

AVALON RARE METALS INC.
(formerly Avalon Ventures Ltd.)

Management Discussion and Analysis of Financial Statements
For the period ended May 31, 2009

This Management Discussion and Analysis (“MDA”) of Avalon Rare Metals Inc. (the “Company”) provides analysis of the Company's financial results for the period ended May 31, 2009. The following information should be read in conjunction with the accompanying unaudited financial statements and the related notes thereto.

This MDA includes certain statements that may be deemed “forward-looking statements”. All statements in this discussion, other than statements of historical fact, that address future production, reserve potential, exploration drilling, exploitation activities and events or developments that the Company expects, are forward-looking statements. Although the Company believes the expectations expressed in such forward-looking statements are based on reasonable assumptions, such statements are not guarantees of future performance and actual results or developments may differ materially from those in the forward-looking statements.

Factors that could cause actual results to differ materially from those in forward-looking statements include market prices, exploitation and exploration successes, continued availability of capital and financing and general economic, market or business conditions. Investors are cautioned that any such statements are not guarantees of future performance and that the actual results or developments may differ materially from those projected in the forward-looking statements. This report is prepared as of *July 10, 2009*.

Nature of Business and Overall Performance

Avalon Rare Metals Inc. is a Canadian junior mineral exploration and development company which is listed on the Toronto Stock Exchange. The Company seeks to build shareholder value by becoming a diversified producer of rare metals and minerals and expanding the markets for its mineral products.

Avalon operates exclusively in Canada with a primary focus on rare metals and minerals including calcium feldspar, lithium, tantalum, cesium, indium, gallium, yttrium and the rare earth elements (“REE”). By definition, REEs refers specifically to the lanthanide series of elements (atomic numbers 57 – 71), whereas the term “rare metals” is a more general “umbrella” term that includes the REE as well as other rare metals including those named above.

The Company is in the process of exploring or developing four of its eight mineral resource properties. All active projects (Thor Lake, Separation Rapids, East Kemptville and Warren Township) are rare minerals or rare metals properties that are at an advanced stage with identified mineral resources that are potentially economic, provided that sales contracts with customers can be secured and project financing arranged.

A positive Preliminary Economic Assessment (“PEA”) on the REE development potential of Thor Lake project was completed in 2007 and this project has become the Company’s top priority due to the large size of the resource and its exceptional enrichment in the “heavy” rare earths, europium through lutetium (“HREE”). A new NI 43-101 compliant resource estimate for the Lake Zone REE deposit was filed in March, 2009 and it is intended that this project will be advanced to the pre-feasibility level of analysis by the end calendar of 2009.

Avalon has adopted the Principles and Guidelines for Responsible Exploration being developed by the Prospectors and Developers Association of Canada (“PDAC”), as policy of the Company and made Corporate Social Responsibility (“CSR”) a Company priority. Avalon applies these principles throughout its operations, particularly with respect to its environmental and community engagement practice on the Thor Lake project.

The global financial crisis in 2008 has resulted in reduced demand and dramatically lower prices for most mineral commodities, but many of the rare metals are notable exceptions, with prices declining to a lesser degree than other mineral commodities. This is attributable to steady demand for these metals due to their importance in a growing number of applications in technology related to energy efficiency and a cleaner environment. Reduced carbon emissions and less reliance on fossil fuels remain a top policy priority for many governments around the world, which should continue to stimulate demand for rare metals, even in a recessionary environment.

The Company remains well-funded and does not expect that the recent volatility in the capital markets will have a significant impact on its operations.

Selected Annual Information

Unless otherwise noted, all currency amounts are stated in Canadian dollars.

The following selected financial data for each of the three most recently completed fiscal years are derived from the audited annual financial statements of the Company, which were prepared in accordance with Canadian generally accepted accounting principles.

For the Years Ending August 31,	2008	2007	2006
	\$	\$	\$
Net revenues	357,539	92,446	87,588
Loss before discontinued operations and extraordinary items	1,391,581	903,019	1,287,581
Loss before discontinued operations and extraordinary items, per share basic and fully diluted	0.02	0.02	0.03
Net loss	1,391,581	903,019	1,287,581
Net loss, per share basic and fully diluted	0.02	0.02	0.03
Total assets	24,384,590	9,130,719	6,930,933
Total long term liabilities	-	-	-
Cash dividends	-	-	-

The Company has recorded losses in each of its three most recently completed fiscal years and expects to continue to record losses until such time as an economic resource is identified, developed and brought into profitable commercial operation on one or more of the Company’s properties or otherwise disposed of at a profit. Since the Company has no revenue from operations, annual operating losses typically represent the sum of business expenses plus any write-offs of mineral properties abandoned during the period. The Company expects to increase its level of business activity in coming years and consequently investors should anticipate that the Company’s annual operating losses will also increase until a new operation begins to generate cash flow.

Results of Operations

Exploration and Development Activities

Resource property expenditures for the three months ended May 31, 2009 totalled \$1,692,097, a 22% decrease over the level of expenditures in the comparable period of the previous fiscal year

(\$2,161,256). Most of these expenditures were incurred on the Thor Lake rare metals project (99%) with the balance being largely incurred on the East Kemptville and Separation Rapids projects. The expenditures on Thor Lake and East Kemptville were largely funded from the flow-through component of the proceeds of the private placement financing completed in December, 2008 while the expenditures on Separation Rapids and Warren Township were funded from working capital. No properties were abandoned during the quarter and no expenditures were written off.

Resource property expenditures for the nine months ended May 31, 2009 totalled \$4,748,373, a 17% increase over the level of expenditures in the comparable period of the previous fiscal year (\$4,054,490). This increase was primarily caused by increased environmental and metallurgical work on Thor Lake, offset partially by reduced drilling expenditures on Thor Lake during this period.

Thor Lake

On the Thor Lake rare metals project, expenditures during the three months ended May 31, 2009 totalled \$1,667,922. Most of these expenditures were incurred on the winter 2009 definition drilling program, the preparation of the resource estimate for the Lake Zone REE deposit, an airborne magnetic survey, a market study on the rare earth elements and continuing metallurgical process development work.

The new NI43-101 compliant resource estimate for the Lake Zone REE deposit was disclosed in a news release dated February 3, 2009 and the full technical report was SEDAR-filed during the quarter by independent technical consultants, Wardrop Engineering Ltd. (“Wardrop”) of Toronto, ON. The new resource estimate provided the first separate estimate of resources in the “Basal Zone” portion of the deposit as detailed below, which due to its relative enrichment in the more scarce and valuable HREE, is considered the main target for initial development. This resource estimate will be updated with the results of the winter drilling during the fourth quarter.

ZONE	Resource Class	Cut-off TREO (%)	Tonnes (x1000)	TREO (%)	HREO (%)	H/T (%)
Basal	IND	1.60	2,186	2.14	0.43	20.0%
Basal	IND	1.80	1,573	2.31	0.47	20.4%
Basal	IND	2.00	1,054	2.52	0.53	20.9%
Basal	IND	2.20	731	2.71	0.57	21.1%
Basal	IND	2.40	505	2.90	0.63	21.7%

ZONE	Resource Class	Cut-off TREO (%)	Tonnes (x1000)	TREO (%)	HREO (%)	H/T (%)
Basal	INF	1.60	28,447	1.99	0.44	22.1%
Basal	INF	1.80	18,181	2.16	0.49	22.4%
Basal	INF	2.00	11,795	2.31	0.52	22.4%
Basal	INF	2.20	6,594	2.48	0.57	22.9%
Basal	INF	2.40	3,460	2.64	0.64	24.1%

Notes:

1. HREO (Heavy Rare Earth Oxides) is the total concentration of: Y₂O₃, Eu₂O₃, Gd₂O₃, Tb₄O₇, Dy₂O₃, Ho₂O₃, Er₂O₃, Tm₂O₃, Yb₂O₃ and Lu₂O₃.
2. TREO (Total Rare Earth Oxides) is HREO plus: La₂O₃, Ce₂O₃, Pr₆O₁₁, Nd₂O₃ and Sm₂O₃

3. Wardrop considers a 1.60% TREO cut-off grade to be a reasonable estimate of potentially economic resources, based on a preliminary estimate of operating costs of \$197.00/tonne.
4. To determine a recommended cut-off grade, Gross Metal Values (GMV) were calculated using 4 year average REE prices (where available) and assuming recoveries of: 74.6% for Y₂O₃ and 82.1% for all other rare earth elements. The metallurgical recoveries include both mineral processing (flotation) and hydrometallurgical recoveries. A 1.60 % TREO cut-off grade closely approximates a \$200/tonne GMV.
5. IND = Indicated, INF = Inferred, H/T = ratio of HREO to TREO expressed as percent.
6. The mineral resource estimates were completed by Thomas C. Stubens, M.A.Sc., P. Eng, Senior Geologist of Wardrop Engineering, Vancouver, BC, and are based on geological interpretations supplied by the Company to Wardrop and modified by Wardrop Engineering Ltd/Inc. Stubens is an “independent qualified person” for the purposes of National Instrument 43-101 Standards of Disclosure for Mineral Projects of the Canadian Securities Administrators and has verified the data disclosed in this release. Joanne Paul, P.Geo., also an “independent qualified person” for the purposes of National Instrument 43-101 Standards of Disclosure for Mineral Projects of the Canadian Securities Administrators, has verified the sampling procedures and QA/QC data delivered to Wardrop and is of the opinion that the data are of good quality and suitable for use in the resource estimates. The field exploration program was carried out under the supervision of J.C. Pedersen, P.Geo., the Company’s Senior Geologist. The Company’s Vice-President, Exploration, Dr. William Mercer, P.Geo. provided overall direction on the project.

The Basal Zone represents an undulating, gently dipping sheet, averaging approximately 20 metres in thickness and extending over a broad area at the base of the Lake Zone deposit at depths typically in the order of 200-250 metres. The current drilling program has two main objectives: 1) better define the southern part of the Basal Zone where some of the best grades and thicknesses were obtained in the 2008 drilling and 2) complete in-fill drilling to reduce average drill spacing and improve the confidence level on the resource to allow more of the Inferred resources to be classified as Indicated.

A total of 5,476.8 metres in 26 holes were drilled up to April 2009, when operations were suspended for Spring Break-up. As at the date of this report all assay results from this program had been received and disclosed to the public. These results confirm some exceptional grades in the Basal Zone, in terms of HREO content, in the southern part of the deposit which is covered by Long Lake. The zone remains open to the south of Long Lake, although one 450 metre step-out hole, designed to test for the potential southern extension based airborne magnetic data failed to confirm this. It is interpreted that the hole did not reach the zone which appears to be deeper in this area than projected and had to be abandoned when it reached the maximum depth range for the drill as presently equipped.

Drilling costs incurred during the quarter totalled \$932,541. An additional \$91,166 was incurred for geological consulting work done in support of this program. The original budget for this program was \$1.5 million and was largely financed with the proceeds of the flow-through private placement completed in December, 2008. As a consequence of more favourable drilling rates and on-site efficiencies, average contract drilling costs are running approximately \$50/m or 30% below 2008 program costs. Drilling operations were carried out under the direct supervision of J.C. Pedersen, P.Geo., under the overall direction of the Company’s Vice-President, Exploration, Dr. William Mercer, P.Geo.

Expenditures of \$205,489 were incurred on the continuation of the metallurgical process development work at SGS Lakefield Research (“SGS”) to design a process flowsheet for beneficiating the REE bearing minerals and to design a hydrometallurgical process for recovering the rare earth oxides from the mineral concentrate. This work is being supervised by Mr. J. R. Goode, P.Eng., a consulting metallurgist with over 40 years of international experience. Flotation study results reported by SGS are indicating recoveries to a bulk cleaner concentrate of 75% to 85% of REE, about 70% to 77% of niobium and tantalum, and 85% of the zirconium with a fourfold concentration of these elements. Further trials are in progress to attempt to upgrade this

concentrate. Hydrometallurgical testing continues with results showing up to 98% to 99% REE and zirconium recovery with NaOH caustic cracking at 600°C followed by HCl dissolution. Subsequent tests, using H₂SO₄ in place of HCl, have produced promising results as an equally efficient but significantly lower cost processing route. A more comprehensive progress report on all the metallurgical testwork completed to date is being prepared for public disclosure in the fourth quarter.

Environmental expenditures of \$175,732 were incurred during the quarter, for continuing costs related to a program of environmental baseline studies on the property, initiated in 2008 and carried out by Stantec (formerly Jacques Whitford). This program included studying waterfowl, aquatic mammals and raptor surveys, vegetation and endangered plant species, both surface and ground waters, water chemistry in the lakes of the area, aquatic biology, terrane analysis and collecting meteorological data. During the current program, environmental work consisted of packer test holes to measure groundwater conditions and some aquatic studies under winter conditions. In addition, office work relating to previous fieldwork is ongoing.

Other expenditures included the airborne geophysical survey (\$68,311), community consultation work (\$74,058) and feasibility/engineering studies of \$99,427 which were related to evaluating proposals from engineering companies for the pre-feasibility study (“PFS”) on the Lake Zone deposit. This resulted in the selection of Scott Wilson Roscoe Postle Associates, Toronto, as the lead consultant for the PFS subsequent to the end of the quarter. Work on the PFS has commenced with resource update and field examination of the Thor Lake site for potential underground ramp, plant and tailings sites. Finally, some marketing expenditures were incurred in the context of defining future markets for the Company’s rare earth products including participation in an international magnetics technology conference in Chicago, IL by Ian London, VP, Market Development as a key-note speaker.

During the quarter, the Company carried out a round of community consultations with community leadership in Lutselk’e, Fort Resolution, Hay River and Yellowknife. This was in connection with the Company’s application for a two-year extension to its land use permit, scheduled to expire in July. No opposition to the proposed permit extension was voiced and the permit extension was received during the quarter. Further consultation meetings are planned for the fourth quarter when a draft Memorandum of Understanding (“MOU”) will be prepared and delivered to local aboriginal groups for discussion. The MOU outlines the proposed contents for a participation arrangement and an Impact Benefit Agreement with First Nations and the basic principles under which the parties will work together to advance the project in a co-operative, timely, yet environmentally and socially responsible way.

The Company has placed a high priority on its performance with respect to community, environment, health and safety at Thor Lake. During the quarter, there was one lost time accident. An employee hired through the Yellowknives Dene First Nation strained his back lifting fuel drums, lost time and did not return to work. Another worker – an employee of the drill company - had a knee injury that resulted in a short period of light duty, and he has since returned to work at site. Site inspections by government land use and WCB inspectors have generally produced positive reports and minor issues which were raised were addressed immediately. All land use inspection reports have been filed on the Company’s website in the Sustainability section.

Warren Township

Expenditures of \$1,125 were incurred on the Warren Township Anorthosite Project during the three months ended May 31, 2009. These were mainly related to the finalization of a Memorandum of Understanding (“MOU”) with the Chapleau Cree First Nation (“CCFN”). The substance of the MOU was disclosed in a news release dated February 26, 2009 and a formal

signing ceremony was conducted during the PDAC convention on March 3, 2009. This work is being carried out under the supervision of Ian London, P.Eng.

Essentially the project will be inactive until issues over the size of the permit area are resolved with the Ontario Ministry of Natural Resources. This work is being carried out under the direction of Fudge & Associates (“Fudge”) of North Bay, Ontario. There are no specific timelines in place for initiation of any new work programs on the project.

Separation Rapids

During the three months ended May 31, 2009, the Company incurred \$20,982 in expenditures on the Separation Rapids Lithium-Tantalum Project. These costs were mainly related to market development work and work related to the Company’s application for a Mining Lease. Subsequent to the end of the quarter, a brief field program was conducted to clean up debris remaining from the Company’s old campsite there, which had steadily deteriorated since last used in 2003. Further work is planned this summer to rehabilitate the old core racks on the site.

The Company continues to implement a pro-active market development program with the glass and ceramics industry to demonstrate the energy-savings and environmental benefits associated with the use of lithium in its batch formulations. This has involved a number of presentations to glass industry participants and interest is growing along with public pressure for the industry to reduce its greenhouse gas emissions.

Work on securing a Mining Lease for the Big Whopper Petalite Deposit and neighbouring lands that may be needed for development work continued during the quarter with a perimeter survey to precisely define the lease boundaries. This work is being supervised by Fudge and it is expected that the lease application will be completed and submitted during the fourth calendar quarter.

Subsequent to the end of the quarter, the Company hosted Chief Eric Fisher and Councillor Glenn Cameron of the Wabaseemoong Independent Nations, Whitedog, ON in Toronto for a meeting to update community leadership on the status of the project. The Company re-iterated its commitment to partnering with the First Nation once the project finally proceeds to development.

East Kemptville

During the three months ended May 31, 2009, the Company incurred expenditures totalling \$2,068 on the East Kemptville Tin-Rare Metals Project in Yarmouth Co., Nova Scotia. The work is being conducted by Bruce Hudgins, P.Geo. of Dartmouth, N.S. (“Hudgetec”), under the supervision of the Company’s Vice-President, Exploration, Dr. William Mercer, P.Geo.

Most of the expenditures incurred during the period were relating to the filing of a detailed update report with the Nova Scotia government as required under the terms of the Special Licence. This was completed earlier in 2008 but revisions were required during the last quarter.

Subsequent to the end of the quarter, the Company formally retained Wardrop Engineering to complete a Preliminary Economic Analysis on the potential for renewed production of tin and by-product indium plus base metals at East Kemptville, including a new NI43-101 compliant resource estimate. The resource estimate is scheduled for completion during the fourth quarter at a budgeted cost of \$250,000, which will satisfy assessment obligations for the Special Licence.

Red Hill

No expenditure was incurred on the Red Hill project during the three months ended May 31, 2009 and none are planned for 2009.

Administration

Administrative expenses incurred during the three months ended May 31, 2009 totalled \$672,263, an 8% decrease over the amount incurred during the comparable quarter in fiscal 2008. The main areas of decreased administrative expenditures were salaries and benefits, interest and financing costs, professional fees and public and investor relations reflecting the Company's efforts to reduce its overall administrative overhead expenditures in 2009.

Expenditures on public and investor relations ("IR") activities for the three months ended May 31, 2009 totalled \$162,931, a 8% decrease over the comparable period in fiscal 2008 (\$177,233). The decrease relates to, reduced advertising expenditures and the termination of some IR consulting contracts. During the quarter the Company participated in the Investor Exchange of the PDAC annual convention, the Milken Institute Conference in Los Angeles, the Calgary Resource and Clean Energy Investment conference and a Trade fair in Yellowknife. Marketing trips were made to New York and San Francisco. Subsequent to the end of the quarter, the Company participated in the Vancouver World Resource Investment Conference and one-day investment conferences in Geneva and Zurich, followed by meetings with investors in Paris, Brussels and finally, Philadelphia.

The Company's rare metals story is attracting considerable new investor interest and attention from a growing number of industry analysts, commentators and newsletter writers including the influential *Dines Letter*. This resulted in a surge in new buying interest in the market beginning in late May which saw the Company's share price recover to its pre-September, 2008 trading levels.

Some costs related to the change of name to Avalon Rare Metals Inc. were incurred during the quarter for design work, and new promotional materials. The re-design of the corporate website was not completed during the quarter as planned but should be completed during the fourth quarter.

Salaries and benefits decreased during the quarter to \$98,209 from \$155,813 in fiscal 2008. The primary reason for the decrease was that the Company had reduced its administrative staff during the quarter ended May 31, 2009. During the quarter, the Company hired Ms. Virginia Morgan as its new Manager, Investor Relations replacing Ajay Chopra, whose relationship with the Company has reverted to a consultancy in the areas of media and government relations.

Interest and financing costs decreased by \$33,862 compared to the same quarter in 2008, reflecting the lower amount of Part XII.6 tax incurred relating to the renunciation of Canadian exploration expenditures arising from the Company's flow-through financing. Interest income totalled \$35,265 for the three months ended May 31, 2009 compared to \$93,778 for the same three month period in fiscal 2008, reflecting the decreased level of cash and cash equivalents in the treasury as well as the decrease in interest rates.

For the nine month period, administrative expenses totalled \$1,941,036 compared with \$2,159,850 during the comparable period in 2008. The main areas of decreased administrative expenditures for the nine month period were transfer and filing fees, salaries and benefits, interest and financing costs and travel expenses. The decreases in these areas were partly offset by the increases in consulting and professional fees.

Transfer and filing fees decreased by \$144,606 compared to the same nine month period in 2008. The decrease in transfer and filing fees compared to the comparable period in 2008 was due to the listing fee paid on Company's graduation to the TSX in February, 2008. Salaries and benefits decreased by \$94,572 compared to the same nine month period in 2008. The primary reason for the decrease was that a bonus awarded to the Company's President and CEO in 2008, did not recur in 2009. Interest and financing costs decreased by \$50,763 for the nine months ended May 31, 2009 compared to the same period in 2008, reflecting the lower amount of Part XII.6 tax

incurred relating to the renunciation of Canadian exploration expenditures arising from the Company's flow-through financing.

During the nine months ended May 31, 2009, the Company renounced Canadian exploration expenditures of \$1,500,000 to the investors in the flow-through private placement completed in December, 2008. This renunciation resulted in a reduction of the Company's future income tax assets of \$405,000 and a corresponding reduction in share capital. However, as the Company has not recognized its future income tax assets, this amount is recorded as a future income tax recovery on the statement of operations.

Summary of Quarterly Results

The following selected financial data is derived from the unaudited interim financial statements of the Company, which were prepared in accordance with Canadian generally accepted accounting principles.

Fiscal Year For the Quarters Ended	2009			2008			2007	
	May 31	Feb.28	Nov. 30	Aug. 31	May 31	Feb. 29	Nov. 30	Aug. 31
	\$	\$	\$	\$	\$	\$	\$	\$
Net revenues	35,265	52,701	44,246	100,003	93,778	141,359	22,399	21,066
Income (loss) before discontinued operations and extraordinary items	(636,998)	(238,665)	(528,161)	(872,767)	(638,340)	(787,411)	906,937	(445,335)
Income (loss) before discontinued operations and extraordinary items, per share, basic and fully diluted	(0.01)	-	(0.01)	(0.01)	(0.01)	(0.01)	0.02	(0.01)
Net income (loss)	(636,998)	(238,665)	(528,161)	(872,767)	(638,340)	(787,411)	906,937	(445,335)
Net income (loss), per share, basic and fully diluted	(0.01)	-	(0.01)	(0.01)	(0.01)	(0.01)	0.02	(0.01)

The fluctuation on quarterly net loss is primarily due to stock-based compensation expenses recognized on stock options granted to directors, officers, employees and consultants of the Company, the write-downs of resource properties and recovery of future income taxes. The costs of resource properties are written down at the time the properties are abandoned or considered to be impaired in value. The write-downs are usually much more significant in terms of dollar amounts in comparison to the Company's expenses for its ordinary activities.

Liquidity and Capital Resources

In management's view, given the nature of the Company's operations, which consist of the exploration and evaluation of mining properties, the most relevant financial information relates primarily to current liquidity, solvency, and planned property expenditures. The Company's financial success will be dependent on the economic viability of its resource properties and the extent to which it can discover new mineral deposits. Such development may take several years to complete and the amount of resulting income, if any, is difficult to determine. The sales value of any mineralization discovered by the Company is largely dependent on factors beyond the Company's control, including the market value of the metals and minerals to be produced. The Company does not expect to receive significant revenue from any of its properties until 2011 at the earliest.

As at May 31, 2009, the Company had working capital of \$6,606,734 (including investments of \$3,943) and cash and cash equivalents on hand of \$6,995,864. During the quarter, 1,302,000

warrants were exercised for total proceeds of \$903,040 (including 1,259,700 re-priced warrants were exercised at the adjusted price of \$0.70 prior to the expiry of May 22, 2009). The proceeds from the warrant exercises have been included in the working capital figure above.

The Company's current overhead expenditures, excluding expenditures on resource property work programs, were approximately \$150,000 per month for the three months ended May 31, 2009, but management is making efforts to further reduce its overhead expenditures in subsequent quarters in 2009. As at the date of this report, the Company's updated budget expenditures on its calendar 2009 work programs are estimated at approximately \$4,000,000, with most of these expenditures being allocated to the Thor Lake REE project for the pre-feasibility study and further definition drilling. This represents an approximately \$1,000,000 budget increase which is entirely related to additional drilling required to define Indicated Resources in the Lake Zone REE deposit, as recommended by the Company's independent engineering consultants.

The Company's present cash resources are sufficient to meet all of its current contractual obligations for the foreseeable future. The Thor Lake, Warren Township, Separation Rapids and Lilypad Lakes properties are all 100% owned by the Company with minimal holding costs, the most significant being annual lease rental fees on Thor Lake of \$15,422.

Under the terms of the East Kemptville special licence, the Company has optional expenditure obligations totalling \$2.5 million over three years and it is currently in good standing. Approximately \$250,000 in additional expenditures is required before August 1, 2009. Expenditures to be incurred during the fourth quarter related to the Preliminary Economic Assessment planned for 2009, will meet this requirement. During the quarter ended May 31, 2009, the Company was granted an amendment to the terms of the Special Licence expenditure requirements, spreading the original \$2.25 million commitment out over an additional year to August 1, 2011 and reducing the current year's commitment to \$250,000.

The Red Hill property is held under option from Teck Cominco Limited ("TCL"). Following receipt of an extension from TCL, expenditures of approximately \$570,000 on this project are required by December 31, 2009 to exercise the option to acquire a 100% interest in this property.

A joint venture with an industry partner or end-user may represent an attractive alternative for financing the more advanced stages in the development of any of the Company's four advanced rare metals projects at Separation Rapids, Thor Lake, East Kemptville, or Warren Township projects, when capital requirements become relatively large.

The Company has an operating lease for its office premises. As at July 14, 2009, the minimum lease commitments under this lease are as follows:

2009	\$12,341
2010	\$88,858
2011	\$88,858
2012	\$29,619

Off Balance Sheet Arrangements

As at May 31, 2009, the Company had no material off balance sheet arrangements such as guaranteed contracts, contingent interests in assets transferred to an entity, derivative instrument obligations or any instruments that could trigger financing, market or credit risk to the Company.

Transactions with Related Parties

All transactions with related parties are in the normal course of business and are measured at the exchange amount. During the nine months ended May 31, 2009, the Company incurred:

- a) accounting fees of \$38,000 with an accounting firm in which an officer is the principal. As at May 31, 2009, accounts payable included \$13,000 accrued to this accounting firm;
- b) consulting fees of \$112,525 with a company owned by an officer of the Company, which were deferred as resource property costs. As at May 31, 2009, accounts payable included \$12,206 payable to this company; and
- c) consulting fees of \$48,400 with an officer of the Company, of which \$32,313 were deferred as resource property costs. As at May 31, 2009, accounts payable included \$7,508 payable to this officer.

Subsequent Events

Subsequent to the nine months ended May 31, 2009, the Company:

- a) issued 475,000 non-flow-through common shares pursuant to the exercise of an equivalent number of stock options for cash proceeds of \$271,000;
- b) granted an aggregate of 200,000 stock options to two of the Company's officers. Each option entitles the holder to purchase one common share of the Company at a price of \$1.41 per share until June 2, 2014. These options vest at the rate of 25% every twelve months following June 2, 2009; and
- c) cancelled 250,000 stock options with an exercise price of \$1.61 per share which expired unexercised.

Proposed Transactions

With four active projects, the Company is not aggressively searching for new mineral property acquisition opportunities at the present time and there are no proposals for new exploration projects under active consideration although with the increased profile of the rare metals amongst prospectors the Company has recently experienced a higher volume of unsolicited property submissions. Management is always interested in evaluating potential transactions or business combinations that are of possible long term strategic value. One such possibility was researched in 2008 and two others have recently been presented to management. One of these appears to be of sufficient interest that it may warrant retaining an independent advisor to consider the opportunity in more detail. The Company is not planning any equity offerings at the present time.

Corporate Social Responsibility ("CSR")

In 2008, the Company adopted the Principles and Guidelines for Responsible Exploration being developed by the Prospectors and Developers Association of Canada (PDAC) as policy of the Company. These Principles for environmental and social best practice were recently announced by PDAC as part of the roll-out of its *E3 Plus* program ("Environmental Excellence in Exploration"), with the "Plus" referring largely to the inclusion of CSR principles as part of E3. Specifically, the Company has committed to implementing the core CSR principles of E3 Plus on its exploration and development programs which are as follows:

1. ADOPT RESPONSIBLE GOVERNANCE AND MANAGEMENT

2. ADOPT ETHICAL BUSINESS PRACTICES

3. RESPECT HUMAN RIGHTS

4. COMMIT TO PROJECT DUE DILIGENCE AND RISK ASSESSMENT

5. ENGAGE HOST COMMUNITIES AND OTHER AFFECTED INTERESTED PARTIES

6. CONTRIBUTE TO COMMUNITY DEVELOPMENT AND WELL-BEING

7. PROTECT THE ENVIRONMENT

8. SAFEGUARD THE HEALTH AND SAFETY OF WORKERS AND THE LOCAL POPULATION

The Company will report on its performance against these principles as part of its continuous disclosure practice as it has in the section above on the Thor Lake project. In addition to that disclosure, the Company participated in Careers Fair for aboriginal youth in June, organized by the Yellowknives Dene First Nation in Dettah, as part of its commitment to promoting skills training.

In July, Company representatives will be participating in the Dene National Assembly to be held in Lutsel K'e, NWT, where Company President, Don Bubar will be speaking generally about economic development opportunities presented by the minerals industry and Company Vice-President, Exploration, Dr. William Mercer, will be participating in a youth career program to highlight career opportunities in the industry. Finally, the Company and Dr. Mercer are participating in the National Aboriginal Science Camp that is being held in the NWT for the first time ever during the week of July 12.

The Company's CSR Advisory Committee met during the quarter to provide input into the scope of work for the proposed environmental baselines studies at Thor Lake and to consider how best to approach certain community consultation objectives there, notably meetings with locally-based environmental NGO's in the NWT and First Nations leadership.

Critical Accounting Estimates

Critical accounting estimates used in the preparation of the financial statements include the value of stock-based compensation and the Company's estimate of recoverable value of its resource properties. These estimates involve considerable judgment and are, or could be, affected by significant factors that are out of the Company's control.

The factors affecting stock-based compensation include estimates of when stock options might be exercised and the stock price volatility. The timing for exercise of options is out of the Company's control and will depend upon a variety of factors, including the market value of the Company's shares and the financial objectives of the stock-based instrument holders.

The Company's recoverability of the recorded value of its resource properties is based on market conditions for minerals, underlying mineral resources associated with the properties and future costs that may be required for ultimate realization through mining operations or by sale. The Company is in an industry that is dependent on a number of factors, including environmental, and legal risks, the existence of economically recoverable reserves, and the ability of the Company to obtain necessary financing to complete the development and future profitable production of its properties or to secure any proceeds from their disposition.

Changes in Accounting Policies Including Initial Adoption

On September 1, 2008, the Company adopted three new accounting standards issued by the CICA: Handbook Section 1535, “Capital Disclosures”, Handbook Section 3862, “Financial Instruments – Disclosures”, and Handbook Section 3863, “Financial Instruments – Presentation”. The Company has applied these new standards on a prospective basis.

Capital Disclosures

Handbook Section 1535 requires disclosure of an entity’s objectives, policies and process for managing capital, quantitative data about what the entity regards as capital and whether the entity has complied with any capital requirements and, if it has not complied, the consequences of such non-compliance. The Company has included disclosures recommended by this new Handbook section in note 2 of the financial statements.

Financial Instruments – Disclosures

Handbook Section 3862 requires an entity to provide disclosures to enable users to evaluate the significance of financial instruments for an entity’s financial position and performance, including disclosures about fair value. In addition, disclosure is required of qualitative and quantitative information about the nature and extent of risks arising from financial instruments, including specified minimum disclosures about liquidity risk and market risk. The quantitative disclosures must also include a sensitivity analysis for each type of market risk to which an entity is exposed, showing how net income and other comprehensive income would have been affected by reasonably possible changes in the relevant risk variable. The Company has included disclosures recommended by this new Handbook section in note 3 of the financial statements.

Financial Instruments – Presentation

Handbook Section 3863 replaces the existing requirements on presentation of financial instruments which have been carried forward unchanged to this new section. The adoption of this standard did not have any impact on the presentation of the Company’s financial statements.

Recent accounting pronouncements issued and not yet effective:

International Financial Reporting Standards (“IFRS”)

The CICA plans to incorporate IFRS into the CICA Handbook as a replacement for current Canadian Generally Accepted Accounting Principles for most publicly accountable enterprises effectively for fiscal years beginning on or after January 1, 2011. The transition date of September 1, 2011 for the Company will require restatement for comparative purposes of amounts reported by the Company for the year ended August 31, 2011. While the Company has begun assessing the adoption of IFRS for 2011, the financial reporting impact of the transition to IFRS has not been determined at this time.

Financial Instruments and Other Risk Factors

The Company's financial instruments consist of cash and cash equivalents, receivables, investments available for sale, and accounts payable.

Management does not believe these financial instruments expose the Company to any significant interest, currency or credit risks arising from these financial instruments. The fair market values

of cash and cash equivalents, receivables and accounts payable approximate their carrying values. Investments available for sale are carried at fair market value.

In conducting its business, the principal risks and uncertainties faced by the Company relate to exploration and development success as well as metal prices and market sentiment to a lesser extent.

Exploration for minerals and development of mining operations involve significant risks, many of which are outside the Company's control. In addition to the normal and usual risks of exploration and mining, the Company often works in remote locations that lack the benefit of infrastructure and easy access.

The prices of metals fluctuate widely and are affected by many factors outside of the Company's control. The relative prices of metals and future expectations for such prices have a significant impact on the market sentiment for investment in mining and mineral exploration companies. The Company relies on equity financing for its long term working capital requirements and to fund its exploration programs. The Company does not anticipate using existing funds to put any of its resources interests into production from its own financial resources. There is no assurance that other forms of financing will be available to the Company, or that it will be available on acceptable terms.

An additional risk factor that has developed over the past two years is access to adequate human resources to carry out work programs, particularly skilled professionals for which there is currently an industry-wide shortage, which can cause delays completing work programs on schedule and in meeting program budgets.

Outstanding Share Data

a) Common and Preferred Shares

The Company is presently authorized to issue an unlimited number of common shares without par value. The Company is also authorized to issue up to 25,000,000 preferred shares without par value, of which none have been issued.

As at the date of this report, the Company had 69,979,448 common shares issued and outstanding.

b) Warrants

As at the date of this report, the Company had 156,250 warrants issued and outstanding with a weighted average exercise price of \$0.50.

c) Stock Options

As at the date of this report, the Company had an aggregate of 3,925,000 incentive stock options outstanding with a weighted average exercise price of \$1.11.

d) Agents' Compensation Options

As the date of this report, the Company had 725,000 Agents' Compensation Options issued and outstanding. Each Agent's Compensation Option entitles the agent holder to purchase one common share at a price of \$1.55 per share, exercisable until November 22, 2009.

Disclosure Controls and Procedures

Disclosure controls and procedures are designed to provide reasonable assurance that material information is gathered and reported to senior management to permit timely decisions regarding public disclosure.

The Chief Executive Officer and Chief Financial Officer have designed or caused to be designed under their supervision, disclosure controls and procedures to provide reasonable assurance that material information is gathered and reported to senior management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to permit timely decisions regarding public disclosure and to provide reasonable assurance that the information required to be disclosed in reports that are filed or submitted under Canadian securities legislation are recorded, processed, summarized and reported within the time period specified in those rules.

Design of Internal Controls

The Chief Executive Officer and Chief Financial Officer have also designed or caused to be designed under their supervision, internal controls over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes.

The Company has very limited administrative staffing and in many instances, the implementation of internal controls relying on segregation of duties is not possible. The Company relies on senior management review and approval to ensure that the controls are as effective as possible.

There has been no change in the Company's internal control over financial reporting during the quarter ended May 31, 2009 that have materially affected, or is reasonably likely to materially affect, the Company's internal controls over financial reporting.

Other Information

Additional information on the Company, including the Company's AIF, is available on SEDAR at www.sedar.com and on the Company's website at www.avalonraremetals.com.