PURE CYCLE CORP
Form 10-Q
January 16, 2007

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended: November 30, 2006

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from to

Commission file number 0-8814

PURE CYCLE CORPORATION

(Exact name of small business issuer as specified in its charter)

Delaware	**84-0705083**
(State of incorporation)	(I.R.S. Employer
	Identification Number)
8451 Delaware St., Thornton, CO	**80260**
(Address of principal executive offices)	(Zip Code)
(303) 292 3456	
Registrant s telephone number	
N/A	
(Former name, former address and former fiscal year, if changed since last report.)	

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o Accelerated filer x Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company filer (as defined in rule 12b-2 of the Exchange Act).

Yes o No x

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of January 12, 2007:

Common stock, 1/3 of $.01 par value	18,368,807
(Class)	(Number of Shares)

PURE CYCLE CORPORATION

INDEX TO NOVEMBER 30, 2006 FORM 10-Q

PART I - FINANCIAL INFORMATION

PURE CYCLE CORPORATION

BALANCE SHEETS

	November 30, 2006 (unaudited)	August 31, 2006 (restated)
ASSETS:		
Current assets:		
Cash and cash equivalents	$ 99,438	$ 374,069
Marketable securities	2,337,747	2,529,406
Trade accounts receivable	45,787	65,420
Interest receivable	32,081	36,880
Prepaid expenses and other current assets	94,611	50,825
Current portion of construction proceeds receivable	64,783	64,783
Total current assets	2,674,447	3,121,383
Investments in water and water systems, net	124,862,968	124,923,693
Construction proceeds receivable, less current portion	784,338	800,172
Note receivable Rangeview Metropolitan District, including accrued interest	458,090	452,230
Property and equipment, net	3,584	4,287
Total assets	$ 128,783,427	$ 129,301,765
LIABILITIES:		
Current liabilities:		
Accounts payable	$ 19,794	$ 34,650
Accrued liabilities	169,957	289,596
Deferred revenues	55,800	55,800
Current portion of long-term debt related parties	26,542	
Total current liabilities	272,093	380,046
Long-term debt related parties		26,542
Deferred revenues, less current portion	1,599,564	1,613,515
Participating Interests in Export Water Supply	6,513,738	6,514,116
Tap Participation Fee payable to HP A&M	66,102,825	66,102,825
Total liabilities *	74,488,220	74,637,044
Commitments and Contingencies		
STOCKHOLDERS EQUITY:		
Preferred stock:		
Par value $.001 per share, 25 million shares authorized; Series B 432,513 shares issued and outstanding (liquidation preference of $432,513)	433	433
Common stock:		
Par value 1/3 of $.01 per share, 40 million shares authorized; 18,368,807 and 18,348,834 shares outstanding	61,684	61,602
Additional paid-in capital	80,732,444	80,609,875
Treasury stock, at cost, 134,979 and 130,279 shares of common stock	(1,053,949)	(1,009,534)
Accumulated comprehensive loss	(3,417)	(10,654)
Accumulated deficit	(25,441,988)	(24,987,001)
Total stockholders equity *	54,295,207	54,664,721
Total liabilities and stockholders equity	$ 128,783,427	$ 129,301,765

* These August 31, 2006 balances have been restated - See Note 1.

See Accompanying Notes to Financial Statements

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PURE CYCLE CORPORATION

STATEMENTS OF OPERATIONS

(unaudited)

	Three Months Ended November 30, 2006	2005
Revenues:		
Metered water usage	$ 35,005	$ 38,643
Wastewater treatment fees	14,752	14,752
Special facility funding	10,377	
Water tap fees	3,574	
Sky Ranch options		12,150
Total revenues	63,708	65,545
Expenses:		
Cost of revenues:		
Water delivery costs	(13,689)	(14,019)
Wastewater treatment costs	(5,909)	(4,586)
Depletion and depreciation	(21,829)	(185)
Total cost of revenues	(41,427)	(18,790)
Gross margin	22,281	46,755
General and administrative expenses	(443,536)	(288,418)
Depreciation	(79,399)	(2,764)
Operating loss	(500,654)	(244,427)
Other income (expense):		
Interest income	44,603	48,840
Gain on sale of marketable securities	1,064	
Interest expense - related parties		(5,340)
Interest expense		(4,185)
Net loss	$ (454,987)	$ (205,112)
Net loss per common share basic and diluted	$ (.02)	$ (.01)
Weighted average common shares outstanding basic and diluted	18,353,443	14,371,263

See Accompanying Notes to Financial Statements

PURE CYCLE CORPORATION

STATEMENTS OF CASH FLOWS

(unaudited)

	Three Months Ended November 30, 2006	2005
Cash flows from operating activities:		
Net loss	$ (454,987)	$ (205,112)
Adjustments to reconcile net loss to net cash used by operating activities:		
Stock compensation expense	78,236	51,019
Depreciation, depletion and other non-cash items	101,933	2,949
Interest expensed on long-term debt related parties		5,340
Interest expensed on long-term debt		4,185
Interest added to construction proceeds receivable	(12,831)	
Interest added to note receivable Rangeview Metropolitan District	(5,860)	(4,955)
Gain on sale of marketable securities	(1,064)	
Changes in operating assets and liabilities:		
Export water proceeds to be remitted to escrow agent		174,890
Trade accounts receivable	19,633	(58)
Construction proceeds receivable	28,665	
Interest receivable and prepaid expenses	(38,987)	(30,149)
Accounts payable and accrued liabilities	(134,495)	(159,043)
Deferred revenues	(13,951)	(12,150)
Net cash used by operating activities	(433,708)	(173,084)
Cash flows from investing activities:		
Investments in water and water systems	(4,000)	(220,167)
Capitalized acquisition costs	(35,800)	
Sales and maturities of marketable securities	199,960	1,487,490
Purchase of marketable securities		(2,391,576)
Purchase of property and equipment		(2,456)
Net cash provided (used) by investing activities	160,160	(1,126,709)
Cash flows from financing activities:		
Payments to Participating Interests in Export Water Supply holders	(1,083)	
Proceeds from the sale of common stock		270,000
Net cash (used) provided by financing activities	(1,083)	270,000
Net change in cash and cash equivalents	(274,631)	(1,029,793)
Cash and cash equivalents beginning of period	374,069	1,973,882
Cash and cash equivalents end of period	$ 99,438	$ 944,089

See Accompanying Notes to Financial Statements

PURE CYCLE CORPORATION

NOTES TO FINANCIAL STATEMENTS

(unaudited)

NOTE 1 - ACCOUNTING PRINCIPLES

The balance sheet as of November 30, 2006, the statements of operations for the three months ended November 30, 2006 and 2005, respectively, and the statements of cash flows for the three months ended November 30, 2006 and 2005 have been prepared by Pure Cycle Corporation (the Company) and have not been audited. In the opinion of management, all adjustments, consisting only of normal recurring adjustments necessary to present fairly the financial position, results of operations and cash flows at November 30, 2006 and for all periods presented have been appropriately made.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) have been condensed or omitted. It is suggested that these financial statements be read in conjunction with the financial statements and notes thereto included in the Company s 2006 Annual Report on Form 10-K. The results of operations for interim periods presented are not necessarily indicative of the operating results for the full year.

The August 31, 2006 balance sheet was derived from the Company s audited financial statements. The items marked with an * on the Company s August 31, 2006 balance sheet have been restated to correct an error in the Company s financial statements, which was brought to the Company s attention by the Securities and Exchange Commission (the Commission) in discussions on January 11, 2007. On its August 31, 2006 balance sheet, the Company recorded a liability and contra-equity receivable related to promissory notes maintained by High Plains A&M, LLC (HP A&M) as described in Note 3 below. Upon review, it was determined that since the probability of HP A&M defaulting on the notes and the Company losing any of the water rights or property subject to the notes being remote, this did not constitute an indirect guarantee pursuant to FASB Interpretation No. 45 *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others (as amended).* Therefore, the Company has removed the liability and contra-equity receivable reflected in its August 31, 2006 financial statements. The Company then evaluated this guarantee under FASB Interpretation No. 46(R) *Consolidation of Variable Interest Entities (as amended)* (FIN 46R) as further described in Note 3.Based on this error, the Company s balance sheet as of August 31, 2006, and the notes related thereto in the Company s 2006 Annual Report on Form 10-K should not be relied upon. Additionally, the Company and the Commission continue to review other purchase accounting issues related to the Company s acquisition of Arkansas River water rights and properties from HP A&M. The Company will amend its 2006 Annual Report on Form 10-K as soon as practicable. Such amendments will only relate to the accounting for the HP A&M asset acquisition and will not impact the Company s statements of operations or cash flows. This restatement has no impact on the Company s previously reported cash flows, net loss or net loss per share.

Share-based Compensation. Effective September 1, 2005, the Company adopted Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment*, (SFAS 123(R)) which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors, including employee stock options, based on estimated fair values. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 107 (SAB 107) relating to SFAS 123(R). The Company has applied the provisions of SAB 107 in its adoption of SFAS 123(R).

Stock-based compensation expense recognized under SFAS 123(R) for the three months ended November 30, 2006 and 2005, was approximately $78,000 and $51,000, respectively.

SFAS 123(R) requires companies to estimate the fair value of share-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as a period expense over the requisite service period in the statement of operations. Stock-based compensation expense recognized during the period is based on the value of the portion of share-based payment awards that is ultimately expected to vest during the period.

Stock-based compensation expense recognized in the Company s statements of operations for the three months ended November 30, 2006 and 2005, includes the following:

- Compensation expense for share-based payment awards granted prior to, but not yet vested as of, September 1, 2005. The compensation expense recognized was based on the grant date fair value estimated in accordance with the pro-forma provisions of Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation* (SFAS 123).

- Compensation expense for share-based payment awards granted subsequent to September 1, 2005. The compensation expense recognized was based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R).

In accordance with SFAS 123(R) stock-based compensation expense recognized in the statements of operations for the three months ended November 30, 2006 and 2005 is based on awards ultimately expected to vest. The Company does not expect any forfeitures of its prior option grants and therefore the compensation expense has not been reduced for estimated forfeitures. No options were forfeited by option holders during the three months ended November 30, 2006 or 2005. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised if necessary, in subsequent periods if actual forfeitures differ from those estimates. In the Company s pro forma information required under SFAS 123 for the periods prior to fiscal 2006, the Company accounted for forfeitures as they occurred. The Company attributes the value of stock-based compensation to expense using the straight-line single option method for all options granted.

The Company uses the Black-Scholes option-pricing model (Black-Scholes model) for the pro forma information required under SFAS 123 as well as the compensation expense recorded pursuant to SFAS 123(R). The Company s determination of the estimated fair value of share-based payment awards on the date of grant using an option-pricing model is affected by the following variables and assumptions:

- The grant date exercise price which is the closing market price of the Company s common stock on the date of grant;
- Estimated option lives based on historical experience with existing option holders;
- Estimated dividend rates based on historical and anticipated dividends over the life of the option;
- Life of the option pursuant to the 2004 Incentive Plan, all option grants have a 10 year life;
- Risk-free interest rates with maturities that approximate the expected life of the options granted;
- Calculated stock price volatility calculated over the expected life of the options granted, which is calculated based on the weekly closing price of the Company s common stock over a period equal to the expected life of the option; and
- Option exercise behaviors based on actual and projected employee stock option exercises and forfeitures.

No options were granted in the three months ended November 30, 2006.

On November 10, 2005, the Financial Accounting Standards Board (FASB) issued FASB Staff Position No. FAS 123(R)-3 *Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards*. The Company has adopted the alternative transition method provided in the FASB Staff Position for calculating the tax effects of stock-based compensation pursuant to SFAS 123(R). The alternative transition method includes simplified methods to establish the beginning balance of the additional paid-in capital pool (APIC pool) related to the tax effects of employee stock-based compensation, and to determine the subsequent impact on the APIC pool and statements of cash flows of the tax effects of employee stock-based compensation awards that are outstanding upon adoption of SFAS 123(R). Because the Company continues to incur net operating losses and therefore has a full valuation allowance on its deferred tax assets, the granting and exercise of stock options currently has no impact on the income tax provision.

Business segments. The operating segments reported below are the segments of the Company for which separate discrete financial information is available and for which results are evaluated by the Company s President in deciding how to allocate resources and in assessing performance. The Company evaluates the performance of its segments based on gross margins of the respective business units before corporate and unallocated shared expenses if any. The accounting policies of the segments are the same as those of the Company as described in Note 2 in the Company s 2006 Annual Report on Form 10-K.

The Company principally has two lines of business: (i) the design and construction of water and wastewater systems, and (ii) the provision of water and wastewater services, which includes the operations and maintenance of systems the Company constructed, to customers within the Company s service area.

Beginning in August 2005 and concluding in fiscal 2006, the Company expanded its water system to enable it to provide water services to the Arapahoe County Fairgrounds. The construction project included the design and construction of a 500,000 gallon water tank, a new deep water well and pipelines. The Company designed the system and hired third party contractors to build the required infrastructure, which was supervised by the Company s engineer. The construction costs totaled $2.6 million, which are capitalized with the Company s investments in water and water systems. As of August 31, 2006, these assets were fully operational and transferred to the service provider segment balance sheet and therefore there are no construction segment assets on the Company s accompanying balance sheet.

The results of operations for the three months ended November 30, 2006 relate entirely to the service provider segment with the exception of (i) the $3,574 of deferred water tap fees recognized as revenues, and (ii) the $10,377 of deferred *Special facility funding* recognized as revenues. There were no operations related to the construction segment for the three months ended November 30, 2005.

Reclassifications. Certain amounts in the prior year financial statements have been reclassified to conform with the current year presentation.

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NOTE 2 MARKETABLE SECURITIES

Marketable Securities. Management determines the appropriate classification of its investments in debt and equity securities at the time of purchase and reevaluates such determinations each reporting period. Debt securities are classified as held-to-maturity when the Company has the positive intent and ability to hold the securities to maturity. The Company had no investments classified as held-to-maturity at November 30, 2006 or August 31, 2006.

Debt securities for which the Company does not have the positive intent or ability to hold to maturity are classified as available-for-sale, along with any investments in equity securities. Securities classified as available-for-sale are marked-to-market at each reporting period. Changes in value on such securities are recorded as a component of *Accumulated comprehensive income.*The cost of securities sold is based on the specific identification method.

The following is a summary of marketable securities at November 30, 2006:

	Cost Basis	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Commercial paper	$ 100,234	$	$	$ 100,234
U.S. government debt securities:				
With unrealized gains:	494,668	1,407		496,075
With unrealized losses held more than 12 months	798,203		(2,999)	795,204
U.S. corporate debt securities:				
With unrealized gains	345,789	1,165		346,954
With unrealized losses held:				
Less than 12 months	401,292		(1,496)	399,796
More than 12 months	301,212		(1,494)	299,718
Total investments	2,441,398	2,572	(5,989)	2,437,981
Less cash equivalents	100,234			100,234
Total marketable securities	$ 2,341,164	$ 2,572	$ (5,989)	$ 2,337,747

The investments that are in a net loss position for greater than twelve months are not deemed to be other than temporary losses based on the nature of the corporate bond markets, the significant fluctuations that have occurred in the markets over the past several years and the limited realized losses the Company has experienced. The Company actively monitors the performance of its investments and adopted a new investment policy in fiscal 2005 to more closely align its investment portfolio with its expected capital requirements.

The Company s marketable securities mature at various dates through December 2007. However, these securities represent the temporary investment of capital and it is not management s intent to hold these securities until maturity.

NOTE 3 INVESTMENTS IN WATER AND WATER SYSTEMS

The Company s investments in water and water systems consist of the following at November 30, 2006 and August 31, 2006:

	November 30, 2006		August 31, 2006	
	Costs	Accumulated Depreciation and Depletion	Costs	Accumulated Depreciation and Depletion
Arkansas River Valley water supply and related assets	$ 102,629,577	$ (76,252)	$ 102,593,777	$
Rangeview water supply	13,928,448	(3,920)	13,924,448	(3,768)
Rangeview water system	167,720	(31,154)	167,720	(28,862)
Paradise water supply	5,520,836		5,520,836	
Arapahoe County Fairgrounds water and water system	2,653,995	(28,901)	2,653,995	(7,225)
Sky Ranch water supply	100,000		100,000	
Water supply other	3,022	(403)	3,022	(250)
Totals	$ 125,003,598	$ (140,630)	$ 124,963,798	$ (40,105)
Net investments in water and water systems	$ 124,862,968		$ 124,923,693	

Acquisition of the Arkansas River Valley Assets. As more fully described in Note 3 to the Company s 2006 Annual Report on Form 10-K, effective May 10, 2006, the Company entered into the Asset Purchase Agreement (the Arkansas River Agreement) with HP A&M to acquire the following assets from HP A&M:

(i) Senior water interests in the Arkansas River and its tributaries represented by shares of the Fort Lyon Canal Company (FLCC) (collectively these are referred to as the Water Rights),

(ii) Certain real property located in Bent, Otero and Prowers counties, Colorado associated with the Water Rights (the Properties) (certain of the Properties are subject to promissory notes maintained by HP A&M as further described below), and

(iii) Certain contract rights, water delivery fixtures, mineral rights, and other water interests related to the Water Rights and Properties (collectively the Water Rights, Properties, and related assets are referred to as the Acquired Assets).

The Company acquired the Water Rights to enhance and better balance its water portfolio by increasing its rights to senior surface water. The Properties and other non-water assets were acquired because the rights to the Arkansas River water the Company seeks to transfer for use in the Denver market are based on the quantity of water historically used to irrigate crops grown on the Properties.

The Company and HP A&M consummated the asset acquisition on August 31, 2006 after the due diligence period provided for in the Arkansas River Agreement. As consideration for the Acquired Assets, on August 31, 2006, the Company issued HP A&M 3,000,000 shares of Pure Cycle common stock and granted HP A&M the right to receive ten percent (10%) of the Company s gross proceeds, or the equivalent thereof, from the future sale of the next 40,000 water taps (the Tap Participation Fee) (the 40,000 figure was reduced to 39,470 at the August 31, 2006 closing date because HP A&M sold certain assets and properties not related to the FLCC shares which were subject to the Arkansas River Agreement and were available for credits against the Tap Participation Fee). The Tap Participation Fee will be due and payable once the Company has sold a water tap and received the consideration due for such water tap. The Company did not sell any water taps during the three months ended November 30, 2006 and therefore made no Tap Participation Fee payments. After five years, under circumstances defined in the Arkansas River Agreement, the Tap Participation Fee can increase to 20% and the number of water taps subject to the Tap Participation Fee would be correspondingly reduced by half. The entire Tap Participation Fee is subject to acceleration in the event of a merger, reorganization, sale of substantially all assets, or similar transactions and in the event of bankruptcy and insolvency events.

Stock-based compensation expense recognized under SFAS 123(R) for the three months ended November 30, 200

Certain of the properties the Company acquired are subject to outstanding promissory notes with principal and accrued interest totaling approximately $14.5 million at November 30, 2006. These notes are secured by deeds of trust on the Properties. The Company did not assume any of these promissory notes and is not responsible for making any of the required payments under these notes. This responsibility remains solely with HP A&M. In the event of default by HP A&M, at the Company s sole discretion, the Company may make payments pursuant to any or all of the notes and cure any or all of the defaults. If the Company does not cure the defaults, it will lose the properties securing the defaulted notes. If HP A&M defaults on the promissory notes, the Company can foreclose on a defined amount of stock issued to HP A&M and reduce the Tap Participation Fee by two times the amount of notes defaulted on by HP A&M. Because HP A&M would lose such a substantial amount of equity and Tap Participation Fees, and based on the financial stability of HP A&M and its owners and affiliated companies, the probability of HP A&M defaulting on the notes is deemed remote.

Because the outstanding notes are collateralized by the Company s real property and water rights, HP A&M is deemed to be a Variable Interest Entity (VIE) as defined by FIN 46R. However, because the Company will not absorb any of HP A&M s expected losses or receive a majority of HP A&M s expected gains, the Company is not deemed the Primary Beneficiary of HP A&M and therefore is not required to consolidate HP A&M. HP A&M became a VIE to the Company on August 31, 2006 when the Company acquired Arkansas River water rights and related properties subject to the outstanding promissory notes. HP A&M is a holding company that acquires water rights and related properties for investment and sale purposes. If HP A&M were to default on the notes, the Company would lose approximately 60 of the 80 real property interests it acquired and the water rights associated with those properties which collateralize the notes, unless the Company cured the notes in default.

Upon the closing, the Company and HP A&M also entered into various agreements which are explained in more detail in the Company s 2006 Annual Report on Form 10-K. One of the agreements is a five year property management agreement with HP A&M, pursuant to which HP A&M holds the right to pursue leasing of the Properties and the Water Rights to interested parties. All lease income associated with leasing the Properties and Water Rights, together with all costs associated with these activities including but not limited to, overhead obligations, real property taxes, and personnel costs, are the sole opportunity and obligation of HP A&M. The Company assumed title to the current farm leases which are subject to the property management agreement effective August 31, 2006. However, pursuant to the Arkansas River Agreement, HP A&M will manage the leases for a period of five years and will receive all lease payments from the lessees as a management fee. Because the Company does not have the risk of loss associated with the leases (HP A&M s management fee is equal to the lease income for the next five years, and contractually HP A&M has the risk of loss on the leases), in accordance with EITF Issue No. 99-19 *Reporting Revenue Gross as Principal versus Net as an Agent (EITF 99-19)*, the lease income and management fees will be reflected on a net revenue basis throughout the term of the management agreement. The leases subject to the property management agreement are all operating leases and expire at various dates through 2010, which is earlier than the expiration date of the management agreement.

The Arkansas River Agreement has been accounted for in accordance with Statement of Financial Accounting Standards No. 141 *Business Combinations* (SFAS 141). The cost of the acquisition was allocated to the Acquired Assets based on estimates of each asset s, or group of assets , respective fair value. SFAS 141 requires assets to be recorded at their fair values as determined by the value of the consideration paid or the value of the assets acquired, whichever is more reliable. Because the consideration paid includes a contingent portion that can not be reasonably estimated due to the nature of the payments, the Company determined that the value of the Acquired Assets was a more reasonable measure than the consideration paid. Therefore, the fair value of the Water Rights was determined by an independent third party appraisal and the remaining assets were valued by internal studies. The difference between the fair values of the Acquired Assets and the value of the equity consideration is recorded as the *Tap Participation Fee Payable to High Plains A&M, LLC* on the accompanying balance sheet. This amount is non-interest bearing and payments are only due if and when the Company sells water taps. The Tap Participation Fee ultimately paid to HP A&M could vary from the amount of the recorded liability. Per SFAS 141, any differences that arise between the actual payments made under the contingent consideration portion of the Arkansas River Agreement and the recorded liability will be accounted for separately at the time this occurs. Pursuant to Emerging Issues Task Force Issue No. 99-12 *Determination of the Measurement Date for the Market Price of Acquirer Securities Issued in a Purchase Business Combination,* the equity consideration was valued based on the average closing price of the Company s common stock two days before and after May 10, 2006, which is the effective date of the Arkansas River Agreement and the date the Arkansas River Agreement was announced.

Due to the timing of the closing of the Arkansas River Agreement and the complexities associated with the valuation of the Acquired Assets, the Company has not finalized its internal studies of the fair value of the Acquired Assets. Therefore, the allocation of the purchase price is based on preliminary data and could change when final evaluations of the Acquired Assets are completed.

In order to utilize the Arkansas River water in the Company s service areas, the Company will be required to convert this water to municipal and industrial uses. Change of water use must be done through the Colorado water courts and several conditions must be present prior to the water court s granting an application for transfer of a water right. A transfer case would be expected to require the Company to meet the following conditions and restrictions: (i) satisfaction of an anti-speculation requirement pursuant to which the applicant must have contractual obligations to provide water service to customers prior to the water court s ruling on the transfer of a water right, (ii) a limitation that the applicant may only transfer the consumptive use portion of its water rights (the Company expects to face opposition to any consumptive use calculation of the historic agricultural uses of its water), (iii) a likely requirement that the applicant mitigate the loss of tax base in the basin of origin, (iv) likely re-vegetation requirements to restore irrigated soils to non-irrigated, and (v) a requirement to meet water quality measures which would be included in the cost of transferring the water rights. The Company will likely need to construct a pipeline, which would be approximately 150 miles long and cost in excess of $400 million, in order to transport the Arkansas River water to its potential customers along the Front Range. The cost for this pipeline is expected to be funded through tap sales utilizing the Company s existing Denver based assets, but there can be no assurances that the Company will be able to generate the funds necessary to complete this pipeline without additional debt or equity offerings.

The Acquired Assets are being depleted and depreciated consistent with the Company s depletion and depreciation policies.

NOTE 4 PARTICIPATING INTERESTS IN EXPORT WATER

The Company commenced the purchase of its Rangeview Water Supply through a Water Commercialization Agreement (WCA), an agreement with a related investor (the LCH Agreement) and the sale of 432,513 shares of Series B Preferred Stock. The WCA was entered into in 1990 and amended in 1991 and 1992 and again in 1996 by the signing of the Comprehensive Amendment Agreement No. 1 (the CAA). The parties to the WCA and CAA agreements provided the Company approximately $11.1 million of financing to acquire the Rangeview Water Supply. This amount (which has been reduced by the transactions described below) is presented on the accompanying balance sheet as *Participating Interests in Export Water supply*, a liability. In addition to repaying the initial $11.1 million of funding, the CAA provided that the Company would pay the parties to the CAA an additional approximate $20.9 million of proceeds from Export Water sales (of which, $218,500 was to be retained by the Company). Under the CAA, these funds are to be repaid strictly with proceeds from the sale of Export Water. Therefore, before the acquisitions noted in the table below, which are further described in the Company s 2006 Annual Report on Form 10-K for the year ended August 31, 2006, the first $32.0 million received from the sale of Export Water was required to be paid to external CAA holders.

As the proceeds from the sale of Export Water are received, and the amounts are remitted to the external CAA holders, the Company allocates a ratable percentage of this payment to the principal portion (the *Participating Interests in Export Water supply* liability account) with the balance of the payment being charged to the contingent obligation portion. The amount allocated to the liability is 35% which is the percentage the $11.1 million represented of the total $32.0 million obligation. The remaining portion, or 65%, is allocated to the contingent obligation. The portion allocated to principal will be recorded as a reduction in the *Participating Interests in Export Water* liability account while the amounts applied to the contingency are recorded on a net revenue basis when funds are received.

The table below details the transactions impacting the CAA obligations since its signing, which are explained in greater detail in the Company s 2006 Annual Report on Form 10-K:

	Export Water Proceeds Received	Export Water Proceeds to Pure Cycle	Total Potential Obligation	Paticipating Interests Liability	Contingency
Original balances	$	$ 218,500	$ 31,807,732	$ 11,090,630	$ 20,717,102
Sky Ranch option payment	50,000		(50,000)	(17,435)	(32,565)
Acquisitions		8,199,333	(8,199,333)	(2,858,920)	(5,340,413)
Balance at August 31, 2004	50,000	8,417,833	23,558,399	8,214,275	15,344,124
Sky Ranch option payment	50,000	(35,000)	(15,000)	(5,231)	(9,769)
Hills at Sky Ranch option payment	10,400	(7,280)	(3,120)	(1,088)	(2,032)
Arapahoe County tap fees *	532,968	(373,078)	(159,890)	(55,754)	(104,136)
Balance at August 31, 2005	643,368	8,002,475	23,380,389	8,152,202	15,228,187
Acquisition		4,698,001	(4,698,001)	(1,638,086)	(3,059,915)
Balance at August 31, 2006	643,368	12,700,476	18,682,388		