oil and natural gas prices or otherwise, it will affect the Company's ability to expend the necessary capital to replace its reserves or to maintain its production. Should the Company's cash flow from operations be insufficient to satisfy its capital expenditure requirements, there can be no assurance that additional debt or equity financing will be available to meet these requirements or that it will be available on acceptable terms. The Company may enter into transactions to acquire assets or shares of other businesses. These transactions may be financed partially or wholly with debt, which may increase the Company's debt levels above industry standards.

**Environmental Risks**

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 international conventions and provincial and municipal laws and regulations. Environmental legislation provides for, among other things, restrictions and prohibitions on spills, releases or emissions of various substances produced in association with oil and 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 liability 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 foreign governments and third parties and may require the Company to incur costs to remedy such discharge.

**Montello Resources Ltd.**  
**Management's Discussion and Analysis**  
**For the Three Months Ended October 31, 2010**

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 Company's financial condition, results of operations or prospects.

**Insurance**

The Company's involvement in the exploration for and development of oil and gas properties may result in liabilities for pollution, blow-outs, property damage, personal injury or other hazards. Although the Company has obtained insurance in accordance with industry standards to address such risks, such insurance has limitations on liability that may not be sufficient to cover the full extent of such liabilities. In addition, such risks may not, in all circumstances be insurable or, in certain circumstances, the Company may elect not to obtain insurance to deal with specific risks due to the high premiums associated with such insurance or other reasons. The payment of such uninsured liabilities would reduce the funds available to the Company. The occurrence of a significant event that is not fully insured against, or the insolvency of the insurer of such event, could have a material adverse effect on the Company's financial position, results of operations or prospects.

**Competition**

The Company actively competes for reserve acquisitions, exploration leases, licenses and concessions and skilled industry personnel with a substantial number of other oil and gas companies, many of which have significantly greater financial resources. The Company's competitors include major integrated oil and natural gas companies and numerous other independent oil and natural gas companies and individual producers and operators. The oil and gas industry is highly competitive. The Company's competitors for the acquisition, exploration, production and development of oil and natural gas properties, and for capital to finance such activities, include companies that have greater financial and personnel resources available to them. Certain of the Company's customers and potential customers are themselves exploring for oil and natural gas, and the results of such exploration efforts could affect the Company's ability to sell or supply oil or gas to these customers in the future. The Company's ability to successfully bid on and acquire additional property rights, to discover reserves, to participate in drilling opportunities and to identify and enter into commercial arrangements with customers will be dependent upon developing and maintaining close working relationships with its future industry partners and joint operators and its ability to select and evaluate suitable properties and to consummate transactions in a highly competitive environment. The supply of service and production equipment at competitive prices is critical to the ability to add reserves at a competitive cost and produce these reserves in an economic and timely fashion. In periods of increased activity these services and supplies can become difficult to obtain. The Company attempts to mitigate this risk by developing strong long term relationships with suppliers and contractors and maintaining close working relationships with industry partners.

Further details on the Company via its news releases, financial statements and MD&A's are available on the Company's website [www.montello.com](http://www.montello.com) and on [www.sedar.com](http://www.sedar.com).