

PURE CYCLE CORP
Form 10-Q
July 10, 2009

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-Q**

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended: May 31, 2009

or

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 registrant as specified in its charter)

Colorado

84-0705083

(State or other jurisdiction of incorporation or organization)

(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, including area code)

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 No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer Non-accelerated filer Smaller Reporting Company
(Do not check if a smaller reporting company)

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

Yes No

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Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of July 8, 2009:

Common stock, 1/3 of \$.01 par value

20,206,566

(Class)

(Number of Shares)

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PURE CYCLE CORPORATION
BALANCE SHEETS

| | (unaudited) May 31, 2009 | August 31, 2008 |
|--|-----------------------------|--------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 946,881 | \$ 5,238,973 |
| Marketable securities | 3,000,636 | |
| Trade accounts receivable | 46,253 | 71,401 |
| Prepaid expenses | 211,695 | 127,018 |
| Current portion of construction proceeds receivable | 64,783 | 64,783 |
| Total current assets | 4,270,248 | 5,502,175 |
| Investments in water and water systems, net | 103,176,549 | 103,346,623 |
| Construction proceeds receivable, less current portion | 427,960 | 467,102 |
| Notes receivable related parties, including accrued interest: | | |
| Rangeview Metropolitan District | 504,761 | 494,799 |
| Well Enhancement and Recovery Systems, LLC | 2,934 | |
| Assets held for sale | 77,940 | 77,940 |
| Property and equipment, net | 15,990 | 8,005 |
| Investment in Well Enhancement and Recovery Systems, LLC | | 2,759 |
| Total assets | \$ 108,476,382 | \$ 109,899,403 |
| LIABILITIES | | |
| Current liabilities: | | |
| Accounts payable | \$ 23,243 | \$ 37,585 |
| Accrued liabilities | 118,691 | 70,478 |
| Deferred revenues | 55,800 | 55,800 |
| Total current liabilities | 197,734 | 163,863 |
| Deferred revenues, less current portion | 1,460,058 | 1,501,910 |
| Participating Interests in Export Water Supply | 1,216,905 | 1,217,876 |
| Tap Participation Fee payable to HP A&M, net of \$56.5 million and \$54.6 million discount | 56,650,329 | 53,848,000 |
| Total liabilities | 59,525,026 | 56,731,649 |
| Commitments and Contingencies | | |
| SHAREHOLDERS EQUITY: | | |
| Preferred stock: | 433 | 433 |
| Par value \$.001 per share, 25 million shares authorized; Series B shares issued and outstanding (liquidation preference of \$432,513) | 432,513 | |

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| | | |
|--|----------------|----------------|
| Common stock: | 67,360 | 67,360 |
| Par value 1/3 of \$.01 per share, 40 million shares authorized; 20,206,566 shares issued and outstanding | | |
| Additional paid-in capital | 92,146,903 | 91,928,398 |
| Accumulated comprehensive income | 3,636 | |
| Accumulated deficit | (43,266,976) | (38,828,437) |
| Total shareholders' equity | 48,951,356 | 53,167,754 |
| Total liabilities and shareholders' equity | \$ 108,476,382 | \$ 109,899,403 |

See Accompanying Notes to Financial Statements

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PURE CYCLE CORPORATION
STATEMENTS OF OPERATIONS
(unaudited)

| | Three months ended: | |
|---|---------------------|----------------|
| | May 31, 2009 | May 31, 2008 |
| Revenues: | | |
| Metered water usage | \$ 31,820 | \$ 36,869 |
| Wastewater treatment fees | 16,744 | 16,744 |
| Recognition of deferred revenues: | | |
| Special facility funding | 10,377 | 10,377 |
| Water tap fees | 3,574 | 3,574 |
| Total revenues | 62,515 | 67,564 |
| Cost of revenues: | | |
| Water service operations | (10,232) | (9,233) |
| Wastewater service operations | (4,495) | (4,921) |
| Depletion and depreciation | (22,131) | (22,121) |
| Total cost of revenues | (36,858) | (36,275) |
| Gross margin | 25,657 | 31,289 |
| Expenses: | | |
| General and administrative expenses | (455,532) | (588,024) |
| Depreciation | (73,243) | (73,251) |
| Operating loss | (503,118) | (629,986) |
| Other income (expense): | | |
| Gain on sale of land | 22,172 | |
| Interest income | 12,863 | 52,748 |
| Other | 1,500 | |
| Share of losses of Well Enhancement and Recovery Systems, LLC | (620) | (37,128) |
| Interest imputed on the Tap Participation Fee payable to HP A&M | (858,000) | (1,114,000) |
| Net loss | \$ (1,325,203) | \$ (1,728,366) |
| Net loss per common share basic and diluted | \$ (0.07) | \$ (0.09) |
| Weighted average common shares outstanding basic and diluted | 20,206,566 | 20,206,566 |

See Accompanying Notes to Financial Statements

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PURE CYCLE CORPORATION
STATEMENTS OF OPERATIONS
(unaudited)

| | Nine Months Ended: | |
|---|--------------------|----------------|
| | May 31, 2009 | May 31, 2008 |
| Revenues: | | |
| Metered water usage | \$ 88,354 | \$ 101,986 |
| Wastewater treatment fees | 50,232 | 50,232 |
| Recognition of deferred revenues: | | |
| Special facility funding | 31,131 | 31,131 |
| Water tap fees | 10,722 | 10,722 |
| Total revenues | 180,439 | 194,071 |
| Cost of revenues: | | |
| Water service operations | (37,973) | (38,673) |
| Wastewater service operations | (16,113) | (13,532) |
| Depletion and depreciation | (66,338) | (66,240) |
| Total cost of revenues | (120,424) | (118,445) |
| Gross margin | 60,015 | 75,626 |
| Expenses: | | |
| General and administrative expenses | (1,547,922) | (1,810,442) |
| Depreciation | (218,808) | (219,985) |
| Operating loss | (1,706,715) | (1,954,801) |
| Other income (expense): | | |
| Interest income | 70,481 | 250,402 |
| Gain on sale of land | 59,671 | |
| Land use payment | 5,000 | |
| Other | 2,099 | |
| Share of losses of Well Enhancement and Recovery Systems, LLC | (7,075) | (37,945) |
| Interest imputed on the Tap Participation Fee payable to HP A&M | (2,862,000) | (3,255,000) |
| Loss on extinguishment of contingent obligations and debt | | (273,723) |
| Loss on sales of marketable securities | | (1,973) |
| Net loss | \$ (4,438,539) | \$ (5,273,040) |
| Net loss per common share basic and diluted | \$ (0.22) | \$ (0.26) |

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| | | | |
|--|-------------------|------------|------------|
| Weighted average common shares outstanding | basic and diluted | 20,206,566 | 20,182,668 |
|--|-------------------|------------|------------|

See Accompanying Notes to Financial Statements

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PURE CYCLE CORPORATION
STATEMENTS OF CASH FLOWS
(unaudited)

| | Nine months ended: | |
|--|--------------------|----------------|
| | May 31, 2009 | May 31, 2008 |
| Cash flows from operating activities: | | |
| Net loss | \$ (4,438,539) | \$ (5,273,040) |
| Adjustments to reconcile net loss to net cash used for operating activities: | | |
| Imputed interest on Tap Participation Fee payable to HP A&M | 2,862,000 | 3,255,000 |
| Depreciation, depletion and other non-cash items | 286,119 | 287,584 |
| Stock-based compensation expense included with general and administrative expenses | 218,505 | 263,761 |
| Share of losses of Well Enhancement and Recovery Systems, LLC | 7,075 | 37,945 |
| Interest added to notes receivable related parties: | | |
| Rangeview Metropolitan District | (9,962) | (15,019) |
| Well Enhancement and Recovery Systems, LLC | (250) | |
| Interest added to construction proceeds receivable | (22,505) | (23,024) |
| Gain on sale of land | (59,671) | |
| Loss on extinguishment of contingent obligations and debt | | 273,723 |
| Loss on sales of marketable securities | | 1,973 |
| Changes in operating assets and liabilities: | | |
| Trade accounts receivable | 25,148 | 18,984 |
| Interest receivable and prepaid expenses | (84,677) | 199,260 |
| Accounts payable and accrued liabilities | 11,699 | 57,878 |
| Deferred revenues | (41,852) | (41,850) |
| Net cash used by operating activities | (1,246,910) | (956,825) |
| Cash flows from investing activities: | | |
| Proceeds from sale of land | 59,671 | |
| Issuance of note to Well Enhancement and Recovery Systems LLC | (7,000) | |
| Purchase of property and equipment | (12,703) | (7,547) |
| Investments in water and water systems | (110,354) | (234,837) |
| Purchase of marketable securities | (2,997,000) | |
| Investment in Well Enhancement and Recovery Systems LLC | | (47,000) |
| Sales and maturities of marketable securities | | 790,661 |
| Net cash (used) provided by investing activities | (3,067,386) | 501,277 |
| Cash flows from financing activities: | | |
| Arapahoe County construction proceeds | 61,647 | 95,898 |
| Payments to contingent liability holders | (1,944) | (2,393) |
| Tap Participation Fee payments to High Plains A&M | (37,499) | |
| Payments on long-term debt related parties | | (26,542) |

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| | | |
|---|-------------|--------------|
| Net cash provided by financing activities | 22,204 | 66,963 |
| Net change in cash and cash equivalents | (4,292,092) | (388,585) |
| Cash and cash equivalents beginning of year | 5,238,973 | 6,095,075 |
| Cash and cash equivalents end of year | \$ 946,881 | \$ 5,706,490 |

See Accompanying Notes to Financial Statements

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PURE CYCLE CORPORATION
NOTES TO FINANCIAL STATEMENTS
MAY 31, 2009

NOTE 1 PRESENTATION OF INTERIM INFORMATION

The May 31, 2009 balance sheet, the statements of operations for the three and nine months ended May 31, 2009 and 2008, and the statements of cash flows for the nine months ended May 31, 2009 and 2008, respectively, 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 May 31, 2009, and for all periods presented have been made appropriately.

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 2008 Annual Report on Form 10-K filed with the Securities and Exchange Commission on November 14, 2008. The results of operations for interim periods presented are not necessarily indicative of the operating results for the full year.

The August 31, 2008 balance sheet was taken directly from the Company's audited financial statements.

Cash and Cash Equivalents

Cash and cash equivalents include all highly liquid debt instruments with original maturities of three months or less. At May 31, 2009, the Company's cash equivalents are comprised entirely of money market funds maintained at high quality financial institutions. The Company has no investments in equity instruments. The Company maintains its cash with various financial institutions, which may exceed federally insured limits throughout the period.

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 May 31, 2009 or August 31, 2008.

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.

At May 31, 2009, the Company's marketable securities are comprised entirely of certificates of deposit maintained at various financial institutions, each of which have invested balances below federally insured limits and pay interest at stated rates through maturity. None of the Company's certificates of deposit had unrealized losses at May 31, 2009. The certificates mature at various dates through February 2011; however, these securities represent temporary investments and it is management's intent to hold these securities available for current operations and not hold them until maturity.

Tap Participation Fee payable to HP A&M

Pursuant to the Asset Purchase Agreement (the Arkansas River Agreement) dated August 31, 2006, the Company granted High Plains A&M, LLC (HP A&M) the right to receive ten percent (10%) of the Company's gross proceeds, or the equivalent thereof, from the sale of the next 40,000 water taps sold by the Company from and after the date of the Arkansas River Agreement (the Tap Participation Fee). As of May 31, 2009, there remain 38,937 taps subject to the Tap Participation Fee. The Tap Participation Fee is 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 or nine months ended May 31, 2009 or 2008. However, the Company did make Tap Participation Fee payments to HP A&M during the three and nine months ended May 31, 2009, as a result of non-irrigated land sales described in Note 3 below.

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PURE CYCLE CORPORATION
 NOTES TO FINANCIAL STATEMENTS
 MAY 31, 2009

The Tap Participation Fee was initially valued at approximately \$45.6 million at the acquisition date using a discounted cash flow analysis of the projected future payments to HP A&M. The \$56.7 million balance at May 31, 2009, includes approximately \$11.9 million of imputed interest, recorded using the effective interest method. The Company estimates the value of the Tap Participation Fee by projecting new home development in the Company's targeted service area over an estimated development period. This was done by utilizing third party historical and projected housing and population growth data for the Denver, Colorado metropolitan area applied to an estimated development pattern supported by historical development patterns of certain master planned communities in the Denver, Colorado metropolitan area. This development pattern was then applied to estimated future water tap fees calculated using historical water tap fees. Based on the weak new home construction market in the Denver metropolitan area, the Company updated its estimated discounted cash flow analysis as of February 28, 2009. There were no significant changes in the assumptions during the three months ended May 31, 2009. Therefore, no change in the Tap Participation Fee was determined necessary. The February 2009 update resulted in the following changes from the prior estimate:

- (i) An increase in the overall future estimated Tap Participation Fee of approximately \$4.7 million (from approximately \$108.5 million to approximately \$113.1 million);
- (ii) A decrease in the imputed effective interest rate from approximately 8.6% to approximately 6.3%;
- (iii) A decrease in the imputed interest expense for the three and nine months ended May 31, 2009, of approximately \$355,700 and \$702,000, respectively, which equates to approximately \$.02 and \$.04 per basic and diluted share, respectively; and
- (iv) A decrease in the imputed interest expense for the year ending August 31, 2009 of approximately \$1.1 million.

Actual new home development in the Company's service area and actual future tap fees inevitably will vary significantly from the Company's estimates which could have a material impact on the Company's financial statements as well as its results of operations. An important component in the Company's estimate of the value of the Tap Participation Fee, which is based on historical trends, is that the Company reasonably expects water tap fees to continue to increase in the coming years. Tap fees are a market based pricing metric which in part demonstrates the increasing costs to acquire and develop new water supplies. It is thus a market metric which in part demonstrates the increasing value of the Company's water assets. The Company continues to assess the value of the Tap Participation Fee liability and updates its valuation analysis whenever events or circumstances indicate the assumptions used to estimate the value of the liability have changed materially. The difference between the net present value and the estimated realizable value will be imputed as interest expense using the effective interest method over the estimated development period utilized in the valuation of the Tap Participation Fee.

The Company imputes interest expense on the unpaid Tap Participation Fee using the effective interest method over the estimated development period utilized in the valuation of the liability. The Company imputed interest of approximately \$858,000 and \$2.9 million during the three and nine months ended May 31, 2009, respectively, and the Company imputed interest of approximately \$1.1 million and \$3.3 million during the three and nine months ended May 31, 2008, respectively.

After five years, under circumstances defined in the Arkansas River Agreement, the Tap Participation Fee can increase to 20% of the Company's water tap fees and the number of water taps subject to the Tap Participation Fee would be correspondingly reduced by half. Payment of the Tap Participation Fee may be accelerated in the event of a merger, reorganization, sale of substantially all assets, or similar transactions and in the event of bankruptcy and insolvency events.

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PURE CYCLE CORPORATION
NOTES TO FINANCIAL STATEMENTS
MAY 31, 2009

Revenue Recognition

The Company's revenue recognition policies have not changed since August 31, 2008, and therefore are more fully described in Note 2 to the financial statements contained in the Company's 2008 Annual Report on Form 10-K. The Company recognized approximately \$3,600 of water tap fee revenues during each of the three month periods ended May 31, 2009 and 2008, related to the Water Service Agreement (the "County Agreement") with Arapahoe County (the "County") entered into in August 2005. The Company recognized approximately \$10,700 of water tap fee revenues during each of the nine month periods ended May 31, 2009 and 2008, related to the County Agreement. In accordance with GAAP, the Company began recognizing the water tap fees as revenue ratably over the estimated service period upon completion of the Wholesale Facilities (defined in the Company's 2008 Annual Report on Form 10-K) in its fiscal 2006. The water tap fees to be recognized over this period are net of the royalty payments to the State of Colorado Board of Land Commissioners (the "Land Board") and amounts paid to third parties pursuant to the Comprehensive Amendment Agreement No. 1 (the "CAA") as further described in Note 6 below.

The Company recognized approximately \$10,400 of Special Facilities (defined in the Company's 2008 Annual Report on Form 10-K) funding as revenue during each of the three month periods ended May 31, 2009 and 2008. The Company recognized approximately \$31,100 of Special Facilities funding as revenue during each of the nine month periods ended May 31, 2009 and 2008. This is the ratable portion of the Special Facilities funding proceeds received from the County pursuant to the County Agreement as more fully described in Note 3 to the Company's financial statements contained in the Company's 2008 Annual Report on Form 10-K.

As of May 31, 2009, the Company has deferred recognition of approximately \$1.5 million of water tap and construction fee revenue from the County, which will be recognized as revenue ratably over the estimated useful accounting life of the assets constructed with the construction proceeds as described above.

Royalty and other obligations

Revenues from the sale of Export Water are shown net of royalties payable to the Land Board. Revenues from the sale of water on the Lowry Range Property are shown net of the royalties to the Land Board and the fees retained by the Rangeview Metropolitan District (the "District").

Depletion and depreciation of water assets

The Company depletes its water assets that are being utilized on the basis of units produced divided by the total volume of water adjudicated in the water decrees. Water systems and other long-lived assets are depreciated on a straight-line basis over their estimated useful accounting lives of between three and thirty years.

Income taxes

On September 1, 2007, the Company adopted FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (an interpretation of FASB Statement No. 109) (FIN 48). FIN 48 prescribes a more-likely-than-not threshold for the recognition and de-recognition of tax positions, providing guidance on the accounting for interest and penalties relating to tax positions and requires that the cumulative effect of applying the provisions of FIN 48 be reported as an adjustment to the opening balance sheet of retained earnings or other appropriate components of equity or net assets in the statement of financial position. The Company did not have any significant unrecognized tax benefits and there was no material effect on its financial condition or results of operations as a result of implementing FIN 48.

The Company files income tax returns with the Internal Revenue Service and the State of Colorado. The tax years that remain subject to examination are fiscal 2005 through fiscal 2008. The Company does not believe there will be any material changes in its unrecognized tax positions over the next twelve months.

The Company's policy is to recognize interest and penalties accrued on any unrecognized tax benefits as a component of income tax expense. As of the date of adoption of FIN 48, the Company did not have any accrued interest or penalties associated with any unrecognized tax benefits, nor was any interest expense recognized during the three or nine months ended May 31, 2009.

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MAY 31, 2009

Recently Issued Accounting Pronouncements

The Company continually assesses any new accounting pronouncements to determine their applicability to the Company. Where it is determined that a new accounting pronouncement affects the Company's financial reporting, the Company undertakes a study to determine the consequence of the change to its financial statements and assures that there are proper controls in place to ascertain that the Company's financials properly reflect the change. New pronouncements assessed by the Company recently are discussed below:

In May 2008, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard (SFAS) No. 162, *The Hierarchy of Generally Accepted Accounting Principles* (SFAS 162). SFAS 162 is intended to improve financial reporting by identifying a consistent framework, or hierarchy, for selecting accounting principles to be used in preparing financial statements that are presented in conformity with GAAP for nongovernmental entities. SFAS 162 will be effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board Auditing amendments to AU Section 411, *The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles*. The Company does not believe that the provisions of SFAS 162 will have a material impact on its financial statements.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interest in Consolidated Financial Statements, an amendment of ARB No. 51* (SFAS 160). SFAS 160 will change the accounting and reporting for minority interests, which will be recharacterized as noncontrolling interests and classified as a component of equity within the balance sheet. SFAS 160 is effective as of the beginning of the first fiscal year beginning on or after December 15, 2008 (September 1, 2009 for the Company). Earlier adoption is prohibited. The Company does not believe that the provisions of SFAS 160 will have a material impact on its financial statements unless the status of its ownership in Well Enhancement and Recovery Systems, LLC (Well Enhancement LLC) changes.

Reclassifications

Certain amounts in the May 31, 2008 financial statements have been reclassified to conform to the current presentation.

NOTE 2 FAIR VALUE MEASUREMENTS

Effective September 1, 2008, the Company adopted SFAS No. 157, *Fair Value Measurements (as amended)* (SFAS 157), as it applies to its financial instruments, and SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115* (SFAS 159). SFAS 157 defines fair value, outlines a framework for measuring fair value, and details the required disclosures about fair value measurements. As permitted by FASB Statement of Position No. 157-2, *Effective Date of FASB Statement No. 157*, the Company elected to defer the adoption of the nonrecurring fair value measurement disclosures of nonfinancial assets and liabilities. The adoption of SFAS 157 for financial instruments did not have a material effect on the Company's financial position, results of operations or cash flows for the three or nine months ended May 31, 2009. SFAS 159 permits companies to irrevocably choose to measure certain financial instruments and other items at fair value. SFAS 159 also establishes presentation and disclosure requirements designed to facilitate comparison between entities that choose different measurement attributes for similar types of assets and liabilities. Except for those assets and liabilities which are required to be recorded at fair value, the Company elected not to record any other assets or liabilities at fair value, as permitted by SFAS 159.

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date in the principal or most advantageous market. The Company uses a fair value hierarchy that has three levels of inputs, both observable and unobservable, with use of the lowest possible level of input to determine fair value.

Level 1 Valuations for assets and liabilities traded in active exchange markets, such as the New York Stock Exchange. The Company had none of these instruments at May 31, 2009.

Level 2 Valuations are obtained from readily available pricing sources via independent providers for market transactions involving similar assets or liabilities. The Company's principal market for these securities is the secondary institutional markets and valuations are based on observable market data in those markets. Level 2 securities include U. S. Government agency obligations. The Company had one Level 2 asset at May 31, 2009.

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PURE CYCLE CORPORATION
 NOTES TO FINANCIAL STATEMENTS
 MAY 31, 2009

Level 3 Valuations for assets and liabilities that are derived from other valuation methodologies, including discounted cash flow models and similar techniques, and not based on market exchange, dealer, or broker traded transactions. Level 3 valuations incorporate certain assumptions and projections in determining the fair value assigned to such assets or liabilities. The Company had one Level 3 liability at May 31, 2009, the Tap Participation Fee liability, which is described in greater detail in Note 1 above.

The Company maintains policies and procedures to value instruments using the best and most relevant data available.

Level 2 Asset Marketable Securities Measured on a Recurring Basis

The Company's marketable securities were acquired during the three months ended May 31, 2009, and are the Company's only financial asset or liability measured on a recurring basis pursuant to SFAS 157. The fair value of the marketable securities are based on the values reported by the financial institution where the funds are held.

These securities include only federally insured certificates of deposit.

Level 3 Liability Tap Participation Fee Payable to HP A&M

The Company's Tap Participation Fee liability is the Company's only financial asset or liability measured on a non-recurring basis pursuant to SFAS 157. As further described in Note 1 above, the Tap Participation Fee liability is valued by projecting new home development in the Company's targeted service area over an estimated development period.

The following table provides information on the assets and liabilities measured at fair value as of May 31, 2009.

| | Carrying Value | Fair Value | Fair Value Measurement Using: | | | Total Gains and Losses |
|---------------------------------|----------------|---------------|--|---|---|------------------------|
| | | | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | |
| Marketable securities | \$ 3,000,636 | \$ 3,000,636 | \$ | \$ 3,000,636 | \$ | \$ 3,636 |
| Tap Participation Fee liability | \$ 56,650,329 | \$ 56,650,329 | \$ | \$ | \$ 56,650,329 | \$ |

The Company deems the following table, which presents the changes in the Tap Participation Fee for the nine months ended May 31, 2009, to be helpful to the users of its financial statements.

| | Fair Value Measurement at May 31, 2009 using Significant Unobservable Inputs (Level 3) | | |
|---|--|--|--|
| | Gross Estimated Tap Participation Fee Liability | Tap Participation Fee Reported Liability | Discount to be imputed as interest expense in future periods |
| Balance at August 31, 2008 | \$ 108,449,321 | \$ 53,848,000 | \$ 54,601,321 |
| Total gains and losses (realized and unrealized): | | | |

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| | | | |
|--|----------------|---------------|---------------|
| Imputed interest recorded as Other Expense | | 2,862,000 | (2,862,000) |
| Increase in estimated value (to be realized in future periods) | 4,758,038 | | 4,758,038 |
| Purchases, sales, issuances, payments, and settlements | (59,671) | (59,671) | |
| Transfers in and/or out of Level 3 | | | |
| Balance at May 31, 2009 | \$ 113,147,688 | \$ 56,650,329 | \$ 56,497,359 |

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PURE CYCLE CORPORATION
NOTES TO FINANCIAL STATEMENTS
MAY 31, 2009

The methodologies for estimating the fair value of financial assets and liabilities that are measured at fair value are discussed above. The methodologies for other financial assets and liabilities are discussed below.

Cash and Cash Equivalents: The Company's cash equivalents are reported using the values as reported by the financial institution where the funds are held. These securities primarily include money market funds and certificates of deposit. The carrying amount of cash and cash equivalents approximate fair value.

Accounts Receivable and Accounts Payable: The carrying amounts of accounts receivable and accounts payable approximate fair value due to the relatively short period to maturity for these instruments.

Notes Receivable and Construction Proceeds Receivable: The carrying amounts of the Company's notes receivable and construction proceeds receivable approximate fair value as they bear interest at rates which are comparable to current market rates.

Assets Held for Sale: Assets held for sale are reported at the lesser of (i) the net book value or (ii) the estimated selling price less cost to sell the assets.

Investments in Water and Water Systems and Property and Equipment: These assets are carried at historical cost and require fair value charges to earnings when they are deemed to be impaired. During the nine months ended May 31, 2009 and 2008, respectively the Company did not incur any impairment charges. Because the Company did not incur any impairment charges during the periods presented, the tabular disclosures otherwise required by SFAS 157 for assets and liabilities measured at fair value on a non-recurring basis are omitted.

Off-Balance Sheet Instruments: The Company's off-balance sheet instruments consist entirely of the contingent portion of the CAA (described further in Note 6 below). Because repayment of this portion of the CAA is contingent on the Sale of Export Water, the Company has determined it does not have a determinable fair value.

NOTE 3 INVESTMENTS IN WATER AND WATER SYSTEMS

The Company's investments in water and water systems consist of the following:

| | May 31, 2009 | | August 31, 2008 | |
|--|---------------------|---|------------------------|---|
| | Costs | Accumulated Depreciation and Depletion | Costs | Accumulated Depreciation and Depletion |
| Arkansas River Valley assets | \$ 81,241,428 | \$ (753,524) | \$ 81,232,769 | \$ (544,126) |
| Rangeview water supply | 14,271,786 | (5,322) | 14,192,298 | (5,034) |
| Rangeview water system | 167,720 | (50,680) | 167,720 | (46,785) |
| Paradise water supply | 5,532,619 | | 5,528,818 | |
| Fairgrounds water and water system | 2,899,863 | (248,301) | 2,899,863 | (182,252) |
| Sky Ranch water supply | 100,000 | | 100,000 | |
| Water supply other | 23,713 | (2,753) | 5,307 | (1,955) |
| Totals | 104,237,129 | (1,060,580) | 104,126,775 | (780,152) |
| Net investments in water and water systems | \$ 103,176,549 | | \$ 103,346,623 | |

The Company's water rights and current water and wastewater service agreements are more fully described in Note 3 to the financial statements contained in the Company's 2008 Annual Report on Form 10-K. Except for the non-irrigated land sale described below, there have been no significant changes to the Company's water rights or water and wastewater service agreements during the three or nine months ended May 31, 2009.

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PURE CYCLE CORPORATION
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Non-irrigated land sales

During the three and nine months ended May 31, 2009, the Company sold certain non-irrigated land parcels at sales prices totaling \$22,172 and \$59,671 in cash, respectively. These figures are net of approximately \$1,400 and \$3,600 of fees, respectively. This land was acquired from HP A&M pursuant to the Arkansas River Agreement. Because the Company assigned no value to the non-irrigated land at the acquisition date (the land was deemed to have a fair value of zero at the acquisition date because it was not being irrigated and therefore was deemed non-essential to the Company's business), the proceeds to the Company are recorded as a gain on sale of land in the accompanying statement of operations. Pursuant to the Arkansas River Agreement, 100% of the proceeds from the sale of the non-irrigated land are required to be paid to HP A&M, which resulted in credits to the Tap Participation Fee in an amount equivalent to the proceeds of the sale of 10 and 28 water taps, respectively. Of this amount, \$22,172 remains to be paid to HP A&M and is included in the accrued liabilities in the accompanying financial statements. Following these payments, 38,937 taps remain subject to the Tap Participation Fee.

NOTE 4 HP A&M PROMISSORY NOTES

Certain of the properties the Company acquired from HP A&M are subject to outstanding promissory notes with principal and accrued interest totaling approximately \$12.4 million and \$12.8 million at May 31, 2009 and August 31, 2008. Additional information regarding these promissory notes, the circumstances under which the Company would be required to make payments pursuant to these notes and the accounting treatment of these notes is more fully described in Note 7 to the Company's financial statements contained in the Company's 2008 Annual Report on Form 10-K.

NOTE 5 INVESTMENT IN, AND NOTE RECEIVABLE FROM, WELL ENHANCEMENT LLC

Effective January 30, 2007, the Company entered into an Operating Agreement with Energy Technologies, Inc. and Hydro Resources Holdings, Inc. (collectively the Company, Energy Technologies, Inc. and Hydro Resources Holdings, Inc. are referred to as the LLC Owners) to form Well Enhancement LLC. Well Enhancement LLC was established to develop a proprietary new deep water well enhancement tool and process which the LLC Owners believe will increase the efficiency of deep water wells in the Denver metropolitan area. Each of the LLC Owners holds a 1/3 interest in Well Enhancement LLC. The President of the Company acts as the manager of Well Enhancement LLC.

The Company uses the equity method to account for its investment in Well Enhancement LLC pursuant to Accounting Principles Board Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock (as amended)* (APB 18) and Emerging Issues Task Force Issue No. 03-16, *Accounting for Investments in Limited Liability Companies* (EITF 03-16). As of May 31, 2009, as a result of the recognition of the Company's 1/3 share of the losses of Well Enhancement LLC, the Company's *Investment in Well Enhancement and Recovery Systems, LLC* account on its balance sheet has been reduced to zero. However, pursuant to APB 18, once the investment account was reduced to zero, the Company began recording its share of Well Enhancement LLC's losses against the note receivable from Well Enhancement LLC described below. The investment account and the receivable account on the Company's balance sheet include \$87,000 of capital contributions made to date, the \$7,000 loan with accrued interest of \$250 and the Company's 1/3 share of the approximately \$274,000 of net losses of Well Enhancement LLC from inception through May 31, 2009.

For the three months ended May 31, 2009 and 2008, the Company recorded approximately \$620 and \$37,100, respectively, of its share of Well Enhancement LLC's losses. For the nine months ended May 31, 2009 and 2008, the Company recorded approximately \$7,100 and \$37,900, respectively, of its share of Well Enhancement LLC's losses. The net losses are primarily a result of research and development costs associated with the design of the well enhancement tool.

As of May 31, 2009, Well Enhancement LLC's assets and liabilities consisted of the following approximate amounts:

Well Enhancement LLC Assets and Liabilities

| | | |
|---|----|--------|
| Cash | \$ | 6,000 |
| Accrued professional fees | \$ | 1,800 |
| Notes payable related parties, including accrued interest | \$ | 21,000 |

On October 27, 2008, the Company loaned Well Enhancement LLC \$7,000 for use in its operations. The note receivable from Well Enhancement LLC carries simple interest at six percent (6%) per annum, and matures on October 27, 2011, with no payments due until maturity.

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PURE CYCLE CORPORATION
 NOTES TO FINANCIAL STATEMENTS
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NOTE 6 PARTICIPATING INTERESTS IN EXPORT WATER

The Company acquired its Rangeview Water Supply through various amended agreements entered into in the early 1990 s. The acquisition was consummated with the signing of the CAA in 1996. Upon entering into the CAA, the Company recorded an initial liability of approximately \$11.1 million, which represents the cash the Company received and used to purchase its Export Water, which is described in greater detail in Note 3 to the Company s financial statements contained in the Company s 2008 Annual Report on Form 10-K. In return, the Company agreed to remit a total of \$31.8 million of proceeds received from the sale of Export Water to the participating interest holders. In accordance with EITF Issue No 88-18, *Sales of Future Revenues*, the obligation for the \$11.1 million was recorded as debt, and the remaining \$20.7 million contingent liability is not reflected on the Company s balance sheet because the obligation to pay this is contingent on sales of Export Water, the amounts and timing of which are not reasonably determinable.

The CAA obligation is non-interest bearing, and if the Export Water is not sold, the parties to the CAA have no recourse against the Company. If the Company does not sell the Export Water, the holders of the Series B Preferred Stock are also not entitled to payment of any dividend and have no contractual recourse against the Company (more fully described in the Company s 2008 Annual Report on Form 10-K).

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. Because the original recorded liability, which was \$11.1 million, was approximately 35% of the original total liability of \$31.8 million, 35% of each payment remitted to the CAA holders is allocated to the recorded liability account. The remaining portion of each payment, or approximately 65%, is allocated to the contingent obligation, which is recorded on a net revenue basis.

In recent years, in order to reduce the long term impact of the CAA, the Company has repurchased various portions of the CAA obligations in priority. The Company did not make any CAA acquisitions during the three or nine months ended May 31, 2009. The prior acquisitions are explained in detail in Note 5 to the Company s financial statements contained in the Company s 2008 Annual Report on Form 10-K.

As a result of the CAA acquisitions, and due to the sale of Export Water, as detailed in the table below, the total remaining potential third party obligation as of May 31, 2009 is approximately \$3.5 million:

| | Export Water Proceeds | Initial Export Water Proceeds to Pure Cycle | Total Potential Third party Obligation | Participating Interests Liability | Contingency |
|---|--------------------------------------|--|---|--|--------------------|
| Original balances | \$ | \$ 218,500 | \$ 31,807,732 | \$ 11,090,630 | \$ 20,717,102 |
| <i>Activity from inception until August 31, 2008:</i> | | | | | |
| Acquisitions | | 28,077,500 | (28,077,500) | (9,789,983) | (18,287,517) |
| Option payments Sky Ranch and The Hills at Sky Ranch | 110,400 | (42,280) | (68,120) | (23,754) | (44,366) |
| Arapahoe County tap fees * | 532,968 | (373,078) | (159,890) | (55,754) | (104,136) |
| Export Water sale payments | 31,177 | (21,824) | (9,353) | (3,263) | (6,090) |
| Balance at August 31, 2008 | 674,545 | 27,858,818 | 3,492,869 | 1,217,876 | 2,274,993 |
| <i>Fiscal 2009 activity:</i> | | | | | |

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| | | | | | |
|----------------------------|------------|---------------|--------------|--------------|--------------|
| Export Water sale payments | 9,282 | (6,497) | (2,785) | (971) | (1,814) |
| Balance at May 31, 2009 | \$ 683,827 | \$ 27,852,321 | \$ 3,490,084 | \$ 1,216,905 | \$ 2,273,179 |

* The Arapahoe County tap fees are less the \$34,522 royalty payment to the Land Board.

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PURE CYCLE CORPORATION
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 MAY 31, 2009

The CAA includes contractually established priorities which call for payments to CAA holders in order of their priority. This means the first three payees receive their full payment before the next priority level receives any payment and so on until full repayment. The Company will receive approximately \$5.1 million of the first priority payout (the remaining entire first priority payout totals approximately \$7.3 million as of May 31, 2009).

NOTE 7 SHAREHOLDERS EQUITY

The Company maintains the 2004 Incentive Plan (the Equity Plan), which was approved by stockholders in April 2004. Executives, eligible employees and non-employee directors are eligible to receive options and stock grants pursuant to the Equity Plan. Pursuant to the Equity Plan, options to purchase shares of stock and restricted stock awards can be granted with exercise prices, vesting conditions and other performance criteria determined by the Compensation Committee of the Board. The Company initially reserved 1.6 million shares of common stock for issuance under the Equity Plan. As of May 31, 2009, the Company has 1,395,811 common shares that can be granted to eligible participants pursuant to the Equity Plan.

Statement of Financial Accounting Standard No. 123 (revised 2004), *Share Based Payment* (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 and to expense the fair value over the vesting period of the grant. For additional information on the Equity Plan, including a summary of the significant assumptions, refer to the Company's Form 10-K for the year ended August 31, 2008.

Stock Options

The following table summarizes the stock option activity for the Equity Plan for the nine months ended May 31, 2009:

| | Number of Options | Weighted- Average Exercise Price | Weighted- Average Remaining Contractual Term | Approximate Aggregate Intrinsic Value |
|-------------------------------------|----------------------|---|--|--|
| Outstanding at beginning of period | 155,000 | \$ 8.50 | | |
| Granted | 15,000 | 2.94 | | |
| Exercised | | | | |
| Forfeited or expired | | | | |
| Outstanding at May 31, 2009 | 170,000 | \$ 8.00 | 6.7 | * |
| Options exercisable at May 31, 2009 | 142,500 | \$ 8.50 | 6.4 | * |

* Intrinsic value
less than zero

The following table summarizes the activity and value of non-vested options as of and for the nine months ended May 31, 2009:

| Number of Options | Weighted- Average Grant Date Fair Value |
|----------------------|--|
|----------------------|--|

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| | | | |
|---|----------|----|------|
| Non-vested options outstanding at beginning of period | 27,500 | \$ | 6.81 |
| Granted | 15,000 | | 2.42 |
| Vested | (15,000) | | 6.25 |
| Forfeited | | | |
| Non-vested options outstanding at May 31, 2009 | 27,500 | \$ | 4.72 |

No options vested during either of the three month periods ended May 31, 2009 and 2008.

The total fair value of options vested during the nine month periods ended May 31, 2009 and 2008, was approximately \$93,700 and \$67,700, respectively.

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PURE CYCLE CORPORATION
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MAY 31, 2009

Stock-based compensation expense for the three months ended May 31, 2009 and 2008, was approximately \$64,900 and \$93,400, respectively. Stock-based compensation expense for the nine months ended May 31, 2009 and 2008, was approximately \$218,500 and \$263,800, respectively.

At May 31, 2009, the Company has unrecognized expenses relating to non-vested options that are expected to vest totaling approximately \$46,200. The weighted-average period over which these options are expected to vest is less than 1 year. The Company has not recorded any excess tax benefits to additional paid in capital.

There were no options exercised during the three or nine months ended May 31, 2009.

In January 2009, the Company granted its directors options to purchase a combined 15,000 shares of the Company's common stock pursuant to the Equity Plan. The options vest one year from the date of grant and expire ten years from the date of grant. The Company calculated the fair value of these options at approximately \$36,300 using the Black-Scholes model with the following variables: weighted average exercise price of \$2.94 (which was the closing sales price of the Company's common stock on the date of the grant); estimated option lives of eight years; estimated dividend rate of 0%; weighted average risk-free interest rate of 2.33%; weighted average stock price volatility of 91.6%; and an estimated forfeiture rate of 0%. The \$36,300 of stock-based compensation is being expensed monthly over the vesting period.

In January 2008, the Company granted its directors options to purchase a combined 15,000 shares of the Company's common stock pursuant to the Equity Plan. The options vest one year from the date of grant and expire ten years from the date of grant. The Company calculated the fair value of these options at approximately \$93,600 using the Black-Scholes model with the following variables: weighted average exercise price of \$7.50 (which was the closing sales price of the Company's common stock on the date of the grant); estimated option lives of eight years; estimated dividend rate of 0%; weighted average risk-free interest rate of 4.25%; weighted average stock price volatility of 90.6%; and an estimated forfeiture rate of 0%. The \$93,600 of stock-based compensation was expensed monthly over the vesting period which was through January 2009.

Restricted Stock

On August 27, 2007, the Company granted 34,189 shares of restricted common stock to the President of the Company pursuant to the Equity Plan. Pursuant to SFAS 123(R), the Company is recognizing compensation expense on this grant based on the grant date fair value of the restricted stock. The grant date fair value of the restricted stock was based upon the market price of the Company's common stock on the date of the grant. The grant date fair value is being amortized to compensation expense over the vesting term of two years. Because there has been no change in the status of the restricted stock, the Company omitted the status table, which is disclosed in Note 8 to the Company's financial statements contained in the Company's 2008 Annual Report on Form 10-K.

As of May 31, 2009, there was approximately \$32,400 of unrecognized compensation expense related to restricted stock awarded under the Equity Plan, which is expected to be recognized during the Company's fiscal 2009.

Loss per common share

Loss per common share is computed by dividing net loss by the weighted average number of shares outstanding during each period. Common stock options and warrants aggregating 170,092 and 155,092 common share equivalents as of May 31, 2009 and 2008, respectively, have been excluded from the calculation of loss per common share as their effect is anti-dilutive.

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Comprehensive Loss

In addition to net loss, comprehensive loss includes the unrecognized changes in the fair value of marketable securities that are classified as available-for-sale as noted in the following table:

| | Three Months Ended | | Nine Months Ended | |
|--|---------------------------|---------------------|--------------------------|---------------------|
| | May 31, 2009 | May 31, 2008 | May 31, 2009 | May 31, 2008 |
| Net loss | \$ (1,325,203) | \$ (1,728,366) | \$ (4,438,539) | \$ (5,273,040) |
| Unrealized gain on marketable securities | 3,636 | | 3,636 | |
| Comprehensive loss | \$ (1,321,567) | \$ (1,728,366) | \$ (4,434,903) | \$ (5,273,040) |

NOTE 8 RELATED PARTY TRANSACTIONS

The Company leases office space from the estate of the son of its former CEO, which is a greater than 5% stockholder. The Company leases the office space on a month-to-month basis for \$1,000 per month.

See Note 5 regarding the \$7,000 loan made to Well Enhancement LLC on October 27, 2008.

In 1995, the Company extended a loan to the District. The loan provided for borrowings of up to \$250,000, is unsecured, bears interest based on the prevailing prime rate plus 2% (5.25% at May 31, 2009) and matures on December 31, 2009. The approximately \$504,800 balance of the note receivable at May 31, 2009 includes principal borrowings of approximately \$229,300 and accrued interest of approximately \$275,500. The approximately \$494,800 balance of the note receivable at August 31, 2008, includes principal borrowings of approximately \$229,300 and accrued interest of approximately \$265,500.

NOTE 9 SUPPLEMENTAL DISCLOSURES OF NON-CASH ACTIVITIES

| | Nine months ended | |
|---|--------------------------|---------------------|
| | May 31, 2009 | May 31, 2008 |
| Increase in estimated Tap Participation Fee liability and related discount | \$ 4,758,038 | \$ 3,867,321 |
| Tap Participation Fee payment due to HP A&M as a result of land sales included in accrued liabilities | \$ 22,172 | \$ |
| Retirement of treasury stock | \$ | \$ 1,979,447 |
| Common stock issued to acquire contingent obligations | \$ | \$ 1,905,277 |

Table of Contents**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**
Disclosure Regarding Forward-Looking Statements

Certain statements in this Quarterly Report, including estimates, projections, forecasts, and assumptions, but excluding purely historical information, are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. The words anticipate, believe, estimate, expect, plan, intend, would and similar expressions relate to us, are intended to identify forward-looking statements. Such statements reflect our current views with respect to future events and are subject to certain risks, uncertainties and assumptions. We cannot assure you that any of our expectations will be realized. Factors that may cause actual results to differ materially from those contemplated by such forward-looking statements include, without limitation, the timing of development of the areas where we may sell our water, including uncertainties related to the development of projects the Company currently has under contract, the market price of water, changes in applicable statutory and regulatory requirements, uncertainties in the estimation of water available under decrees, costs of delivery of water and treatment of wastewater, uncertainties in the estimation of costs of construction projects, the strength and financial resources of our competitors, our ability to find and retain skilled personnel, climatic and weather conditions, labor relations, availability and cost of material and equipment, delays in anticipated permit and construction dates, environmental risks, the results of financing efforts and the ability to meet capital requirements, and general economic conditions. We undertake no obligation to update or revise publicly any forward-looking statements, whether as a result of new information, future events or otherwise.

Overview

The following sections focus on the key indicators reviewed by management in evaluating our financial condition and operating performance, including the following:

- Revenue generated from providing water and wastewater services;
- Expenses associated with developing our water assets; and
- Cash available to continue development of our water rights and service agreements.

The following Management's Discussion and Analysis (MD&A) is intended to help the reader understand our results of operations and financial condition and should be read in conjunction with the accompanying financial statements and the notes thereto and the financial statements and the notes thereto contained in our 2008 Annual Report on Form 10-K. This overview summarizes the MD&A, which includes the following sections:

Our Business a general description of our business, our services and our business strategy.

Results of Operations an analysis of our results of operations for the periods presented in our financial statements.

Liquidity, Capital Resources and Financial Position an analysis of our cash position and cash flows, as well as a discussion of our financing arrangements

Critical Accounting Policies and Estimates a discussion of our critical accounting policies that require critical judgments, assumptions and estimates.

Our Business*Our Water Assets*

Our water assets are comprised of the following annual entitlements which are described in greater detail in our 2008 Annual Report on Form 10-K:

- Approximately 60,000 acre-feet of senior water rights in the Arkansas River and its tributaries;
- Approximately 11,650 acre-feet of water located in Arapahoe County, Colorado at property known as the Lowry Range (an approximately 27,000 acre property located in Arapahoe County, Colorado, owned by State Board of Land Commissioners (the Land Board)), which we can export from the Lowry Range to supply water to nearby communities and developers in need of additional water supplies (this water asset is referred to as our Export Water);

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Approximately 321 acre-feet of groundwater located in Arapahoe County acquired pursuant to an Agreement for Water Service (the County Agreement) with Arapahoe County (the County);

Approximately 89 acre-feet of water located beneath Sky Ranch together with the right to purchase an additional 671 acre-feet of water (for a total of 760 acre-feet) pursuant to the Sky Ranch Agreements (however, see information on Sky Ranch bankruptcy in the Risk Factors section of the 2008 Annual Report on Form 10-K); and

Conditional water rights in western Colorado that entitle us to build a 70,000 acre-foot reservoir to store Colorado River tributary water and a right-of-way permit from the U.S. Bureau of Land Management for property at the dam and reservoir site (collectively known as the Paradise Water Supply).

In addition to the water we own as described above, we also have the exclusive rights to provide water and wastewater services to approximately 24,000 acres of the Lowry Range through 2081 using approximately 15,050 acre-feet of water. This water is required to be used solely on the Lowry Range (collectively we refer to the 15,050 acre-feet of water designated for use on the Lowry Range and the 11,650 acre-feet of Export Water as our Rangeview Water Supply).

For further details on our current service agreements please refer to our 2008 Annual Report on Form 10-K.

We provide water and wastewater services utilizing water assets we own, concentrating our services to customers along the Front Range of the metropolitan Denver area. We currently provide water services to approximately 247 single-family-equivalent water connections and 157 single-family-equivalent wastewater connections located in the southeastern Denver metropolitan area. We plan to utilize our significant water assets, which are summarized below, to provide residential/commercial water and wastewater services to other customers located along the Front Range, principally targeting the I-70 corridor which is located east of downtown Denver and south of the Denver International Airport. This area is predominately undeveloped and is expected to experience substantial growth over the next 30 years. Our ability to increase our customer base is dependent on new development in our targeted service area and on our ability to enter into contracts to deliver water and wastewater service with land owners, land developers, home builders, and municipalities.

We own nearly 12,000 acre-feet per year of decreed groundwater and surface water rights in the Denver area and have the exclusive rights to use, through the year 2081, approximately 16,700 acre-feet per year of decreed groundwater and surface water located at the Lowry Range (the Lowry Range is described in further detail in Item 1 of our 2008 Annual Report on Form 10-K). In addition to these Denver based assets, we also own approximately 60,000 acre-feet per year of Arkansas River water that is currently being used to irrigate approximately 17,000 acres of land owned by the Company in southeastern Colorado and 70,000 acre-feet of conditionally decreed Colorado River water rights on the western slope of Colorado.

We contract with land owners, land developers, home builders, cities, and municipalities to design, construct, operate and maintain water and wastewater systems using our balanced water portfolio consisting of surface water and groundwater supplies, surface water storage, alluvial aquifer storage, and reclaimed water supplies. We generate cash flows and revenues by (i) selling taps (connections) to our water and wastewater systems and/or (ii) monthly service fees and consumption charges from metered deliveries. Tap fee (connection) charges are a one-time fee typically paid by developers which are used to recoup the cost of the Company's water rights and for construction of the various facilities required to withdraw, store, treat and deliver water to customers and reclaim, store, treat and deliver treated effluent water to satisfy irrigation demands. Monthly service fees and consumption charges from metered deliveries of water and flat monthly fees for wastewater are paid by customers—homeowners, business owners or consumers of water and wastewater services. Monthly service fees include (i) base monthly fees, (ii) monthly metered water usage fees (both potable and irrigation uses which are charged at different rates) and (iii) other service related fees.

We did not sell any water taps or wastewater taps during the three or nine months ended May 31, 2009 and 2008. We received approximately \$31,800 and \$36,900 from the sale of water during the three months ended May 31, 2009 and 2008, respectively, and we received approximately \$88,400 and \$102,000, respectively, from the sale of water during the nine months ended May 31, 2009 and 2008, respectively. We received approximately \$16,700 from monthly wastewater service fees during both three month periods presented, and approximately \$50,200 from monthly wastewater service fees during both nine month periods presented. Currently all monthly water and wastewater fees

are generated utilizing our Rangeview Water Supply which is defined below. See Critical Accounting Policies below regarding our revenue recognition policies for tap fees and construction fees.

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The water rights we own in the Arkansas River in southeastern Colorado are currently being used for agricultural purposes on farms that we own, which are being leased to area farmers. Pursuant to agreements we entered into with High Plains A&M, LLC (HP A&M), described in greater detail in Note 3 to the financial statements contained in our 2008 Annual Report on Form 10-K, the management of these farm leases is being performed by HP A&M through August 31, 2011. After that date, depending on certain factors described in Note 3 to the financial statements contained in our 2008 Annual Report on Form 10-K, HP A&M may extend the management services agreement, or we may assume management of the farms. Pursuant to the farm management agreement, while HP A&M is managing the leases, HP A&M is responsible for all expenses associated with maintaining the leases with the exception of the water assessment fees paid to the Fort Lyon Canal Company (FLCC), which are borne by us. The FLCC is the canal that supplies the water to the farms. As compensation for their farm management responsibilities, HP A&M retains all lease and other income associated with the farms and the water used thereon.

Since our Arkansas River water is currently being used for agricultural purposes, in order to use this water for municipal purposes we must file a change of use application with the Colorado Water Court. This will likely be a long-term process, which may extend from one to more than three years, and require a substantial amount of capital for legal and engineering services. If we successfully change the use of our water rights to include municipal uses, we would then need to construct a pipeline and other infrastructure to transport the water to the Front Range, which could cost in excess of \$500 million. We have not yet filed a change of use application. However, we are diligently working with local interests to determine the least intrusive method of transferring water off our farms to serve customers along the Front Range. We are conducting a rotational crop study program and participating in discussions with area interests including the Lower Arkansas Valley Super Ditch (Super Ditch), which is a group of Arkansas Valley irrigators that have assembled to study alternatives to traditional buy and dry agricultural to municipal water transfers. See also our Risk Factors in our 2008 Annual Report on Form 10-K for additional information on the risks associated with a water transfer case and other risks associated with the Arkansas River water.

Recent Developments

On June 1, 2009, the Colorado Supreme Court upheld the decision of the District Court, Water Division I, State of Colorado (the Water Court) requiring the City of Aurora to remove certain reservoir sites from its Water Court applications because the reservoir sites were already adjudicated to us pursuant to agreements with the Land Board.

Results of Operations*Executive Summary*

The results of our operations for the three months ended May 31, 2009 and 2008 are as follows:

Summary Table 1

| | Three Months Ended: | | | |
|--|----------------------------|---------------------|------------------|---------------------|
| | May 31, 2009 | May 31, 2008 | \$ Change | % Change |
| Millions of gallons of water delivered | 7.6 | 10 | (2.4) | -24% |
| Water revenues generated | \$ 31,800 | \$ 36,900 | \$ (5,100) | -14% |
| Operating costs to deliver water (excluding depreciation and depletion) | \$ 10,200 | \$ 9,200 | \$ 1,000 | 11% |
| Water delivery gross margin % | 68% | 75% | | |
| Wastewater treatment revenues | \$ 16,700 | \$ 16,700 | \$ | 0% |
| Operating costs to treat wastewater | \$ 4,500 | \$ 4,900 | \$ (400) | -8% |
| Wastewater treatment gross margin % | 73% | 71% | | |
| General and administrative expenses | \$ 455,500 | \$ 588,000 | \$ (132,500) | -23% |
| Net losses | \$ 1,325,200 | \$ 1,728,400 | \$ (403,200) | -23% |

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The results of our operations for the nine months ended May 31, 2009 and 2008 are as follows:

Summary Table 2

| | Nine Months Ended: | | | % Change |
|--|--------------------|--------------|--------------|-------------|
| | May 31, 2009 | May 31, 2008 | \$ Change | |
| Millions of gallons of water delivered | 19.2 | 25.5 | (6.3) | -25% |
| Water revenues generated | \$ 88,400 | \$ 102,000 | \$ (13,600) | -13% |
| Operating costs to deliver water (excluding depreciation and depletion) | \$ 38,000 | \$ 38,700 | \$ (700) | -2% |
| Water delivery gross margin % | 57% | 62% | | |
| Wastewater treatment revenues | \$ 50,200 | \$ 50,200 | \$ | 0% |
| Operating costs to treat wastewater | \$ 16,100 | \$ 13,500 | \$ 2,600 | 19% |
| Wastewater treatment gross margin % | 68% | 73% | | |
| General and administrative expenses | \$ 1,547,900 | \$ 1,810,400 | \$ (262,500) | -14% |
| Net losses | \$ 4,438,500 | \$ 5,273,000 | \$ (834,500) | -16% |

Water and Wastewater Usage Revenues

Our water service charges include a base monthly fee and a usage fee which is based on a tiered pricing structure that provides for higher prices as customers use greater amounts of water. Our rates and charges are established based on the average of three surrounding communities as specified in our agreements with the Land Board.

Our wastewater customers are charged flat monthly fees based on their number of tap connections.

Comparison of usage fees and gross margins

Water deliveries for the three and nine months ended May 31, 2009, decreased 24% and 25%, respectively, over the comparable periods in 2008. This was mainly attributable to above average precipitation in Colorado during the spring months which results in reduced water demands and reduced water usage fees. Water usage fees decreased 14% and 13%, for the three and nine months ended May 31, 2009, respectively, as a result of the decreased water usage described above, partially offset by the July 2008 rate increase.

The decreased usage also led to decreases in the water operating gross margins for the three and nine months ended May 31, 2009 over the comparable periods in 2008. In addition we also incurred certain tri-annual testing fees during our first fiscal quarter of 2009 which resulted in lower gross margins for the nine months ended May 31, 2009 compared with the comparable period in 2008.

Wastewater operation gross margin for the three months ended May 31, 2009 was comparable with the three months ended May 31, 2008, while the gross margin for the nine months ended May 31, 2009 decreased approximately 5% over the comparable period in 2008 mainly a result of higher testing costs during the current fiscal year and higher energy costs in the current year.

Tap Fees

We recognized approximately \$3,600 of water tap fee revenues during each of the three month periods ended May 31, 2009 and 2008, related to the County Agreement. We recognized approximately \$10,700 of water tap fee revenues during each of the nine month periods ended May 31, 2009 and 2008, related to the County Agreement. In accordance with accounting principles generally accepted in the United States of America (GAAP), we began recognizing the water tap fees as revenue ratably over the estimated service period upon completion of the Wholesale Facilities in fiscal 2006. The water tap fees to be recognized over this period are net of the royalty payments to the Land Board and amounts paid to third parties pursuant to the Comprehensive Amendment Agreement No. 1 (the CAA) as further described in Note 6 to the accompanying financial statements.

We recognized approximately \$10,400 of Special Facilities funding as revenue during each of the three month periods ended May 31, 2009 and 2008. We recognized approximately \$31,100 of Special Facilities funding as revenue during

each of the six month periods ended May 31, 2009 and 2008. This is the ratable portion of the Special Facilities funding proceeds received from the County pursuant to the County Agreement as more fully described in Note 3 to the financial statements contained in our 2008 Annual Report on Form 10-K.

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As of May 31, 2009, we have deferred recognition of approximately \$1.5 million of water tap and construction fee revenue from the County, which will be recognized as revenue ratably over the estimated useful accounting life of the assets constructed with the construction proceeds as described above.

General and Administrative Expenses

General and administrative expenses for the three and nine months ended May 31, 2009 decreased 23% and 14%, respectively, over the comparable periods in 2008. These decreases were a result of our cost reduction efforts in response to the economy and the delay in the development of the Lowry Range as a result of the developer's withdrawal from its development agreement with the Land Board.

Our general and administrative expenses for the three months ended May 31, 2009 and 2008, respectively, are comprised of approximately:

\$124,900 and \$124,700 of salary and salary related expenses, which does not include approximately \$64,900 and \$93,400, respectively, of stock-based compensation expenses recognized pursuant to Statement of Financial Accounting Standard No. 123 (revised 2004), *Share Based Payment* (SFAS 123(R)), \$83,900 and \$82,600 of water assessment expenses associated with canal systems (the majority of which are related to the FLCC), which provide water to the farms we own in the Arkansas River Valley in southern Colorado as described further in the Liquidity and Capital Resources section below, \$80,400 and \$161,300 of professional fees, which decreased because the 2008 figure includes a significant amount of expenses associated with negotiations with the former developer of the Lowry Range related to our provision of water services to the development per our agreements with the Land Board, \$13,700 and \$11,500 of expenses associated with being a public company, generally related to press releases, NASDAQ listing fees, and EDGAR filing fees, \$13,500 and \$17,600 of fees and insurance premiums related to our board of directors, and \$12,400 and \$37,500 of consulting fees, generally related to negotiations with the Lowry Range project and other pending water service agreements which decreased due to a reduction in the number of consultants we were using as a result of the withdrawal of the developer from the Lowry Range as noted above.

Our general and administrative expenses for the nine months ended May 31, 2009 and 2008, respectively, are comprised of approximately:

\$369,800 and \$367,300 of salary and salary related expenses, which does not include approximately \$218,500 and \$263,800, respectively, of stock-based compensation expenses recognized pursuant to SFAS 123(R), \$272,700 and \$297,400 of professional fees, the decrease is mainly attributable to withdrawal of the developer of the Lowry Range as noted above, \$258,100 and \$249,300 of water assessment expenses associated with canal systems as described above, the increase is mainly attributable to higher FLCC assessment fees for the acquisition of additional water by the FLCC for irrigation purposes, \$125,700 and \$123,600 of fees and insurance premiums related to our board of directors, \$74,800 and \$190,200 of consulting fees, generally related to negotiations with the Lowry Range project and other pending water service agreements which decreased due to a reduction in the number of consultants we were using as a result of the withdrawal of the developer from the Lowry Range as noted above, and \$50,000 and \$115,900 of expenses associated with being a public company, the decrease is mainly attributable to the reincorporation into Colorado, which resulted in our no longer having to pay Delaware franchise fees.

Table of Contents*Other Income and Expenses*

Interest income totaled approximately \$12,900 and \$52,700 for the three months ended May 31, 2009 and 2008, respectively. Interest income totaled approximately \$70,500 and \$250,400 for the nine months ended May 31, 2009 and 2008, respectively. This represents interest earned on the temporary investment of capital, interest accrued on our notes receivable from related parties and interest accrued on the construction proceeds receivable from Arapahoe County. The decrease is due to the continued decline in interest rates both on our invested capital and for the notes receivable from related parties. Our temporary investments were invested in overnight money market funds related to treasury obligations until March 2009 when we transferred approximately \$3.0 million into federally insured certificates of deposit with scheduled maturities and set interest rates which are not subject to market risk. Our certificates of deposit are held by various financial institutions in amounts less than federally insured limits.

Imputed interest expense related to the Tap Participation Fee payable to HP A&M (as defined in the *Liquidity and Capital Resources* section below) totaled approximately \$858,000 and \$1.1 million for the three months ended May 31, 2009 and 2008, respectively. Imputed interest expense related to the Tap Participation Fee payable to HP A&M totaled approximately \$2.9 million and \$3.3 million for the nine months ended May 31, 2009 and 2008, respectively. This represents the expensed portion of the difference between the estimated fair value of the liability and the net present value of the liability recognized under the effective interest method. See also Note 1 to the accompanying financial statements for discussion on the revaluation of the Tap Participation Fee and its impact to the nine months ended May 31, 2009 financial statements.

During the nine months ended May 31, 2009, we received a \$5,000 land use payment from an energy company searching for natural gas on certain of our Arkansas Valley properties and we received \$2,100 for our engineer providing water system consulting services to various non-water customer commercial water users.

Net losses for the three and nine months ended May 31, 2009 decreased approximately 23% and 16%, respectively, over the comparable periods in 2008. The decrease is attributable to the changes in the operating items described above, and during the three and nine months ended May 31, 2009, we recognized approximately \$22,200 and \$59,700, respectively, of gains related to the sale of non-irrigated land we owned in the Arkansas River Valley in Southern Colorado.

Liquidity and Capital Resources

At May 31, 2009, we had working capital (current assets less current liabilities) of approximately \$4.1 million, and cash, cash equivalents and marketable securities totaling approximately \$3.9 million. We believe that at May 31, 2009, we have sufficient working capital and cash and cash equivalents to fund our operations for the next year. However, there can be no assurance that we will be successful in marketing the water from our primary water projects which we require to fund our long-term operations. In order to generate working capital to support our operations, we may incur additional short or long-term debt or seek to sell additional equity securities. We have an effective shelf registration statement pursuant to which we may elect to sell up to another \$5.7 million of stock at any time and from time to time.

Development of the water that we own, have rights to use, or may seek to acquire, will require substantial capital investments. We anticipate that capital required for the development of the water and wastewater systems will be financed through the sale of water taps to developers. A water tap fee refers to a charge we impose to fund construction of Wholesale Facilities (Wholesale Facilities are further defined in our 2008 Annual Report on Form 10-K) and permit access to our water delivery system. We anticipate tap fees will be sufficient to generate funds with which we can design and construct the necessary Wholesale Facilities. However, once we receive tap fees from a developer, we are contractually obligated to construct the Wholesale Facilities for the taps paid for, even if our costs are not covered by the fees we receive. We cannot assure you that these sources of cash will be sufficient to cover all our capital costs.

On a monthly basis, water customers are charged a flat base fee and usage fees, generally charged per 1,000 gallons of water delivered to the customer, and wastewater customers are charged flat monthly service fees. These fees are used to fund on-going operational expenses, including general and administrative expenses.

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As further described in our 2008 Annual Report on Form 10-K, *Critical Accounting Policies* below and Note 1 to the accompanying financial statements, pursuant to the Arkansas River Agreement we agreed to pay HP A&M 10% of our water tap fees received on the sale of the next 40,000 water taps we sell from and after the date of the Arkansas River Agreement (the Tap Participation Fee). As of May 31, 2009, we have estimated the ultimate value of the Tap Participation Fee payable to HP A&M at approximately \$113.1 million. The balance reflected on the accompanying balance sheet of approximately \$56.7 million excludes the discount of \$56.4 million based on a discounted cash flow valuation analysis, which was originally prepared at August 31, 2006, and was updated as of February 28, 2009 (no update was deemed necessary at May 31, 2009). See Note 1 in the accompanying financial statements for the impact of the revaluation. The actual amount to be paid will inevitably be different from our estimates. Tap participation payments are not payable to HP A&M until we receive water tap fee payments. We did not sell any taps, but did make Tap Participation Fee payments during the nine months ended May 31, 2009 related to the sale of non-irrigated property, and there remain 38,937 taps subject to the Tap Participation Fee as of May 31, 2009.

We are obligated to pay annual water assessment charges to various canal systems, which are fees assessed to the canal shareholders for the upkeep and maintenance of the canal the agricultural delivery canals for our Arkansas River water. The majority of the payments are paid to the FLCC, which are made in three payments each calendar year. In December 2008, the board of the FLCC approved a decrease to the calendar 2009 assessments from \$15.00 per share to \$14.50 per share, which equates to a decrease in our water assessments from approximately \$325,000 per year to approximately \$314,000 per year.

Repayment of all related party and non-related party debt

At May 31, 2009, we had no outstanding related party or non-related party debt.

Operating Activities

Operating activities include revenues we receive from the provision of water and wastewater services to our customers, costs incurred in the delivery of those services, general and administrative expenses, and depletion/depreciation expenses.

Cash used by operating activities was approximately \$1.2 million and \$956,800 for the nine months ended May 31, 2009 and 2008, respectively. Despite the decreases in our general and administrative expenses and our net operating losses as described above, cash used by operations increased approximately \$290,100 or 30%, period over period, mainly due to the following:

Decreased interest earned on our temporary investments, approximately \$138,400,

Increased prepaid expenses due to timing of annual contract payments, approximately \$84,700,

Decreased interest earned on our notes receivable due to payments and decreases in interest rates, approximately \$41,500,

Decreased accounts payable due to timing of payments, approximately \$14,300, and

Decreased water usage revenues as described above, approximately \$13,600.

We incurred approximately \$286,100 and \$287,600 of depreciation, depletion and other non-cash charges during the nine months ended May 31, 2009 and 2008, respectively, which is a change of less than 1%.

We will continue to provide domestic water and wastewater service to customers in our service area and we will continue to operate and maintain our water and wastewater systems with our own employees.

Investing Activities

We continue to invest in legal and engineering fees associated with our water rights, and we continue to invest in the right-of-way permit fees to the Department of Interior Bureau of Land Management and legal and engineering costs for our Paradise Water Supply.

Investing activities used approximately \$3.1 million during the nine months ended May 31, 2009, predominately for the purchase of marketable securities (\$3.0 million) and investments in water supplies and systems (\$110,400).

Investing activities provided approximately \$501,300 for the nine months ended May 31, 2008. The 2008 investing

cash flows were positively impacted by the sale or maturity of approximately \$790,700 of available-for-sale securities. Without the effects of the sale or maturity of the marketable securities, investing activities would have used approximately \$289,400 during the nine months ended May 31, 2008, entirely for investments in water supplies and systems and the purchase of property and equipment.

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On October 31, 2003 we entered into the Denver Groundwater Purchase Agreement (the "DGPA") with the developer of Sky Ranch. The DGPA provides us the right to purchase a total of 223 acre-feet of adjudicated decreed water rights owned by the developer. Under the DGPA, we can acquire 44.6 acre-feet of water per year (or 20% of the total 223 acre-feet) for a payment of \$50,000 (acquiring the entire 223 acre-feet requires payments totaling \$250,000). On March 26, 2004 and May 26, 2005, we purchased a total of 89.2 acre-feet of Denver aquifer groundwater for payments totaling \$100,000. During our fiscal 2007 and fiscal 2006 we made the two required \$50,000 payments pursuant to the DGPA, for which we have not received the water rights deeds from the developer, nor has the developer cashed either of the payments. In November, 2007, the developer of Sky Ranch filed for Chapter 11 bankruptcy protection. Because of the bankruptcy and since we have not received our water rights deeds from Sky Ranch, in November 2007 we cancelled the two uncashed checks issued to Sky Ranch and reversed the \$100,000 that was included in the Prepaid Expenses account on our Balance Sheet. We will continue to follow the bankruptcy proceedings of Sky Ranch and vigorously seek to enforce our rights under the DGPA and other Sky Ranch agreements.

Financing Activities

Financing activities provided approximately \$22,200 during the nine months ended May 31, 2009, predominately due to approximately \$61,600 of construction proceed payments received from Arapahoe County, which were partially offset by the approximately \$37,500 Tap Participation Fee payments made to HP A&M related to the sale of the non-irrigated land. Financing activities provided approximately \$67,000 during the nine months ended May 31, 2008. This was mainly due to the receipt of approximately \$95,900 of construction proceed payments from Arapahoe County partially offset by the repayment of approximately \$26,600 of related party debt.

Off-Balance Sheet Arrangements

Our off-balance sheet arrangements consist entirely of the CAA, which is more fully described in Note 5 to the financial statements contained in our 2008 Annual Report on Form 10-K, and in Note 6 to the accompanying financial statements.

Recently Issued and Recently Adopted Accounting Pronouncements

See Note 1 to the accompanying financial statements regarding recently issued and recently adopted accounting pronouncements.

Critical Accounting Policies

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions about future events that affect the amounts reported in the financial statements and accompanying notes. Future events and their effects cannot be determined with absolute certainty. Therefore, the determination of estimates requires the exercise of judgment. Actual results inevitably will differ from those estimates, and such differences may be material to the financial statements.

The most significant accounting estimates inherent in the preparation of our financial statements include estimates associated with the timing of revenue recognition, the impairment analysis of our water rights, management's valuation of the Tap Participation Fee, and stock-based compensation. Below is a summary of these critical accounting policies.

Revenue Recognition

Our revenues consist mainly of tap fees and monthly service fees. In accordance with applicable GAAP, as detailed in our 2008 Annual Report on Form 10-K, proceeds from tap sales are deferred upon receipt and recognized in income based on whether we own or do not own the facilities constructed with the proceeds. Tap fees derived from agreements for which we construct infrastructure the customer will own are recognized in accordance with Statement of Position 81-1 *Accounting for Performance of Construction-Type and Certain Production-Type Contracts* (SOP 81-1), whereby we recognize tap fees as revenue and costs of construction based on the percentage-of-completion method. The percentage-of-completion method requires management to estimate the percent of work that is completed on a particular project, which could change materially throughout the duration of the construction period and result in significant fluctuations in revenue recognized during the reporting periods throughout the construction process. We did not recognize any revenues pursuant to SOP 81-1 during the three or nine months ended May 31, 2009 or May 31, 2008, respectively.

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Tap fees derived from agreements for which we own the infrastructure are recognized in accordance with Staff Accounting Bulletin No. 104 *Revenue Recognition* (SAB 104), whereby the up-front fees are recognized as revenue ratably over the estimated service life. Although the cash will be received up-front and most construction will be completed within one year of receipt of the proceeds, revenue recognition may occur over 30 years or more. Management is required to estimate the service life, and currently the service life of the tap fees is based on the estimated useful life of the assets constructed with the tap fees. The useful life of the asset is based on management's estimation of an accounting based useful life and may not have any correlation to the actual life of the asset or the actual service life of the tap. This is deemed a reasonable recognition life of the revenues because the depreciation of the assets constructed generating those revenues will be matched with the revenues.

Impairment of Water Assets and Other Long-Lived Assets

In accordance with Statement of Financial Accounting Standard No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (SFAS 144), we review our long-lived assets for impairment at least annually or whenever management believes events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. We measure recoverability of assets to be held and used by a comparison of the carrying amount of an asset to estimated future undiscounted net cash flows we expect to be generated by the eventual use of the asset. If such assets are considered to be impaired and therefore the costs of the assets deemed to be unrecoverable, the impairment to be recognized would be the amount by which the carrying amount of the assets exceeds the estimated fair value of the assets.

We estimate that we have the ability to provide water services to approximately 180,000 SFEs using our combined Front Range and Arkansas River water assets which have a carrying value of approximately \$97.6 million as of May 31, 2009. Based on the carrying value of our water rights, the long term and uncertain nature of any development plans, current tap fees (\$21,500) and estimated gross margins, we estimate that we would need to add approximately 8,400 new water connections (requiring approximately 5% of our portfolio) to generate net revenues sufficient to recover the costs of our Front Range and Arkansas River water assets. If tap fees increase 5%, we would need to add approximately 8,000 new water taps (requiring approximately 4.8% of our portfolio) to recover the costs of our Front Range and Arkansas River water assets. If tap fees decrease 5%, we would need to add approximately 9,000 new water taps (requiring approximately 5.3% of our portfolio) to recover the costs of our Front Range and Arkansas River water assets.

Our water assets will be utilized in the provision of water services which inevitably will encompass many housing and economic cycles. Our service capacities are quantitatively estimated based on an average single family home utilizing .4 acre-feet of water per year. Our water supplies are legally decreed to us through the Water Court. The Water Court decree allocates a specific amount of water (subject to continued beneficial use) which does not change. Thus, individual housing and economic cycles do not have an impact on the number of connections we can serve or the amount of water legally decreed to us.

We report assets to be disposed of at the lower of the carrying amount or fair value less costs to sell.

Our Front Range and Arkansas River Water Rights

We determine the undiscounted cash flows for our Denver based assets and the Arkansas River Valley assets by estimating tap sales to potential new developments in our service area and along the Front Range, using estimated future tap fees less estimated costs to provide water services, over an estimated development period. Actual new home development in our service area and the Front Range, actual future tap fees, and actual future operating costs, inevitably will vary significantly from our estimates, which could have a material impact on our financial statements as well as our results of operations. We last performed an impairment analysis as of August 31, 2008, and determined that our Rangeview and Arkansas River water assets were not impaired and their costs were deemed recoverable in accordance with SFAS 144. Our impairment analysis is based on development occurring within areas in which we have service agreements (e.g. Sky Ranch and the Lowry Range) as well as in surrounding areas including the Front Range, and the I-70 corridor. Although the withdrawal of the Lowry Range developer, the Sky Ranch bankruptcy filing, and changes in the housing market throughout the Front Range have delayed our estimated tap sale projections, they do not alter our water ownership structure nor our service obligation to these properties. We plan on updating our impairment analysis as of August 31, 2009 unless other events or circumstances warrant an update prior to that date.

Table of Contents**Our Paradise Water Rights**

Every six years the Paradise Water Supply is subject to a Finding of Reasonable Diligence review by the water court and the State Engineer. For a favorable finding, the water court must determine that we continue to diligently pursue the development of the water rights. If the Water Court does not make such a finding, our right to the Paradise Water Supply would be lost and we would be required to impair the Paradise Water Supply asset. The most recent diligence review was started in our fiscal 2005 and was completed in 2008, but not without objectors and not without us having to agree to certain stipulations to remove the objections. In order to continue to maintain the Paradise water right, over the next six years we must (i) select an alternative reservoir site; (ii) file an application in Water Court to change the place of storage; (iii) identify specific end users and place(s) of use of the water; and (iv) identify specific source(s) of the water rights for use. We fully intend to meet the stipulations by the date of the next diligence review.

For our Paradise Water Supply, we determined the undiscounted cash flows by estimating the proceeds we could derive from the leasing of the water rights to commercial, industrial, and agricultural users along the western slope of Colorado, and based on the impairment analysis we completed pursuant to SFAS 144 as of August 31, 2008, we believe the Paradise Water Supply is not impaired and the costs are deemed recoverable. We plan on updating our impairment analysis as of August 31, 2009 unless other events or circumstances warrant an update prior to that date.

Tap Participation Fee

On August 31, 2006, we acquired 60,000 acre-feet of Arkansas River water along with approximately 17,000 acres of real property and other associated rights from HP A&M. Along with common stock issued to HP A&M, we agreed to pay HP A&M 10% (this may increase to 20% under circumstances described in Note 7 to the financial statements contained in our 2008 Annual Report on Form 10-K) of our tap fees on the sale of the next 40,000 water taps we sell from and after the date of the Arkansas River Agreement, of which 38,937 water taps remain to be paid as of May 31, 2009. The Tap Participation Fee is payable when we sell water taps and receive funds from such water tap sales or other dispositions of property purchased in the HP A&M acquisition. The Tap Participation Fee liability is valued by estimating new home development in our service area over an estimated development period. This was done by utilizing third party historical and projected housing and population growth data for the Denver metropolitan area applied to an estimated development pattern supported by historical development patterns of certain master planned communities in the Denver metropolitan area. This development pattern was then applied to estimated future water tap fees determined by using historical water tap fee trends. Based on updated new home activity in the Denver metropolitan area, we updated the estimated discounted cash flow analysis as of February 28, 2009. Due to a lack of significant changes, no such update was deemed necessary as of May 31, 2009. Actual new home development in our service area and actual future tap fees inevitably will vary significantly from our estimates which could have a material impact on our financial statements as well as our results of operations. An important component in our estimate of the value of the Tap Participation Fee, which is based on historical trends, is that we reasonably expect water tap fees to continue to increase in the coming years. Tap fees are a market based pricing metric which in part demonstrates the increasing costs to acquire and develop new water supplies. It is thus a market metric which in part demonstrates the increasing value of our water assets. We continue to assess the value of the Tap Participation Fee liability and update its valuation analysis whenever events or circumstances indicate the assumptions used to estimate the value of the liability have changed materially. The difference between the net present value and the estimated realizable value will be imputed as interest expense using the effective interest method over the estimated development period utilized in the valuation of the Tap Participation Fee.

Obligations Payable by HP A&M

Certain of the properties we acquired pursuant to the Arkansas River Agreement are subject to outstanding promissory notes with principal and accrued interest totaling approximately \$12.4 million at May 31, 2009. These notes are secured by deeds of trust on the properties. We did not assume any of these promissory notes and are not responsible for making any of the required payments under these notes. This responsibility remains solely with HP A&M. However, in the event of default by HP A&M, we may make payments on any or all of the notes and cure any or all defaults. If we do not cure the defaults, we will lose the properties securing the defaulted notes. If HP A&M defaults on the promissory notes, we can foreclose on a defined amount of Pure Cycle stock issued to HP A&M being held in escrow and reduce the Tap Participation Fee by two times the amount of notes defaulted on by HP A&M. Although

the likelihood of HP A&M defaulting on the notes is deemed remote, which is the primary reason these notes are not reflected on our balance sheet, we continue to monitor the status of the notes for any indications of default. We are not aware of any defaults by HP A&M as of May 31, 2009.

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Stock based compensation

We recognize stock-based compensation expense pursuant to Statement of Financial Accounting Standard No. 123 (revised 2004), *Share Based Payment* (SFAS 123(R)). 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 and to expense the fair value over the vesting period of the grant. The fair value of share-based payments requires management to estimate/calculate various inputs such as the volatility of the underlying stock, the expected dividend rate, the estimated forfeiture rate and an estimated life of each option. These assumptions are based on historical trends and estimated future actions of option holders and may not be indicative of actual events which may have a material impact on our financial statements.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

General

Pure Cycle has limited exposure to market risks from instruments that may impact the *Balance Sheets, Statements of Operations, and Statements of Cash Flows*, such exposure is due primarily to changing interest rates.

Interest Rates

The primary objective for our investment activities is to preserve principal while maximizing yields without significantly increasing risk. This is accomplished by investing in diversified short-term interest bearing investments. As of May 31, 2009, the majority of our capital is invested in certificates of deposit with stated maturities and locked interest rates and therefore not subject to interest rate fluctuations. We have no investments denominated in foreign country currencies and therefore our investments are not subject to foreign currency exchange risk.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedure

Our management is responsible for establishing and maintaining adequate internal control over financial reporting as such term is defined in Rule 13a-15(f) of the Securities Exchange Act of 1934, as amended (the Exchange Act). Our internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP.

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports filed or submitted to the SEC under the Exchange Act is recorded, processed, summarized and reported within the time periods specified by the Commission s rules and forms, and that information is accumulated and communicated to management, including the principal executive and financial officer as appropriate, to allow timely decisions regarding required disclosures. The President and Chief Financial Officer evaluated the effectiveness of disclosure controls and procedures as of May 31, 2009, pursuant to Rule 13a-15(b) under the Exchange Act. Based on that evaluation, the President and Chief Financial Officer concluded that, as of the end of the period covered by this report, the Company s disclosure controls and procedures were effective. A system of controls, no matter how well designed and operated, cannot provide absolute assurance that the objectives of the system of controls are met, and no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within a company have been detected.

Changes in Internal Control Over Financial Reporting

None

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PART II

Item 1A. Risk Factors

Our business, operations, and financial condition are subject to significant risks. These risks include those listed in our 2008 Annual Report on Form 10-K and as set forth below and may include additional risks of which we are not currently aware or which we currently do not believe are material. If any of the events or circumstances described in these risk factors actually occurs, our business could be materially adversely affected. These risks should be read in conjunction with the other information set forth in this report and our 2008 Annual Report on Form 10-K.

We are dependent on the development of the Lowry Range, Sky Ranch, and other areas near our Rangeview Water Supply that are potential markets for our Rangeview Water Supply.

Providing water service using our Rangeview Water Supply is one of our principal sources of future revenue. The timing and amount of these revenues will depend significantly on the development of the Lowry Range, Sky Ranch and other potential developments near our Rangeview Water Supply and along the Colorado Front Range. The development of these areas is not within our control.

Lowry Range

As we reported in a Form 8-K filed with the Commission on January 9, 2009, the developer of the Lowry Range terminated its development agreement with the Land Board. We are not aware of any other projects planned by the Land Board and it may be some time before the Land Board commences another project. Moreover, there can be no assurance that development will occur or that water sales will occur on acceptable terms or in the amounts or time required for us to support our costs of operation.

Additionally, the City of Aurora (Aurora) applied for the right to store water in certain reservoir sites, on the Lowry Range, in Water Court. In that proceeding, Aurora applied for the right to store water in certain reservoir sites on the Lowry Range which had previously been adjudicated by the Rangeview Metropolitan District and the Land Board dating back to 1988. As noted above, on June 1, 2009, the Colorado Supreme Court upheld the decision of the Water Court requiring Aurora to remove our reservoir sites from its Water Court application. While Aurora has been unsuccessful so far in obtaining rights to the adjudicated reservoirs under the Lease, additional legal action may become necessary to enforce our rights to the reservoirs and to provide water and wastewater service to the Lowry Range. If additional legal proceedings become necessary and our rights under the Lease are adversely ruled upon in such legal proceedings, it could materially adversely impact the value of our interests, including the value of our Rangeview Water Supply.

Because of the prior use of the Lowry Range as a military facility, environmental clean-up may be required prior to development, including the removal of unexploded ordnance. There is often significant delay in adoption of development plans, as the political process involves many constituencies with differing interests. In the event water sales are not forthcoming or development of the Lowry Range is delayed, we may incur additional short or long-term debt obligations or seek to sell additional equity to generate operating capital. In addition, the Land Board may not develop large portions of the Lowry Range significantly limiting our ability to utilize the non-Export Water specifically reserved for use on the Lowry Range.

Item 6. Exhibits

Exhibits

- 31 Certification pursuant to section 302 of the Sarbanes-Oxley Act of 2002.*
- 32 Certification pursuant to section 906 of the Sarbanes-Oxley Act of 2002.*

* Filed herewith.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned hereunto duly authorized.

PURE CYCLE CORPORATION

/s/ Mark W. Harding

Mark W. Harding
President and Chief Financial Officer
July 10, 2009

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EXHIBIT INDEX

| Exhibit No. | Description |
|--------------------|---|
| 31 | Certification pursuant to section 302 of the Sarbanes-Oxley Act of 2002.* |
| 32 | Certification pursuant to section 906 of the Sarbanes-Oxley Act of 2002.* |

* Filed herewith.