



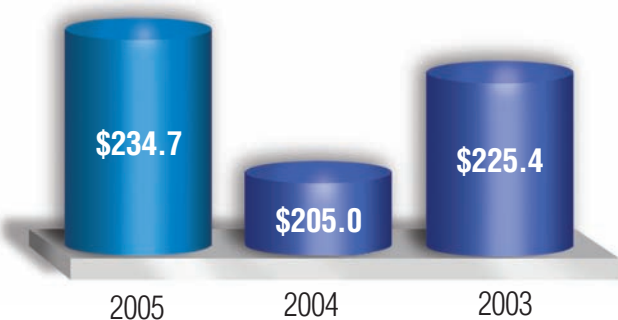
A N N U A L R E P O R T 2 0 0 5

financial highlights

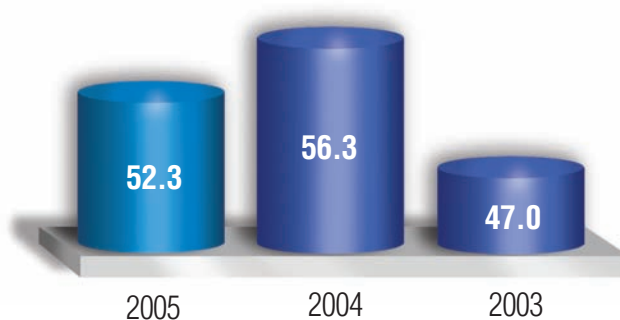
For the years ended August 31:

| | 2005 | 2004 | 2003 |
|--|------------|------------|----------|
| Total revenue ('000s) | \$ 234.7 | \$ 205.0 | \$ 225.4 |
| Gross margin ('000s) | \$ 205.8 | \$ 173.3 | \$ 187.9 |
| Working capital ('000s) | \$ 5,740.3 | \$ 5,738.7 | \$ 541.7 |
| Total assets (in millions) | \$ 26.0 | \$ 25.6 | \$ 20.4 |
| Stockholders' equity (in millions) | \$ 15.4 | \$ 13.3 | \$ 4.4 |
| Gallons of water delivered (in millions) | 52.3 | 56.3 | 47.0 |

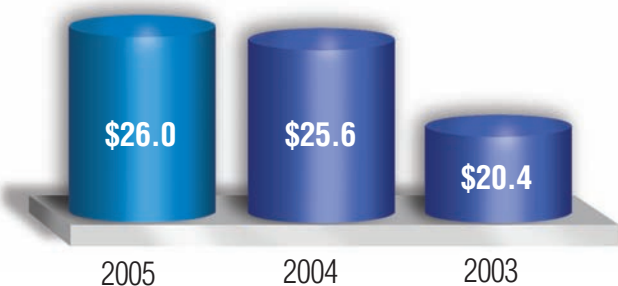
Revenues (thousands)



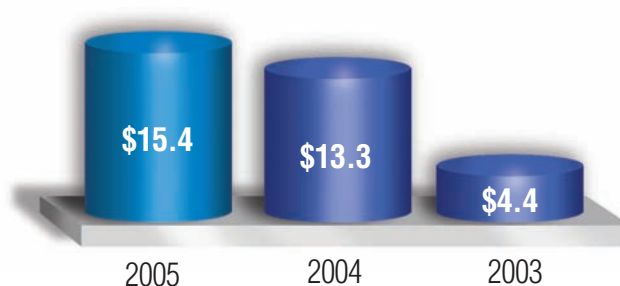
Millions of Gallons of Water Delivered



Total Assets (millions)



Stockholders' Equity (millions)



letter from the president

I am pleased to present Pure Cycle Corporation's 2005 Annual Report. You will notice that along with our Form 10-KSB we have also included the Proxy Statement for our 2006 Annual Stockholders' Meeting to be held on January 17, 2006. Our hope is that these two documents will provide helpful information to assist you with casting your vote for this year's proxy issues.

Fiscal 2005 had many encouraging signs of growth and development for the company. Before I get to the highlights for this past fiscal year, let me begin with a brief description of Pure Cycle, our valuable water assets, and what we are doing to monetize these assets.

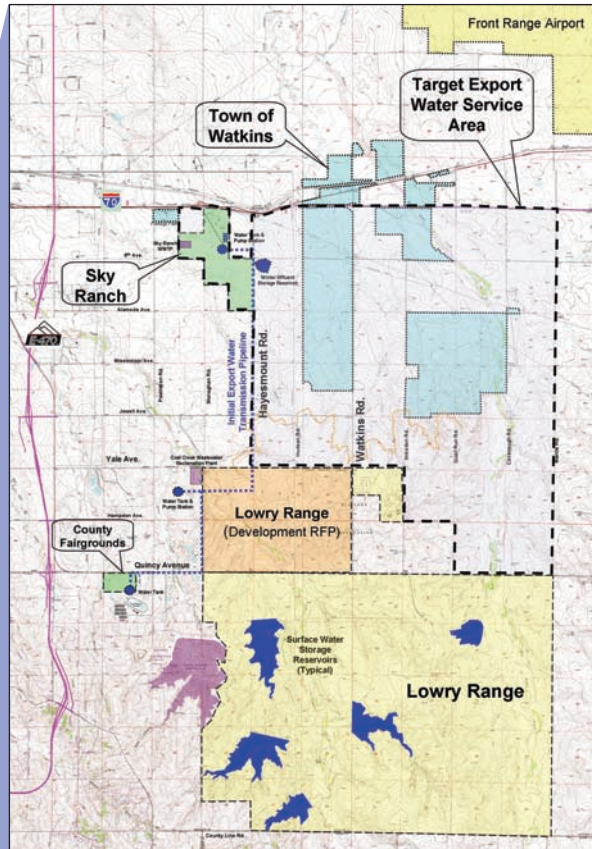
Pure Cycle is an investor-owned water company that provides water and wastewater services to customers located in the Denver, Colorado metropolitan area (see map). We design, construct and operate our systems based on the belief that water is a valuable and often misused, if not wasted, natural resource. With this in mind, our water systems utilize a dual pipe distribution system, which allows us to provide pure clean drinking water to our customers, to collect and treat the wastewater from these customers, and then to utilize the treated effluent for irrigation purposes. In other words, we reclaim, recycle and reuse our valuable water supplies thereby enhancing our service capabilities in a water short region.

Throughout the west, and more particularly the southwest, water is scarce and is seldom naturally available where it is needed most. Water providers in the west have built an extensive network of reservoirs, tunnels, canals, and pipelines to divert, store and transport water from where it is available to various points of use. To make these diversions possible, and to encourage the highest and best use of the water, water ownership interests must be protected so that owners may safely invest in these diversion systems. In the United States, laws and policy governing the ownership of water are typically defined at the individual state level. Colorado has a rich history of protecting water ownership interests as real property

rights that can be bought and sold based on the principles of a free market. It is this free market principle, applied to the delivery of water service, which most clearly differentiates Pure Cycle from most other investor-owned water utilities across the country.

In Colorado, water ownership is one of the most protected and sovereign property rights. Water is one of the few real property interests that is protected against governmental con-

demnation powers of eminent domain. Stated more simply, if owners of water do not wish to sell their water, they can not be compelled to do so. The Public Utilities Commission of Colorado has intentionally not regulated the purchase and sale of water interests. As demand for



water in the southwest region exceeds the water that is available, this scarce resource continues to increase in value. This appreciation in value is evidenced by our 18% increase in tap fees during 2005 (effective July 1, 2005, our tap fees increased from \$12,420 to \$14,740). The rates we charge our customers are governed by our water privatization agreement with the State of Colorado Board of Land Commissioners (referred to as the "State Land Board" throughout this Annual Report). Our rates are market driven and based on the average rates and charges of three surrounding water providers. Some water providers in the Denver metropolitan area are charging tap fees in excess of \$22,000. From a historical perspective, average tap fees in the Denver metropolitan area were around \$7,000 in the year 2000.

We derive revenue from our water assets in two principal manners: (i) the sale of water taps, which give customers the



letter from the president

right to connect to our water systems and obtain service therefrom, and (ii) monthly service fees, which are comprised of a flat fee and a metered consumption charge. In 2005 we expanded our customer base by entering into a water service agreement with Arapahoe County for its new county fairgrounds. This agreement allows us to extend our water system to a new market directly west of the Lowry Range service area. Our main water supply and all of our current customers are located in Arapahoe County and we are pleased to provide service to the new Arapahoe County Fairgrounds (the new fairgrounds are discussed further below).

The Lowry Range Property

Our Denver-based water assets, which we use to serve our existing customers, have the capacity to serve up to 80,000 single family equivalents (“SFE” which is the measure of demand placed on the water system by a typical single family residence but which includes all types of water system customers such as offices, schools, businesses, etc.). This level of development could be readily supported at the Lowry Range and our other target service areas. The Lowry Range consists of 26,000 acres of undeveloped land located in the southeastern portion of the Denver metropolitan area about 12 miles south of the Denver International Airport. As described by the State Land Board, “the Lowry Range is one of the largest parcels under single ownership next to a major metropolitan area in the nation. It is a highly desirable location for entities looking for land on which to build new homes.”

Under agreements with the State Land Board and the Rangeview Metropolitan District, we own or have the exclusive rights to use: (i) nearly 30,000 acre-feet per year of groundwater, (ii) approximately 3,200 acre-feet per average year of surface water, and (iii) 25,000 acre-feet of surface storage. Approximately 18,000 acre-feet per year of the groundwater and one-half of the surface water is reserved for use exclusively at the Lowry Range, which can provide service to approximately 47,000 SFE. The remaining water, the “Export Water”, has a capacity to serve approximately 33,000 SFE and can be exported off the Lowry Range to serve other areas in the Denver metropolitan region.

The area surrounding the Lowry Range has experienced tremendous growth in recent years. Development is occurring along three borders of the property. Recognizing this heightened development activity in the immediate vicinity of the Lowry Range, in October 2005 Colorado’s Governor Bill

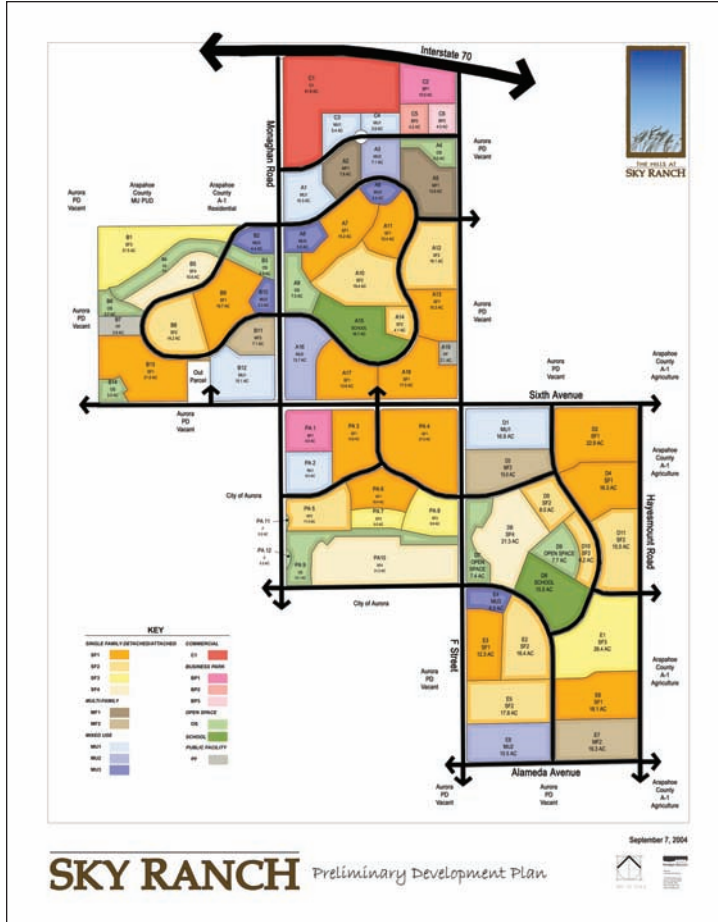
Owens, together with the State Land Board, announced plans to solicit proposals for assistance with the development of an initial 3,800 acres of the Lowry Range as well as separate proposals for assistance with conservation and open space uses of the balance of the property. The release of these requests for proposals followed the State Land Board’s adoption of a three-part vision for the overall use of the property, which consists of (i) development of water resources, (ii) open space and conservation plans, and (iii) “smart growth”. Proposals are due to the State Land Board by April 20, 2006. We look forward to working with the State Land Board and the development community on this exciting project.

Currently, we provide service to five customers at the Lowry Range, the largest of which is the 500-bed Ridge View youth services campus (pictured below). The campus is operated by a private contractor for the Colorado Department of Human Services and includes 238,000 square feet of program space, residence halls, athletic playing fields, and other amenities. In fiscal 2005, water and wastewater service fee revenue from this campus was \$171,000, which accounted for 81% of our total service fee revenues.



Sky Ranch

Sky Ranch is a planned 950-acre development located 4 miles north of the Lowry Range along Interstate 70. Sky Ranch is a mixed use master planned community slated for up to approximately 4,800 residences (comprised of a mixture of single family detached homes, single family attached homes and multifamily units). Additional development proposed at Sky Ranch includes up to one million



square feet of retail and commercial development, schools, open space, and other community facilities. Under the Sky Ranch water service agreements, we have acquired 89 acre-feet of water from the developer with the rights to acquire an additional 671 acre-feet, which water will be used to serve the first 1,500 taps at Sky Ranch. The remaining taps will be served with our Export Water. Water facilities to be constructed to serve Sky Ranch will be funded primarily through the sale of water taps, which are one-time fees paid by developers and builders to access our water system. We estimate that the water facilities will cost approximately \$25 million at build out and we will develop these facilities incrementally as development occurs in a manner that benefits both Pure Cycle and the customers at Sky Ranch.

Based on earlier discussions with the developer of Sky Ranch, we originally expected Sky Ranch to purchase their initial taps in 2005. However, due to delays associated with a complicated land transaction and the completion of the final engineering and design work for the development, this did not happen. In recent weeks we have met with the developer regarding its final designs for the development and specifical-

ly addressing water and wastewater infrastructure locations, sizing, capacities and phasing schedules. We look forward to beginning construction on the water facilities in 2006.

Arapahoe County Fairgrounds

In August 2005, we welcomed our newest customer with the signing of a water service agreement with Arapahoe County to provide water service to its new county fairgrounds. The new fairgrounds are located south of Quincy Avenue and east of E-470 about 1 mile west of the Lowry Range. Plans for the fairgrounds envision a multi-use project which will be developed in several phases. The new fairgrounds will provide year-round access to open space and multipurpose buildings for County residents and serve a variety of uses including urban forestry, natural resource and wildlife education, consumer and family education, science fairs, rodeos, concerts, theater and heritage arts. The bike, equestrian and pedestrian trails and open space at the fairgrounds property will be accessible to everyone and will expand upon the adjoining open space and recreational amenities in the City of Aurora and proposed for at the Lowry Range. The County plans to open the first-phase of the fairground facilities in the summer of 2006 for the 100th anniversary celebrations

of Arapahoe County.

Under the fairground's water service agreement, the County purchased water taps for 38.5 single family equivalents for \$567,000, based on our tap fees that became effective on July 1, 2005. The County will also provide funding of approximately \$1.25 million which we will use to build certain facilities required to extend water service to the fairgrounds. The



letter from the president

picture above was taken in November 2005 and shows the 500,000 gallon, 175-foot tall elevated water storage tank being constructed to serve the fairgrounds. The tank is scheduled for completion in April 2006. Taking advantage of efficiencies that can be realized on construction projects of this size, we are building additional capacity into the fairgrounds infrastructure that will enable us to serve future customers both on and off of the Lowry Range while at the same time increasing the level of service to our existing customers. Additionally, we are acquiring approximately 360 acre-feet per year of groundwater from the County. Although this new asset is not reflected on our FY2005 balance sheet since we have not yet received the associated water rights deeds, we will use this newly acquired water in conjunction with our other water assets to expand and enhance our capabilities to meet the area's water needs. We are excited about this opportunity with the County and look forward to watching the fairgrounds open and grow over the coming years.

Other Target Service Areas

The Denver Regional Council of Governments projects that the population of the Denver metropolitan area will grow to over 3.9 million people by the year 2030, which is a 50% increase over the population in 2005. As the population increases, the need for additional water supplies grows more and more critical. It is estimated that an additional 200,000 acre-feet of water per year will be required over the next twenty five years to meet the growing demands for water in the Denver metropolitan area. Although over 80% of Colorado's population resides on the eastern side of the Rocky Mountains, over 80% of Colorado's water originates as snow and rain on the western side of the Rocky Mountains. This imbalance between where water demands exist and where water supplies originate and are available is a main concern of every water provider along the Front Range. To address this imbalance, developers and property owners must typically identify and make available adequate water supplies to serve their proposed developments in order to obtain favorable consideration for rezoning and other development approvals. Numerous reservoirs and tunnels have been built to transport an average of 500,000 acre-feet per year of water from other river basins (including the Arkansas and Colorado Rivers) to meet water demand along the Front Range. Even with these trans-basin diversions, the Denver metro area still faces a 'water supply crisis' by the year 2025. Further, the additional 1.3 million people projected for the Denver metropolitan area by year 2030 equates to an additional 350,000 new homes and

an additional 120 million gallons per day of wastewater, which is nearly equal to the current flow at the region's largest wastewater reclamation facility.

In light of these projections, we believe we are well positioned to significantly grow our customer base and enhance stockholder value. Our most significant water assets are located in the southeastern Denver metropolitan area and we continue to expand our water and wastewater service capabilities and to increase our water portfolio holdings. We have master planned our water and wastewater management programs to take full advantage of our water storage assets and to optimize the reuse of our valuable water supplies by implementing dual-pipe distribution systems.

As discussed above and in our financial statements, Pure Cycle achieved growth in its water asset holdings, targeted service area, and customer base during 2005. I also want to welcome a new member to our board of directors. Mr. Peter Howell was a former CEO of Mr. Coffee and currently serves on the boards of Libbey, Inc. as well as numerous privately held companies. Mr. Howell received a Masters in Economics from Cambridge University and is certainly a welcome addition to our board. Sadly though, this year we also said goodbye to our former CEO and longtime director Mr. Thomas P. Clark. Tom passed away in June 2005. Tom's guidance and friendship will be missed by all who knew him and I personally lost one of my closest friends.

As we continue to negotiate new water and wastewater service agreements, and as we seek to acquire new water supplies to further enhance our already valuable water portfolio, I would like to personally thank our stockholders for all your continued support and dedication to Pure Cycle.

If you would like to read more about Pure Cycle, or contact me with any questions or comments, please visit our web site at www.purecyclewater.com.



Mark W. Harding, *President*

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549**

Form 10-KSB

☒ ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended August 31, 2005

☐ TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Commission File Number 0-8814

PURE CYCLE CORPORATION

(Name of small business issuer as specified in its charter)

| | |
|--------------------------|--------------------------------------|
| Delaware | 84-0705083 |
| (State of incorporation) | (I.R.S. Employer Identification No.) |

| | |
|---|------------|
| 8451 Delaware Street, Thornton, CO 80260 | |
| (Address of principal executive office) | (Zip Code) |

Issuer's telephone number: **(303) 292-3456**

| | | |
|--|-----------------------|--|
| Securities registered under Section 12(b) of the Exchange Act: | <u>Title of Class</u> | <u>Name of each exchange on which registered</u> |
| | None | None |

Securities registered pursuant to Section 12(g) of the Exchange Act:

**Common Stock,
1/3 of \$.01 par value
(Title of class)**

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

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B contained in this form, and no disclosure will be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB []

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

Yes [] No [X]

Revenues for fiscal year ended August 31, 2005: \$234,654

The approximate aggregate market value of the voting stock and non-voting common equity held by non-affiliates: \$68,553,000 (based upon closing price on the NASDAQ SmallCap market on October 31, 2005)

Number of shares of Common Stock outstanding, as of October 31, 2005: 14,532,148

Transitional Small Business Disclosure Format (Check One): Yes [] No [X]

Documents incorporated by reference: Portions of the Registrant's definitive Proxy Statement for the Registrant's 2006 Annual Meeting of Stockholders are incorporated by reference under part III of this annual report on form 10KSB.

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**“SAFE HARBOR” STATEMENT UNDER THE UNITED STATES PRIVATE
SECURITIES LITIGATION REFORM ACT OF 1995**

Statements that are not historical facts contained in this Annual Report on Form 10-KSB are forward looking statements that involve risk and uncertainties that could cause actual results to differ from projected results. The words “anticipate,” “believe,” “estimate,” “expect,” “plan,” “intend” and similar expressions, as they 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.

PART I

Item 1. Description of Business

General

Pure Cycle Corporation was incorporated in the State of Delaware in 1976. We were founded on the belief that water is a precious commodity, one that is often undervalued and therefore used inefficiently. We continue to operate under this belief today. Our business emphasizes the design, construction, operation and maintenance of water and wastewater reclamation systems. Utilizing our significant water assets located in the Denver, Colorado metropolitan area, we withdraw, treat, store and deliver water to our customers, and then collect wastewater from our customers which is treated and reused through our dual distribution system. To ensure we have sufficient water to meet the needs of our customers and to promote an efficient and environmentally responsible water management program, we design and operate dual distribution water systems whereby domestic water demands and irrigation demands are provided through separate independent infrastructure. Our dual distribution system design promotes efficient water resource management and reduces the amount of water that is “wasted” by traditional water systems, enabling us to maximize the use of our valuable water supplies.

The Denver metropolitan region continues to experience tremendous growth and with the limited availability of new water supplies, many metropolitan planning agencies are requiring property developers to demonstrate adequate water availability prior to any consideration for zoning requests for property development. We believe we are well positioned to market and sell our water and wastewater services to municipalities, developers and homebuilders seeking to develop new communities both within the Lowry Range Property (which is described below) as well as in other areas in the growing Denver metropolitan region.

Description of Our Water Assets and Related Service Agreements

The water assets we own or have the exclusive rights to use consist of the following annual entitlements:

- We own approximately 11,650 acre-feet of water located at the Lowry Range Property, which we can “Export” from the Lowry Range Property to supply water to nearby communities and developers in need of additional water supplies (this water asset is referred to as our “Export Water”);
- We have the exclusive rights to use, through 2081, approximately 17,620 acre-feet of water located at the Lowry Range Property. This water is required to be used specifically on the Lowry Range Property (collectively we refer to the 17,620 acre-feet of water designated for use specifically on the Lowry Range Property and the 11,650 acre-feet of Export Water as our “Rangeview Water Supply”);

- Pending satisfactory receipt of a Water Rights Deed, we will own approximately 363 acre-feet of groundwater we acquired from Arapahoe County (the “County”) pursuant to an Agreement for Water Service (the “County Agreement”). This water will be used in conjunction with our Rangeview Water Supply;
- We own approximately 89 acre-feet of water located beneath Sky Ranch (described below) together with the right to purchase an additional 671 acre-feet of water (for a total of 760 acre-feet), which will be used to provide water service to the initial 1,500 taps purchased at Sky Ranch; and
- We own conditional water rights in western Colorado that entitle us to build a 70,000 acre-foot reservoir to store tributary water on the Colorado River; a right-of-way permit from the U.S. Bureau of Land Management for property at the dam and reservoir site; and four tributary water wells with a theoretical capacity to produce approximately 56,000 acre-feet of water annually (collectively known as the “Paradise Water Supply”).

Construction of water and wastewater systems and the providing of water and wastewater services are subject to individual water and wastewater service agreements. We negotiate individual agreements with developers and/or homebuilders to provide the design, construction and operation of water and wastewater systems and services. Our service contracts outline our obligations to design, construct and operate certain facilities necessary to develop and treat water and treat and reuse wastewater. These service agreements include the timing of installation of the facilities, required capacities of the systems, and locations for the services to be provided. Service agreements address all aspects of the development of the water and wastewater systems including: (i) the purchase of water and wastewater taps in exchange for our obligation to construct the wholesale water and wastewater facilities; (ii) the establishment of payment terms, timing and location of “Special Facilities” (if any); and (iii) specific terms related to our provision of ongoing water and wastewater services.

The Rangeview Water Supply and Related Agreements

Rangeview Agreements

We acquired the Rangeview Water Supply in 1996 when (i) on April 4, 1996, the State of Colorado Board of Land Commissioners (the “State Land Board”) and the Rangeview Metropolitan District (the “District”), a quasi-municipal political subdivision of the State of Colorado, entered into the Amended and Restated Lease Agreement, (ii) on April 11, 1996, we entered into the Agreement for Sale of Export Water with the District, and (iii) on April 11, 1996, we entered into the Service Agreement with the District to design, construct, operate and maintain the water systems to provide water service to the Lowry Range Property through 2081 (collectively these agreements are referred to as the “Water Privatization Agreements”). The Water Privatization Agreements provide that we will design, construct, operate and maintain the District’s water system to provide water service to the District’s customers on the Lowry Range Property. Pursuant to the Water Privatization Agreements, approximately 17,620 acre-feet of water per year located on the Lowry Range Property is dedicated for use specifically on the Lowry Range Property. In exchange for providing water service to customers within our service area, we will receive 95% of all amounts received by the District relating to water services, after the District pays the required royalties to the State Land Board initially totaling approximately 12% of gross revenues received from water sales. The District’s service area is located in Arapahoe County and is bordered by the City of Aurora. A number of residential housing developments are currently under construction directly adjacent to the District’s service area.

We also design, finance, construct, operate and maintain the District’s wastewater system to provide wastewater service to customers within our service area. In exchange for providing wastewater service for the District’s customers within our service area, we receive 100% of the District’s wastewater tap fees, and 90% of the District’s wastewater usage fees as well as the rights to sell the reclaimed water.

Lowry Range Property Water and Export Water

The Lowry Range Property encompasses approximately 26,000 acres, of which 24,000 acres are within our exclusive service area. The Lowry Range Property is located in unincorporated Arapahoe County 15 miles southeast of Denver and 12 miles directly south of the Denver International Airport. The State Land Board acquired the property in the 1960’s and has stated that the Lowry Range Property is one of the most valuable pieces of property in its nearly 2.5 million acre portfolio. The State Land Board has explored a number of development

models for the property including: development similar to that which is ongoing adjacent to the property's western borders; a new planned community; and a compact development model with high density "village" centers surrounded by large expanses of open space. In October 2005, the State Land Board announced that it is seeking a partner to "assist with the entitlement, resource planning and development" of the Lowry Range Property. To do this, the State Land Board issued two requests for proposals ("RFPs"), one for the development of an initial 3,800 acres of the Lowry Range Property and a second for the conservation of a majority of the remaining property. Also in October 2005, the State Land Board adopted a three-part vision for the overall use of the property, consisting of (i) development of water resources, (ii) open space and conservation plans, and (iii) "smart growth" or contained development of the property. We do not have any guidance from the State Land Board relating to the timing of any development on the Lowry Range Property; however, responses to the RFPs are due to the State Land Board by April 20, 2006. Additional water sales will only occur after development has commenced. In the event development of the Lowry Range Property and the surrounding areas is delayed, or the State Land Board determines to limit the use of significant portions of the Lowry Range Property for open space, we may be required to incur additional short-term or long-term debt obligations or seek to sell additional equity to generate operating capital until demand arises for our water assets.

The Rangeview Water Supply is a combination of tributary surface water, nontributary groundwater rights, and storage rights associated with the Lowry Range Property. We own the rights to use 11,650 acre-feet of tributary surface water and non-tributary groundwater that can be exported off the Lowry Range Property to serve area users. We also have the exclusive rights to use an additional 17,620 acre-feet of tributary surface water and nontributary groundwater to serve customers on the Lowry Range Property. The Export Water we own, together with water that is owned by the State Land Board that we have contracted to utilize under our service agreements, totals over 29,270 acre-feet of water per year.

Based on independent engineering estimates, the 17,620 acre-feet of water designated for use on the Lowry Range Property is capable of providing water service to approximately 46,500 Single Family Equivalent ("SFE") units, and the 11,650 acre-feet of Export Water we own can serve approximately 33,600 SFE units throughout the Denver metropolitan region, for a combined total service capacity of approximately 80,100 SFEs. An SFE is defined in the District's Rules and Regulations as the amount of water required each year by a family of four persons living in a single family house on a standard sized lot.

On the Lowry Range Property, we operate both the water and the wastewater systems during our contract period and the District owns both systems. However, after 2081 ownership of the water system servicing customers on the Lowry Range Property will revert to the State Land Board, with the District retaining ownership of the wastewater system. Off the Lowry Range property, we will use our Export Water to provide water and wastewater services to our customers, and we will own the assets. We plan to contract with third parties for the construction of these facilities.

Export Water

Colorado municipalities have strong incentives to attract commercial development to their areas, as a large portion of their revenues are derived through sales tax receipts. Cities and municipalities historically have used water availability as a means to attract development. As water has become scarce, cities and municipalities have begun requiring property developers to demonstrate that they have sufficient water supplies for their proposed projects before the cities and municipalities will consider rezoning applications.

Our water marketing activities are centered around targeting our water and wastewater services to developers and homebuilders developing new areas of the Denver metropolitan area. Our water supplies are largely undeveloped and are located in the southeast portion of the greater Denver area in Arapahoe County, one of the fastest growing regions of the Denver metropolitan area. We work with area developers to investigate water supply constraints, water and wastewater utility issues, market demand, transportation concerns, employment centers and other issues in order to identify suitable areas for development. As projects are identified, the Company negotiates specific water and wastewater service agreements which include the timetable for development, the specifications for water and wastewater service capacities, the timing of those services and the timing of payments for such services.

A portion of the proceeds from the sale of Export Water are subject to the Comprehensive Amendment Agreement No. 1 (the "CAA"), which is one of the agreements we used to purchase our Export Water and is more fully described in "*Item 6 – Critical Accounting Policies – Accounting for CAA Payments*" and Note 4 of the accompanying financial statements.

Arapahoe County Fairgrounds Agreement for Water Service

Effective August 3, 2005, we entered into the County Agreement to design, construct, operate and maintain a water system for, and provide water services to, the new Arapahoe County Fairgrounds and Regional Park (the "Fairgrounds"). The County Agreement includes the following: (i) the County purchased water taps for 38.5 SFEs for approximately \$567,500, or \$14,740 per tap; (ii) we agreed to design and build certain Special Facilities (defined below) required to provide water service to the Fairgrounds, for which the County will pay us approximately \$1.25 million, and (iii) we agreed to buy approximately 363 acre-feet of groundwater from the County for \$293,000. As of August 31, 2005, we have not received the Water Rights Deed, and therefore, we will not capitalize the cost of this water until the satisfactory transfer of this deed.

We expect to service the Fairgrounds using our Export Water, therefore, the tap fees we received generate royalty payments to the State Land Board. The agreement with the State Land Board requires royalty payments on Export Water sales based on the net revenues we receive. These net revenues are defined as proceeds from the sale of Export Water less direct and indirect costs, including reasonable overhead charges, associated with the withdrawal, treatment and delivery of Export Water. Based on this, in September 2005 we made a royalty payment to the State Land Board of approximately \$34,500, which is 10% of the net revenues we received from the sale of Export Water taps. This is shown as Royalties Payable to the State Land Board in the accompanying balance sheet. In addition to the royalties to the State Land Board the tap fees received from the County are subject to the CAA. Therefore, approximately \$533,000 of the tap fees received from the County, which is the total tap fees less the \$34,500 State Land Board royalty, was distributed to the escrow agent, as required by the CAA, in September 2005. Based on the 2004 CAA acquisitions we made, we received \$373,100, or 70% of this distribution, and external parties received \$159,900, or 30%. The \$159,900 paid to third parties in September 2005 is reflected in the accompanying balance sheet as *Payable to contingent obligation holders*. The tap fees retained by the Company will be used to construct the Wholesale Facilities required to provide water service to the Fairgrounds.

Pursuant to the County Agreement, payment for the design and construction of the Special Facilities required an initial payment of \$397,000 (which we received in August 2005), credits totaling \$240,000 for the groundwater we purchased from the County as described below, and monthly payments of approximately \$6,850 for 10 years (this includes interest at 6% per annum). The monthly payments begin upon acceptance of the construction of the Special Facilities.

Pursuant to the County Agreement, the payments for the water we purchased from the County were made in the form of water tap credits and credits against the Special Facility surcharges payable to us by the County. Therefore, instead of the County paying us \$567,500 in cash for the water taps, we received a net payment of \$514,500 (received in August 2005) and rights to 27 acre-feet of groundwater with a value of approximately \$53,000. Further, instead of the County paying us \$1.25 million in cash for the Special Facilities surcharges, we received an initial cash payment of \$397,000 (received in August 2005), rights to 336 acre-feet of groundwater with a value of approximately \$240,000, and an obligation from the County to pay the remaining \$608,000 over the next ten years (as described above). The water we acquired we will be capitalized as part of "Investments in Water and Water Systems" in our balance sheet upon the satisfactory receipt of the Water Rights Deed. Additionally, this water is pending final adjudication, and therefore, the amounts acquired, as well as the costs, may be adjusted upon the final adjudication as necessary.

In August 2005, we entered into a contract with a third party to construct a 500,000 gallon water tank for use at the Fairgrounds. The water tank will cost approximately \$900,000, which is payable based on contractual milestones over the next twelve months. In August 2005, we made the initial payment of \$218,500 (which is recorded as construction in progress on the accompanying balance sheet). No other construction contracts have

been entered into as of the date of this filing; however, we anticipate all construction activities will be performed by third party contractors.

Sky Ranch Water Supply and Water Service Agreements

On October 31, 2003, and May 14, 2004, we entered into two Water Service Agreements (collectively the “Sky Ranch Agreements”) with the developer of approximately 950 acres of property located 4 miles north of the Lowry Range Property along Interstate 70 in Colorado, known as Sky Ranch. Under the Sky Ranch Agreements, we will provide water service to the homes and other buildings that are expected to be built at Sky Ranch, which could be as high as 4,850 SFEs.

Based on discussions with the developer of Sky Ranch, we had anticipated the developer purchasing the initial taps in our second quarter of fiscal 2005. To date, we have not received any payments for tap purchases from the developer, but we continue to have discussions with the developer regarding timing of tap purchases and the expected start date of the project. The developer has informed us that it is actively engineering the final design of the project and is marketing lots to several national home builders with operations in the Denver area. Based on these discussions, we have begun the design and engineering of the required water facilities but will not initiate construction until such time as we receive notice from the developer to proceed together with payment for the initial tap purchases.

As part of the Sky Ranch Agreements, the developer will dedicate approximately 537 acre-feet of water to us in exchange for a \$3,400 per tap credit for the first 767 water taps purchased. Additionally, pursuant to the Sky Ranch Agreements, the developer is required to pay us \$3.41 million for the construction of certain Special Facilities required to extend service to Sky Ranch. As of August 31, 2005, none of this water has been dedicated to us because Sky Ranch has not yet purchased any water taps.

On October 31, 2003 we entered into the Denver Groundwater Purchase Agreement (the “DGPA”) which provides us the option to purchase a total of 223 acre-feet of adjudicated water rights owned by the developer of Sky Ranch for five payments of \$50,000 each, or a combined total of \$250,000. Under the DGPA, we can acquire 44.6 acre-feet of water per year (or 20% of the total 223 acre-feet) for \$50,000. On March 26, 2004, and May 26, 2005, we exercised our options and purchased a total of 89.2 acre-feet of Denver aquifer groundwater for payments totaling \$100,000. We anticipate exercising our remaining options over the next three years to complete the purchase of the remaining 133.8 acre-feet of Denver aquifer groundwater from Sky Ranch which will require payments totaling \$150,000.

By combining the 537 acre-feet of water to be dedicated by the developer of Sky Ranch together with the 89.2 acre-feet of water already purchased, and the 133.8 acre-feet anticipated to be purchased under the DGPA, we will have acquired a total of 760 acre-feet of water from Sky Ranch, which we plan to use to provide water service to the first 1,500 SFEs at Sky Ranch.

Paradise Water Supply

In 1987 we acquired the conditional rights to build a 70,000 acre-foot reservoir to store tributary water on the Colorado River; a right-of-way permit from the U.S. Bureau of Land Management for property at the dam and reservoir site; and four tributary water wells with a theoretical capacity to produce approximately 56,000 acre-feet of water annually. We will seek to utilize our Paradise Water Supply to deliver water to customers located in the Denver metropolitan area or to customers in the downstream states of Nevada, Arizona and California. However, due to the strict regulatory requirements for constructing an on-channel reservoir, completing this conditional storage right at its decreed location could be difficult. As a result, there can be no assurance that we will ever be able to make use of this asset or sell the water profitably. Every six years our Paradise Water Supply is subject to a Finding of Reasonable Diligence review by the water court and the State Engineer to determine if we are diligently pursuing the development of the water rights. During fiscal 2005, the State Engineer began this review. At this time we are unable to estimate when the review will be complete or the final outcome of the review. An unfavorable outcome could include the State Engineer and water court canceling our conditional rights, which would have a material adverse effect on our financial statements. Since we acquired the Paradise Water Supply in

1987, we have received a satisfactory Finding of Reasonable Diligence at each of these reviews. We will continue to vigorously defend our rights to the Paradise Water Supply.

In accordance with Financial Accounting Standards Board (“FASB”) Statement of Financial Accounting Standard No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (“SFAS 144”), at least annually, we review our long-term assets, including our Paradise Water Supply, for indicators of impairment. Consistent with SFAS 144, we compare the carrying amount of our Paradise Water Supply asset to the sum of the undiscounted cash flows from the expected eventual use of the asset. Our assessment of the recoverability of the carrying value of the Paradise Water Supply assumes revenues from water tap sales and monthly metered water usage fees offset by wholesale development costs, which are based on engineering estimates, over a 35 year development horizon. Based on the latest annual assessment (last test performed as of August 31, 2005), the fair value of the Paradise Water Supply exceeded the carrying value, and therefore, no impairment was found to exist.

Revenues

We generate revenues predominately from three sources: (i) Water and wastewater tap fees, (ii) Construction fees, and (iii) Monthly service fees.

We negotiate the payment terms for tap fees, construction fees, and other water and wastewater service fees with each developer or builder before we commit to providing service and before construction of the project begins.

Water and Wastewater Tap Fees

Tap fees are typically paid by the developer in advance of any construction activities. Tap fees are designed to: (i) fund construction of the “Wholesale Facilities”, and (ii) defray the acquisition costs of obtaining water rights. Wholesale Facilities are those facilities necessary to withdraw, treat and deliver water and treat and re-use wastewater, such as wells and pump stations, water collection pipelines, water treatment plants, storage tanks and wastewater treatment plants. Tap fees are payable by the developers in advance of their construction activities, are non-refundable and are typically added to the cost of the house or business.

Under our privatization agreement with the District and the State Land Board, pricing for water tap fees (as well as water usage charges described further below) is controlled through a market-driven pricing mechanism in which our rates and charges may not exceed the average of similar rates and charges of three nearby communities (referred to as the “rate-based districts”). Due to increases in tap fees at the rate-based districts, effective July 1, 2005, water tap fees increased to \$14,740 per tap, which is an increase of 18.7% over the prior year. Wastewater tap fees remained unchanged at \$4,883. Table 1 provides a summary of our tap fees over the past several years:

Table 1 – Water System Tap Fees

| | Year | | | | | |
|---------------------|----------|-----------|-----------|-----------|-----------|-----------|
| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
| Tap fees (per SFE) | \$ 8,165 | \$ 10,500 | \$ 10,500 | \$ 11,150 | \$ 12,420 | \$ 14,740 |
| Percentage Increase | - | 28.6% | - | 6.2% | 11.4% | 18.7% |

Developers owning rights to either surface water or groundwater underlying their properties can receive a credit against a portion of their tap fees if they sell their water to us.

Construction Fees

The development of water and wastewater systems may require the construction of facilities to extend services to an individual development, which facilities likely would not be used by other customers. These facilities are commonly referred to as “Special Facilities”. Special Facilities can include items such as infrastructure required during the construction of the permanent water and wastewater systems, transmission pipelines to transfer water from one location to another, temporary storage facilities, etc. Generally we are not responsible for the design and

construction of the Special Facilities - this is the developer's responsibility - but we are typically responsible for the operation and maintenance of these Special Facilities. We will accept responsibility for the design and construction of the Special Facilities, if the developer provides funding for the construction and determines the timing, location and capacity levels of the facilities. We will then budget, plan and manage the construction of the Special Facilities. If the developer constructs the Special Facilities, they are required to dedicate those to us at no charge. If we construct the Special Facilities, we capitalize the construction costs, and upon completion, we own the Special Facilities.

If we agree to build the Special Facilities, the funding received from the developer is deferred until construction is completed and the assets are placed into operation. At that time, the funding from the developer is recorded as income over the estimated service period, which is also the estimated useful life of the assets constructed with those funds. The depreciation charges for the Special Facilities are recorded as costs of revenue over the estimated useful life of the assets.

Developers are usually responsible for the design and construction of "Retail Facilities" - the water distribution system that transports the water throughout the subdivision or community. Retail Facilities are constructed pursuant to our design standards and are inspected by our engineers prior to completion. Once we certify that the Retail Facilities have been constructed in accordance with our design criteria, the developer will dedicate the Retail Facilities to us or the District at no cost. At Sky Ranch, the developer will dedicate the Retail Facilities to the District. We, or the District, are then responsible for the operation and maintenance of the Retail Facilities.

"Customer Facilities" consist of water service pipelines, plumbing, meters and other components that carry potable water and reclaimed water from the street to the customer's house and collect wastewater from the customer's house and transfer it to the street. In many cases, portions of the Customer Facilities are constructed by the developer, again pursuant to our design standards, but are owned and maintained by the customer.

Monthly Service Fees

Monthly water usage charges are assessed to each customer connected to our water system and are based on actual metered usage each month. Water usage pricing is based on a tiered pricing structure which is based on our rate-based districts. Effective July 1, 2005, the tiered pricing structure increased to the following amounts based on increases at the rate-based districts:

Table 2 – Tiered Pricing Structure

| Consumption (1,000 gallons/month) | Price (\$/1,000 gallons) |
|--------------------------------------|-----------------------------|
| zero to 10 | \$2.46 |
| >10 to 20 | \$3.17 |
| >20 | \$5.54 |

The pricing structure is sensitive to the date and volume of water use. Based on this, for a typical residential customer using approximately 0.4 acre-feet of water annually, water usage fees would approximate \$600 per year.

Wastewater customers are charged a flat monthly fee, which as of July 1, 2005, was increased to \$34.80 per tap, or approximately \$420 per year per tap. We also collect other relatively small fees and charges from residential customers and other end users to cover miscellaneous administrative and service expenses, such as application fees, review fees and permit fees.

State Land Board Royalties and District Fees

Under the Water Privatization Agreements, the State Land Board is entitled to royalty payments based on a percentage of revenues earned from water sales that utilize water dedicated for use on the Lowry Range Property or for Export Water Sales. The calculation of royalties depends on whether the customer is located on the Lowry Range Property, or elsewhere, and whether the customer is a public or private entity. In addition, for water sales to customers located on the Lowry Range Property, the District is entitled to a 5% fee, which is calculated after the

royalty payment to the State Land Board, and the District is entitled to a fee of 10% of our wastewater fees (not including wastewater tap fees) for customers on the Lowry Range Property. The State Land Board does not receive a royalty on wastewater tap fees or service fees.

The Water Privatization Agreements were written prior to any development of the Lowry Range Property or areas outside of the Lowry Range Property that could utilize our Export Water. For that reason, the Water Privatization Agreements could not anticipate all the specific circumstances that might arise in the future as we enter into and negotiate agreements for the sale of Export Water or for the provision of service to the Lowry Range. Therefore, the Water Privatization Agreements may not clearly delineate the rights and responsibilities of the parties for each transaction that may arise. We anticipate that we will be required to enter into negotiations with the State Land Board from time to time to clarify the applicability of contract terms to circumstances that were not anticipated at the time we entered into the Water Privatization Agreements. We cannot assure you that the outcome of such negotiations will be favorable to us.

Lowry Range Property Customers

For services to customers located on the Lowry Range Property, the District collects fees from customers, pays the royalties to the State Land Board, retains its own fee, and remits the remainder to us. Payments from customers who are on the Lowry Range Property generate royalties to the State Land Board at a rate of 12% of gross revenues. The State Land Board has the option to convert their royalty interest whereby, instead of the 12% royalty payments, they could elect to receive royalty payments equal to 50% of the aggregate net profits of the District and us if (i) metered production in any calendar year exceeds 13,000 acre-feet, or (ii) 10,000 surface acres on the Lowry Range Property have been rezoned to a non-agricultural use and finally platted and water tap agreements have been entered into with respect to all improvements to be constructed on such acreage. To date neither of these conditions has been met.

Export Water Customers

Payments for Export Water also generate royalty payments to the State Land Board. These royalties vary depending on a number of factors including whether the customer is a public or private entity.

When we withdraw, treat and deliver the water to the user and incur the costs related to this process, the royalty to the State Land Board is based on our “Net Revenues,” which are our gross revenues less costs, including reasonable overhead allocations, incurred as a direct or indirect result of incremental activity associated with the withdrawal, treatment and delivery of Export Water. Royalties payable to the State Land Board for water sold escalate based on the amount of Net Revenue we receive and are lower for sales to a water district or similar municipal or public entity than for sales to a private entity as noted in Table 3:

Table 3 – Royalties for Export Water Sales

| Net Revenues | Royalty Rate | |
|-----------------------------|----------------------|---------------------|
| | Private Entity Buyer | Public Entity Buyer |
| \$0 - \$45,000,000 | 12% | 10% |
| \$45,000,001 - \$60,000,000 | 24% | 20% |
| \$60,000,001 – \$75,000,000 | 36% | 30% |
| \$75,000,001 - \$90,000,000 | 48% | 40% |
| Over \$90,000,000 | 50% | 50% |

Current Operations

We have designed and constructed, and we currently operate and maintain, water and wastewater facilities that service customers on the Lowry Range Property. We currently have one water facility that during fiscal 2005 delivered approximately 52.3 million gallons of potable water ranging from approximately 2 million gallons per

month in the winter to over 8 million gallons per month in the summer. Our wastewater treatment plant currently has a permitted capacity of 130,000 gallons per day and receives about 20,000 gallons per day.

At this time, we operate and maintain all of our water and wastewater facilities with limited assistance from third party contractors. We design, construct and operate the facilities serving customers on the Lowry Range Property and plan to operate this system, together with facilities serving customers in areas outside the Lowry Range Property, in a unified manner to capitalize on economies of scale.

In 1998, we entered into a water service agreement with the State of Colorado Department of Human Services to provide water and wastewater services to a juvenile correction facility on the northwestern edge of the Lowry Range Property known as the Ridge View Youth Services Center. We designed this system to provide water and wastewater services to approximately 200 SFEs at the Ridge View Youth Services Center. Upon completion in 2001, we commenced service to the Ridge View Youth Services Center. During fiscal 2005, approximately 98% of our total water and wastewater treatment revenues were from two customers.

Projected Operations

In October 2003 and May 2004, we entered into the Sky Ranch Agreements with the developer of Sky Ranch to provide water to the development, which could include up to 4,850 SFE units, as described above. Under the Sky Ranch Agreements, the developer must purchase at least 400 water taps before occupancy of the first home. The Sky Ranch Agreements permit the developer to add additional taps annually, with at least 310 taps to be purchased each year after construction begins. This schedule is designed to provide us with adequate funds with which to construct the Wholesale Facilities needed to provide water service to the areas being built.

We will develop water and wastewater infrastructure in stages to meet demand. We anticipate that development of the entire 29,270 acre-feet of water located on the Lowry Range Property will require between 250 and 300 high capacity water wells ranging in depth from 800 feet to over 2,500 feet. We will drill separate wells into each of the three principal aquifers and each well will deliver water to central water treatment facilities for treatment prior to delivery to customers. We also intend to build structures to divert surface water to up to four storage reservoirs to be located on the Lowry Range Property. The surface water will be diverted when available and, prior to distribution to our customers, will be treated by a separate water treatment facility that we will build specifically to treat surface water. Based on preliminary independent engineering estimates, the full build-out of water facilities on the Lowry Range property will cost approximately \$340 million and will accommodate water service for up to 80,000 SFE units, which includes both customers located in and outside the Lowry Range Property service area.

We design, construct and operate our own wastewater treatment facilities using advanced treatment technologies currently available in the market. We plan to store our treated effluent water in surface water reservoirs for reuse in our irrigation water system. The combination of deep well water from our non-tributary water supplies, surface water supplies from two surface water streams that flow through the Lowry Range Property and the reuse of the treated effluent water supplies will provide an integrated water management system that maximizes the use and reuse of our valuable water supplies. Based upon preliminary engineering estimates, we anticipate the full build-out of wastewater facilities on the Lowry Range Property will cost approximately \$68 million and will accommodate up to 12.3 million gallons of wastewater per day serving an estimated 47,000 SFE units.

We use third party contractors to construct our facilities and we employ licensed water and wastewater operators to operate our water and wastewater systems. At full build-out, we expect to employ approximately 50 professionals to operate our systems, read meters, bill customers, and manage our operations. We will take advantage of advanced technologies to keep personnel requirements and operating costs low, such as systems that enable meter readings and billings to be done remotely, reducing associated handling and labor costs.

Rangeview Metropolitan District

The Rangeview Metropolitan District is a quasi-municipal corporation and political subdivision of Colorado formed in 1986 for the purpose of providing water and wastewater service to the Lowry Range Property. The District will utilize the 17,620 acre-feet of water leased to it by the State Land Board located on the Lowry Range Property for service to customers on the Lowry Range Property.

The District is run by an elected board of directors. The only eligible voters and the only persons eligible to serve as directors are the owners of property within the boundaries of the District. We own certain rights to the real property which encompass the current boundaries of the District. The current directors of the District are Mark W. Harding, Scott E. Lehman (both are employees of Pure Cycle), Ryan T. Clark (by reason of his role as manager of TPC Ventures, LLC, Ryan Clark is deemed an indirect beneficial owner of more than 10% of Pure Cycle common stock) and Tom Lamm.

We are party to a Right of First Refusal Agreement with the owners of the property comprising the District. Pursuant to a tenancy in common agreement, in the event of death, bankruptcy or incompetence of any tenant, that tenant's estate or representative must offer the property interest of that tenant to the remaining tenants for purchase. If the remaining tenants do not purchase all of such person's interest, the property must be offered to us pursuant to the Right of First Refusal Agreement. In addition, if any tenant wants to sell his interest in the parcel, such tenant must find a bona fide buyer and then offer the property to us. We have the right, at our option, to buy the property by matching the terms of the bona fide third party offer or by paying the appraised value of the property as determined by independent appraisers. A tenant may also negotiate a sale directly with us if he elects not to locate a bona fide buyer. Each of the directors listed above, as well as Pure Cycle, currently own an undivided interest in the land comprising the District. Under applicable Colorado law, entities are not qualified to serve as directors of municipal districts and may not vote. Our President and Secretary serve as elected members of the Board of Directors of the District. Pursuant to Colorado law, directors are entitled to receive \$50 for each board meeting or a maximum of \$950 per year.

We and the board of directors of the District transact business on an arms-length basis. The conflicts of interest of the directors in transactions between us and the District are disclosed in filings with the Colorado Secretary of State. The District and we were each represented by separate legal counsel in negotiating the water service agreement and wastewater service agreement between the parties. The agreements were also approved by the two members of the District's board who were not our employees and by the State Land Board.

It is likely that at some point in the future, the board of directors of the District will be comprised entirely of directors independent from us. As the State Land Board develops the Lowry Range Property, landowners on the Lowry Range Property may petition to include their land within the District's boundaries. Provided such petition complies with applicable law, the District is required by its lease with the State Land Board to proceed with due diligence to include the area designated in such petition within the District's boundaries. As the District's boundaries expand, the base of persons eligible to serve as directors and eligible to vote will also increase.

Water Reclamation

With interest heightened by a recent drought in Colorado and the fact that over 60 percent of the water that originates in Colorado leaves the state, most water providers in Colorado are actively pursuing the use of reclaimed wastewater for irrigation and other non-potable uses. In many ways we have led the effort in the metropolitan area to design water reuse systems and have assisted in establishing regulatory standards for water reuse water quality standards, having participated in the Department of Public Health's regulatory rule making process defining water quality standards for reuse water. Our master plan for our service area, which includes the Lowry Range Property and services to Sky Ranch, and all other areas in which we will provide services, calls for the installation of a dual pipe water distribution and reclamation system. A dual pipe distribution system is where one pipe supplies the customer with pure potable drinking water and a second pipe supplies raw or reclaimed water to homes for irrigation and other nonpotable uses. About one-half of the water needed to meet Denver-area residential water demands is used for landscaping and the irrigation of lawns. We, along with most major water providers, believe

that raw or reclaimed water supplies provide an essentially drought-proof supply of irrigation water for the Front Range and our service area.

The Colorado Department of Public Health and Environment in August 2005, adopted rules defining water quality standards for raw and reclaimed water uses for residential irrigation customers. We expect that the implementation of an extensive water reclamation system, in which essentially all wastewater treatment plant effluent water will be re-used to meet nonpotable water demands, will greatly expand our capability to provide quality water service and will reinforce our philosophy that emphasizes the importance of water recycling.

Competition

Although we have exclusive long term water and wastewater service contracts for the Lowry Range Property, providing water service using our Export Water is subject to competition. Alternate sources of water are available, principally from other private parties, such as farmers owning senior water rights that are no longer being economically used in agriculture and municipalities seeking to annex newly developed areas in order to increase their tax base. Our principal competition in areas close to the Lowry Range Property is the neighboring City of Aurora. The principal factors affecting competition for potential purchasers of Export Water include the availability of water for the particular purpose, the cost of delivering the water to the desired location, and the reliability of the water supply during drought periods. We believe that our assets provide us with a competitive advantage because our legal rights to the assets have been confirmed for municipal use, our water supply is close to Denver area water users and our pricing structure is competitive. Further, the size of the Lowry Range Property and the amount of property that can be served by the Export Water will provide us with economies of scale that should give us advantages over our competitors.

Water to Meet Colorado's Demand

In common with large portions of the desert west, the Denver metropolitan area is semi-arid, receiving an average of only 13 inches of precipitation annually. Eighty percent of the State's water supplies reside west of the Continental Divide, while 80 percent of the population resides east of the Continental Divide. Roughly 80 percent of Colorado's annual surface water supply comes from snow melt. Due to wide fluctuations in snowfall from year to year and area to area, the amount of surface water that can be captured for use varies greatly. Further, the State is obligated through compacts and treaties to allow much of the water that originates in the State to flow out of the State for use by downstream out-of-state users.

Most of the State's population resides along the "front range," which extends from Pueblo to Fort Collins and lies along the eastern side of the Rocky Mountains. The largest population center is the greater Denver metropolitan area which has been growing at above average rates for decades. By the 1960s, water available during an average precipitation year from Denver's primary source of surface water, the South Platte River, was no longer sufficient to meet the area's needs. To address this imbalance, numerous reservoirs and tunnels have been built to transport an average of 500,000 acre-feet per year of Arkansas River water and Colorado River water located in western and southern Colorado to metropolitan Denver water providers. Even with this diversion, the U.S. Department of the Interior has identified the Denver metropolitan area as one that is 'highly likely' to experience a 'water supply crisis' by 2025.

The Denver Regional Council of Governments ("DRCOG"), a voluntary association of 50 county and municipal governments in the Denver metropolitan area, estimates that from the year 2005 to 2030 the population in the Denver metropolitan area will grow to 3.9 million people, an increase of 1.3 million people. To accommodate this growth, DRCOG has estimated that the Denver metropolitan area will grow from roughly 500 square miles to roughly 770 square miles during the same 25-year period. This will add approximately 350,000 new single family equivalent connections which will require more than 100,000 acre-feet of water annually.

With our Rangeview Water Supply, based on independent engineering evaluations, we are positioned to supply water to meet the needs of approximately 80,000 single family equivalent connections, or approximately 320,000 people.

Risk Factors

Our business faces significant risks. These risks include those listed 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 the following 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.

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

We expect that our principal source of future revenue will be from long term contracts with the State Land Board, which expire in 2081 and entitle us to provide water service to the Lowry Range Property and the Sky Ranch Agreements that entitle us to provide water service to the Sky Ranch development. The timing and amount of these revenues will depend significantly on the development of these areas. The Lowry Range Property is owned by the State Land Board, which is in the early stages of considering various development alternatives, but no timetable exists for development. We are not able to determine the timing of water sales or the timing of development. 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. Because of the prior use of the Lowry Range Property 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 Property is delayed, we may incur additional short or long-term debt obligations or seek to sell additional equity to generate operating capital.

Our operations are significantly affected by the general economic conditions for real estate development and the pace and location of real estate development activities in the greater Denver metropolitan area, most particularly areas such as Sky Ranch which are near to our Rangeview Water Supply and thus are potential markets for our Export Water. Increases in the number of our water and wastewater connections, our connection fees and our billings and collections will depend on real estate development in this area. We have no ability to control the pace and location of real estate development activities which affect our business.

Our net losses may continue and we may not have sufficient liquidity to pursue our business objectives.

We have experienced significant net losses and could continue to incur net losses. For the years ended August 31, 2005 and 2004, we had net losses of approximately \$1,051,000 and \$1,976,000, respectively, on revenues of \$235,000 and \$205,000, in the respective periods. Our cash flows from operations have been insufficient to fund our operations in the past, and we have been required to raise debt and equity capital to remain in operation. Since 1998, we have raised approximately \$10.1 million through the issuance of approximately 2.5 million shares of common stock to support our operations. Our ability to fund our operational needs and meet our business objectives will depend on our ability to generate cash from future operations. If our future cash flow from operations and other capital resources are insufficient to fund our operations and the significant capital expenditure requirements to build our water delivery systems, we may be forced to reduce or delay our business activities, or seek to obtain additional debt or equity capital, which may not be available on acceptable terms, or at all.

The rates we are allowed to charge customers are limited by the District's contract with the State Land Board and our contract with the District and may be insufficient to cover our costs of construction and operation.

The prices we can charge for our water and wastewater services are subject to pricing regulations set in the District's contract with the State Land Board and our contract with the District. Both the tap fees and our usage rates and charges are based on the average of the rates of our rate-based districts. Annually we survey the tap fees and rates of our rate-based districts and set our tap fees and rates and charges based on the average of those charged by this group. Our costs associated with the construction of water delivery systems and the production, treatment and delivery of our water are subject to market conditions and other factors, which may increase at a significantly greater rate than the prices charged by our rate-based districts. Factors beyond our control and which cannot be

predicted, such as drought, water contamination and severe weather conditions, like tornadoes and floods, may result in additional labor and material costs that may not necessarily be recoverable under our operations and maintenance contracts, creating additional differences from the costs of our rate base water providers. Increased customer demand can also increase the overall cost of our operations. If the costs for construction and operation of our water services, including the cost of extracting our groundwater, exceed our revenues, we may petition the State Land Board for rate increases. There can be no assurance that the State Land Board would approve a rate increase beyond the average of the rate-based districts. Our profitability could be negatively impacted if we experience an imbalance of costs and revenues and are not successful in receiving approval for rate increases.

We only have three employees and may not be able to manage the increasing demands of our expanding operations.

We expect that our activities relating to the Sky Ranch agreement will significantly expand our business, and we are actively pursuing additional development opportunities in areas near Sky Ranch, as well as acquisition opportunities to continue to grow our operations. We currently have only three employees to administer our existing assets, interface with applicable governmental bodies, market our services and plan for the construction and development of our future assets. We may not be able to maximize the value of our water assets because of our limited manpower. We depend significantly on the services of Mark W. Harding, our President. The loss of Mr. Harding would cause a significant interruption of our operations. The success of our future business development and ability to capitalize on growth opportunities depends on our ability to attract and retain additional experienced and qualified persons to operate and manage our business. State regulations set the training, experience and qualification standards required for our employees to operate specific water and wastewater facilities. Failure to find state-certified and qualified employees to support the operation of our facilities could put us at risk, among other things, for operational errors at the facilities, for improper billing and collection processes, and for loss of contracts and revenues. We cannot assure you that we can successfully manage our assets and our growth.

Our business is subject to governmental regulation and permitting requirements. We may be adversely affected by any future decision by the Colorado Public Utilities Commission to regulate us as a public utility and to impose regulation.

The Colorado Public Utilities Commission (“CPUC”) regulates investor-owned water companies that hold themselves out to the public as serving, or ready to serve, all of the public in a service area. The CPUC regulates many aspects of public utilities' operations, including the location and construction of facilities, establishing water rates and fees, initiating inspections, enforcement and compliance activities and assisting consumers with complaints.

Although we act as a service provider under contracts with quasi-municipal metropolitan districts that are exempt by statute from regulation by the CPUC, the CPUC could decide to regulate us as a public utility. If this were to occur, we might incur significant expense challenging the CPUC's assertion of authority, and we may be unsuccessful. In the future, existing regulations may be revised or reinterpreted, and new laws and regulations may be adopted or become applicable to us or our facilities. If we become regulated as a public utility, our ability to generate profits could be limited and we might incur significant costs associated with regulatory compliance.

There are many obstacles to our ability to sell our Paradise Water Supply.

We currently earn no revenues from our Paradise Water Supply, which as of August 31, 2005 has a recorded cost of approximately \$5.5 million. Our ability to convert our Paradise Water Supply into an income generating asset is limited. While there is demand for water in the downstream states of California, Nevada and Arizona, Colorado law prohibits the export of water out of state without obtaining a Water Court decree. To issue a decree the Water Court must find that the export is not in violation of the provisions of interstate compacts and does not prevent Colorado from complying with its interstate compact obligations. In addition, there are significant difficulties and costs involved in transporting the water out of the Colorado River watershed to the Denver metropolitan area. As part of our Water Court decree for the Paradise Water Supply, we are permitted to construct a storage facility on the Colorado River. However, due to the strict regulatory requirements for constructing an on-

channel reservoir, completing the conditional storage right at its decreed location would also be difficult. As a result, we cannot assure you that we will ever be able to make use of this asset or sell the water profitably.

Our Paradise Water Supply is also conditioned on a Finding of Reasonable Diligence from the water court every six years. To arrive at that finding, a water court must determine that we continue to diligently pursue the development of the water rights, either by us or by some third party who has a contractual commitment for its use. If the water court is unable to make such a finding, our right to the Paradise Water Supply may be lost. The State Engineers office began its latest review of our conditional water rights in fiscal 2005. At this time we are unable to estimate when the review will be complete or the outcome of this review. Since we acquired the Paradise Water Supply in 1987, we have received a satisfactory Finding of Reasonable Diligence at each of these reviews.

Conflicts of interest may arise relating to the operation of the District.

Our officers, employees and a majority shareholder, constitute a majority of the directors of the Rangeview Metropolitan District and Pure Cycle, along with our officers and employees and one unrelated individual, own as tenants in common, the 40 acres that form the District. Pursuant to State law, directors are entitled to receive \$50 for each board meeting or a maximum compensation of \$950 per year. We have made loans to the District to fund its operations. At August 31, 2005, total principal and interest owed to us by the District was approximately \$431,000. The District is a party to our agreements with the State Land Board and receives fees of 5% of the revenues from the sale of water on the Lowry Range Property, and will hold title to the water distribution system at the Sky Ranch development. Proceeds from the fee collections will initially be used to repay the District's obligations to us, but after these loans are repaid, the District is not required to use the funds to benefit Pure Cycle. We have received benefits from our activities undertaken in conjunction with the District, but conflicts may arise between our interests and those of the District, and with our officers who are acting in dual capacities in negotiating contracts to which both we and the District are parties. We expect that the District will expand when more properties are developed and become part of the District, and our officers acting as directors of the District will have fiduciary obligations to those other constituents. There can be no assurance that all conflicts will be resolved in the best interests of Pure Cycle and its stockholders. In addition, other landowners coming into the District will be eligible to vote and to serve as directors of the District. There can be no assurances that our officers and employees will remain as directors of the District or that the actions of a subsequently elected board would not have an adverse impact on our operations.

We are required to maintain stringent water quality standards and are subject to regulatory and environmental risks.

We must provide water that meets all federal and state regulatory water quality standards and operate our water and wastewater facilities in accordance with the standards. We face contamination and pollution issues regarding our water supplies. Improved detection technology, increasingly stringent regulatory requirements, and heightened consumer awareness of water quality issues contribute to an environment of increased focus on water quality. In contrast with other providers in Colorado, we are combining the water delivery and wastewater treatment processes, which may introduce technical treatment issues that make compliance with water quality standards more difficult. We cannot assure you that we will be able in the future to reduce the amounts of contaminants in our water to acceptable levels. In addition, the standards that we must meet are constantly changing and becoming more stringent. For example, in February 2002, the U.S. Environmental Protection Agency lowered the arsenic standard in drinking water from 50 parts per billion to 10 parts per billion. Future changes in regulations governing the supply of drinking water and treatment of wastewater may have a material adverse impact on our financial results.

We handle certain hazardous materials at our water treatment facilities, primarily sodium hypochlorite. Any failure of our operation of the facilities in the future, including sewage spills, noncompliance with water quality standards, hazardous materials leaks and spills, and similar events could expose us to environmental liabilities, claims and litigation costs. We cannot assure you that we will successfully manage these issues, and failure to do so could have a material adverse effect on our future results of operations by increasing our costs for damages and cleanup.

Our contracts for the construction of water and wastewater projects may expose us to certain completion and performance risks.

We will rely on independent contractors to construct our water and wastewater facilities. These construction activities may involve risks, including shortages of materials and labor, work stoppages, labor relations disputes, weather interference, engineering, environmental, permitting or geological problems and unanticipated cost increases. These issues could give rise to delays, cost overruns or performance deficiencies, or otherwise adversely affect the construction or operation of the water delivery system.

In addition, we may experience quality problems in the construction of our systems and facilities, including equipment failures. We cannot assure you that we will not face claims from customers or others regarding product quality and installation of equipment placed in service by contractors.

Certain of our contracts may be fixed-price contracts, in which we may bear all, or a significant portion of, the risk for cost overruns. Under these fixed-price contracts, contract prices are established in part based on fixed, firm subcontractor quotes on contracts and on cost and scheduling estimates. These estimates may be based on a number of assumptions, including assumptions about prices and availability of labor, equipment and materials, and other issues. If these subcontractor quotations or cost estimates prove inaccurate, or if circumstances change, cost overruns may occur, and our financial results would be negatively impacted. In many cases, the incurrence of these additional costs is not within our control.

We may have contracts in which we guarantee project completion by a scheduled date. At times, we may guarantee that the project, when completed, will achieve certain performance standards. If we fail to complete the project as scheduled, or if we fail to meet guaranteed performance standards, we may be held responsible for cost impacts and/or penalties to the customer resulting from any delay or for the costs to alter the project to achieve the performance standards. To the extent that these events occur, and are not due to circumstances for which the customer accepts responsibility, and cannot be mitigated by performance bonds or the provisions of our agreements with contractors, the total costs of the project could exceed our original estimates and our financial results would be negatively impacted.

Our customers may require us to secure performance and completion bonds for certain contracts and projects. The market environment for surety companies has become more risk averse. We secure performance and completion bonds for our contracts from these surety companies. To the extent we are unable to obtain bonds, we may not be awarded new contracts. We cannot assure you that we can secure performance and completion bonds where required.

We may operate engineering and construction activities for water and wastewater facilities where design, construction or system failures could result in injury to third parties or damage to property. Any losses that exceed claims against our contractors, the performance bonds and our insurance limits at facilities so managed could result in claims against us. In addition, if there is a customer dispute regarding performance of our services, the customer may decide to delay or withhold payment to us.

Item 2. Description of Property

We currently occupy approximately 1,800 square feet of office space at a cost of \$1,000 per month, which is leased from the estate of our former CEO, Mr. Thomas P. Clark, at the address shown on the cover page. The lease is a month-to-month agreement that can be cancelled by either party at any time.

We own a total gross volume of 1,165,000 acre-feet (approximately 11,650 acre-feet per year) of non-tributary groundwater, an option to substitute 1,650 acre-feet of tributary surface water in exchange for a total gross volume of 165,000 acre-feet of non-tributary groundwater, and surface storage rights from the District. See *"Item 1. Description of Our Water Assets and Related Service Agreement - Rangeview Water Supply and Related Agreements"*. We are a party to two eighty-five year Water Privatization Agreements with the District and the State Land Board which entitle us to design, construct, operate and maintain the water and wastewater systems which serve customers within the District's service area. In exchange, we receive 95% of all amounts received by the

District for water services net of royalties totaling 12% of gross revenues to the State Land Board, 100% of the District's wastewater tap fees and 90% of the District's wastewater usage fees.

We own approximately 70,000 acre-feet of conditional water rights, water wells and related assets in the State of Colorado by assignment and quitclaim deed. See *"Item 1. Description of Our Water Assets and Related Service Agreement - Paradise Water Supply."*

We own 89.2 acre-feet of groundwater located in the Sky Ranch development. This represents 40% of the 223 acre-feet of groundwater we will own upon exercise of our options under the DGPA. See *"Item 1. Description of Our Water Assets and Related Service Agreement – Sky Ranch Water Supply and Water Service Agreements."*

We own an undivided 59.9% interest as a tenant-in-common in a 40-acre parcel of undeveloped land located in unincorporated Arapahoe County comprising the Rangeview Metropolitan District.

Item 3. Legal Proceedings

None

Item 4. Submission of Matters to a Vote of Security Holders

No matters were submitted to a vote of stockholders during the quarter ended August 31, 2005.

PART II

Item 5. Market for Common Equity and Related Stockholder Matters

Markets

Our common stock is traded on the NASDAQ SmallCap market under the symbol PCYO. Table 4 shows, for the fiscal periods indicated, the high and low sales prices of our common stock as reported by NASDAQ. Effective April 26, 2004, we completed a ten-for-one reverse stock split. Accordingly, all amounts have been restated to reflect the reverse split.

Table 4 High and Low Sales Prices

| | Fiscal 2005 | | Fiscal 2004 | |
|----------------|-------------|--------|-------------|---------|
| | Low | High | Low | High |
| Fiscal Quarter | | | | |
| First | \$7.05 | \$9.40 | \$2.00 | \$ 5.10 |
| Second | \$6.30 | \$9.50 | \$4.00 | \$13.00 |
| Third | \$3.06 | \$7.85 | \$6.00 | \$10.70 |
| Fourth | \$6.57 | \$8.90 | \$6.50 | \$10.25 |

On October 31, 2005, the last reported sale price of our common stock was \$6.50 per share, and there were 3,572 holders of record of our common stock.

Dividends

We have never paid any dividends on our common stock and expect for the foreseeable future to retain all of our earnings from operations, if any, for use in expanding and developing our business. Any future decision as to the payment of dividends will be at the discretion of our board of directors and will depend upon our earnings, financial position, capital requirements, plans for expansion and such other factors as our board of directors deems relevant. The terms of our Series B Preferred Stock prohibit payment of dividends on common stock unless all dividends accrued on the Series B Preferred Stock have been paid.

Recent Sales of Unregistered Securities

Effective March 18, 2005, we amended certain of our outstanding warrants to allow the warrant holders to use the current market value of the underlying stock as consideration for the payment of the exercise price of the warrants. Immediately following such amendments, warrant holders holding rights to purchase 39,282 shares of Common Stock having a warrant exercise price of \$1.80 per share used 9,568 shares underlying such warrants and having a current market value of \$7.39 per share to purchase 29,714 newly issued shares of common stock. As of August 31, 2005, we continue to have outstanding warrants to purchase 15,612 shares of common stock at an exercise price of \$1.80 per share.

All of these shares were issued in reliance of Section 4(2) of the Securities Exchange Act of 1933, as amended, as transactions not involving a public offering.

Item 6. Management's Discussion and Analysis of Financial Condition or Plan of Operation

Readers are cautioned that forward-looking statements contained in this Form 10-KSB should be read in conjunction with our disclosure under the heading: "SAFE HARBOR STATEMENT UNDER THE UNITED STATES PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995" on page 3.

General

Pure Cycle is an investor owned water and wastewater provider engaged in the design, operation and maintenance of water and wastewater systems primarily in the Denver metropolitan area with assets available to serve areas in the southwestern United States. We own approximately 1.2 million acre-feet of water (11,650 acre-feet annually) and have entered into two 85 year water and wastewater Service Agreements with the District and the State Land Board which enable us to provide water and wastewater service to the District's service area and other customers located throughout the Denver area.

We are aggressively pursuing the marketing and sale of our services to developers and home builders in the Denver metropolitan region to generate current and long term revenues. As a result of the continuing growth of the Denver metropolitan region and the limited availability of new water supplies, many metropolitan planning agencies are requiring property developers to first demonstrate adequate water availability prior to any consideration for zoning requests on property development. This has resulted in us marketing our water to area developers and home builders seeking to develop new projects as well as other municipal water providers in need of additional water supplies.

We also market our 70,000 acre-feet of Paradise Water Supply to private and municipal water providers in Nevada, Arizona and California, although significant legal issues relating to interstate water transfers exist. We continue to identify, market and discuss our water supply arrangements with private companies and municipal water providers to whom we have made proposals. However, due to the strict regulatory requirements for constructing an on-channel reservoir at its current decreed location, which is required for us to utilize this asset, we cannot assure you that we will ever be able to make use of this asset or sell the water profitably.

Critical Accounting Policies

Our financial statements are prepared in accordance with Accounting Principles Generally Accepted in the United States of America ("GAAP"), which requires management to make estimates and assumptions that affect reported amounts of assets and liabilities and disclosure of contingent liabilities at the date of the financial statements, and reported amounts of revenues and expenses during the reporting period. Actual results could differ significantly from those estimates.

We have identified certain key accounting policies on which our financial condition and results of operations are dependent. These key accounting policies most often involve complex matters or are based on subjective judgments or decisions. In the opinion of management, our most critical accounting policies are those related to

revenue recognition, impairment of water assets and other long-lived assets, depletion and depreciation, accounting for Participating Interests in Export Water, royalty and other obligations, and income taxes. Management periodically reviews its estimates, including those related to the recoverability and useful lives of assets. Changes in facts and circumstances may result in revised estimates.

Revenue Recognition

Our revenues consist mainly of tap fees, construction fees and monthly service fees. Emerging Issues Task Force Issue No. 00-21 *Revenue Arrangements with Multiple Deliverables* ("EITF 00-21"), governs how to identify when goods or services, or both, that are separately delivered but included in a single sales arrangement should be accounted for individually. Based on the criteria of EITF 00-21, we account for each of the items contained in our service agreements individually. That is, we determine the proper revenue recognition for tap fees, construction fees and services fees independent of one another.

We recognize revenues relating to the sale of water and wastewater taps as income upon receipt of payment if the Wholesale Facilities required to provide the service are in place and operational. If the Wholesale Facilities are not in place and operational, we defer recognition of the tap fee revenue until the required facilities are completed and placed in service. We recognize construction fees received to build assets that we will own, as income over the estimated service life, which is also the estimated useful life of the assets. Additionally, we capitalize construction costs and amortize those as costs of revenue over the assets estimated useful life. We recognize water and wastewater service revenues at the end of the month in which the services are performed. Water service fees are based upon metered water deliveries to customers. Wastewater customers are charged flat monthly fees.

Impairment of Water Assets and Other Long-Lived Assets

We review our long-lived assets for impairment at least annually, or whenever 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 future undiscounted net cash flows we expect to be generated by the eventual use of the asset (the fair value). If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. We report assets to be disposed of at the lower of the carrying amount or fair value less costs to sell. We believe there were no impairments in the carrying amounts of our investments in water and water systems at August 31, 2005.

Accounting for CAA Payments

The balance sheet liability captioned "Participating Interests in Export Water Supply" (the "Participating Interests") represents an obligation which arose under the Water Commercialization Agreement (the "WCA"), as amended by the CAA.

Upon entering the CAA, we recorded an initial liability of approximately \$11.1 million, which represents the cash we received and used to purchase our Export Water Supply. In return we 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 our balance sheet as the obligation to pay this is contingent on our ability to sell Export Water, for which the amounts and the timing are not reasonably determinable.

As of August 31, 2005, the remaining Participating Interests liability reflected on our balance sheet totaled \$8.2 million, and the contingent liability not reflected on our balance sheet totaled \$15.2 million. For more information see "Note 4 – Participating Interests in Export Water" to the accompanying financial statements.

Royalty and other obligations

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

Depletion and depreciation of water assets

Water supplies that are being utilized are depleted on the basis of units produced divided by the total volume of water adjudicated in the water decrees. Water systems are depreciated on a straight line basis over their estimated useful lives.

Income taxes

We use the asset and liability method of accounting for income taxes. Under the asset and liability method, deferred tax assets and liabilities are recognized for the estimated future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which we expect to recover or settle those temporary differences. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. A valuation allowance is provided for deferred tax assets until realization is more likely than not.

Results of Operations

Water and Wastewater Usage Revenues

During fiscal 2005, we delivered approximately 52.3 million gallons of water compared to the delivery of 56.3 million gallons of water in fiscal 2004, a 7% decrease. These water deliveries generated water usage revenues of \$152,000 in fiscal 2005, and \$146,000 in fiscal 2004, a 4% increase. Our water service charges are based on a tiered pricing structure that provides for higher prices as customers use greater amounts of water. Table 2 included above in *Item 1 – Description of Business*, outlines our tiered pricing structure. The increase in usage fees is due primarily to higher seasonal water deliveries during peak times and increased usage fees effective July 1, 2005, which were based on increases at our rate-based districts.

Our wastewater customers are charged a flat monthly fee, which also increased effective July 1, 2005. During fiscal 2005 and 2004, our wastewater revenues totaled \$58,000 and \$55,000, respectively.

We incurred approximately \$17,000 in operating costs related to the water system for both fiscal 2005 and 2004, and we incurred approximately \$9,000 and \$11,000 in operating costs related to the wastewater system in fiscal 2005 and 2004, respectively. The decrease in operating costs for the wastewater system is due mainly to one time expenses incurred in 2004 that improved the efficiency of the operations and benefited 2005.

General and Administrative and Other Expenses

General and administrative expenses for fiscal years 2005 and 2004 were \$1.35 million and \$823,000, respectively. The increase of \$527,000 or 64%, was due mainly to the following factors:

- Salaries and related expenses, including healthcare costs, increased by \$224,000 to \$691,000, due to the addition of a new controller in September 2004, higher than anticipated increases in healthcare premiums, and a bonus paid to our President.
- Franchise taxes increased more than \$74,000 over the prior year due to increases in the authorized and outstanding common stock following the equity offering in 2004. In early 2005, we reduced the number of shares authorized to be issued which will reduce the 2006 franchise taxes.
- Board of director fees increased by \$61,000 to \$111,000 due to us obtaining a directors and officers insurance policy and the addition of one Board member in February 2005.

- Legal expenses increased by \$58,000 to \$124,000 due to increased legal work related to increased operations, the signing of the County Agreement, and related corporate legal requirements. We are not aware of any claims or litigation against the Company.

Interest income increased by \$107,000 to \$150,000 in fiscal year 2005, due primarily to the temporary investment of proceeds from our stock offering in the fourth quarter of fiscal 2004 in marketable securities.

Interest expense decreased by \$140,000 to \$34,000 in fiscal 2005, due primarily to the repayment of certain notes following the stock offering in the fourth quarter of fiscal 2004.

Our net loss decreased by \$925,000 to \$1.1 million. General and administrative expenses increased over the year, which increased our net loss; however, overall net loss decreased in 2005 due to us recording approximately \$1.1 million of extinguishment charges relating to our acquisition of a portion of the CAA and the LCH obligation in fiscal 2004, which did not recur in fiscal 2005.

Liquidity and Capital Resources

Our working capital, defined as current assets less current liabilities, at August 31, 2005 was approximately \$5.0 million, and we had cash and cash equivalents and marketable securities on hand totaling \$5.5 million at August 31, 2005. We believe that at August 31, 2005, we have sufficient working capital to fund our operations for the next year. However, there can be no assurances that we will be successful in marketing the water from our primary water projects in the near term. In the event increased revenues and cash flows from providing water services are not achieved, we may incur additional short or long-term debt or seek to sell additional equity securities to generate working capital to support our operations.

Development of any of the water that we have, or are seeking to acquire, will require substantial capital investments. We anticipate that additional capital for the development of the water will be financed by the entity purchasing such water through the sale of water taps to developers and water delivery charges to users. A water tap charge refers to a charge we impose to fund construction of Wholesale Facilities and permit access to a water delivery system (e.g., a single-family home's tap into our water system), and a water service charge refers to a water customer's monthly water bill, generally charged per 1,000 gallons of water delivered to the customer. Annually, the developer must purchase not less than a minimum number of taps, the proceeds from which are used to expand the capacity of our Wholesale Facilities to deliver water to additional customers in the development. We anticipate that the system 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 can not assure you that our source of cash will be sufficient to cover our capital costs.

On August 3, 2005, we entered into the County Agreement to provide water service to the Fairgrounds. Pursuant to the County Agreement we will design and build the Special Facilities and the Wholesale Facilities, which are expected to be completed in April 2006, for an anticipated Fairgrounds opening date in July 2006.

Funding of \$1.25 million for the construction of the Special Facilities will come from the County and will be provided as follows: (i) an initial payment of \$397,000 (received in August 2005), (ii) credits for the County selling us 336 acre-feet of groundwater valued at \$240,000 (the water asset will be recorded in our balance sheet upon satisfactory delivery of the Water Rights Deed), and (iii) \$608,000 paid over ten years, which will include interest at 6%, which based on currently scheduled payments will result in us receiving \$205,000 in interest. These funds will be used to construct the Special Facilities, which we will own and operate. We anticipate construction costs paid to contractors will total approximately \$1.3 million. We made the initial payment of \$218,500 on the water tower in August 2005. Construction of this tower began in September 2005. The remaining payments for the water tower, totaling \$680,000, are due upon the completion of various milestones throughout construction.

We will also design and build the Wholesale Facilities utilizing funds from the sale of water taps to the County. The net funds that we retained of \$321,000 (which is the total tap fees of \$568,000 net of water dedication credits of \$52,000, royalty payments to the State Land Board of \$35,000 and payments to external CAA holders of \$160,000)

will be used to construct facilities that will provide water service to the Fairgrounds, provide capacity to our existing customers and provide us required systems for potential additional development opportunities in and around the Fairgrounds. The construction of the Wholesale Facilities is expected to begin in March 2006, and we expect third party contracts to cost a total of approximately \$96,000. We will own and operate the Wholesale Facilities.

When the Fairgrounds begin operations, we will charge the County water usage fees consistent with the Rates and Charges included in the District's Rules and Regulations, which are expected to cover the costs of providing the ongoing water service.

On October 31, 2003, and then on May 14, 2004, we entered into the Sky Ranch Agreements with the developer of Sky Ranch. Pursuant to the Sky Ranch Agreements we will provide water for all homes and buildings to be constructed at Sky Ranch, which could go as high as 4,850 SFE units. Additionally, the developer must purchase at least 400 water taps before occupancy of the first home. The Sky Ranch Agreements permit the developer to add additional taps annually, with at least 310 taps to be purchased each year. This schedule is designed to provide us with adequate funds with which to construct the Wholesale Facilities needed to provide water service to the areas being developed.

To the extent that water service is provided using Export Water, we are required to pay a royalty to the State Land Board equal to 12% of the net revenue after deducting our costs. If the developer exercises its option to purchase Export Water, we expect to dedicate approximately 1,200 acre-feet, or approximately 10%, of our Export Water supply (which is about 4.2% of our overall Rangeview Water Supply) for this project. We estimate we will spend approximately \$25.0 million for infrastructure costs related to the development and delivery of water to the Sky Ranch development.

At August 31, 2005, we had outstanding debt to three related parties totaling \$1.46 million (which includes \$763,000 of accrued interest). Of the \$1.46 million, \$189,000 bears simple interest at 9.01%, \$52,000 bears simple interest at 8.36%, \$425,000 bears simple interest at the Applicable Federal Rate for short-term obligations (3.58% at August 31, 2005) and \$27,000 bears no interest. The notes are payable at various dates between August 2007, and October 2007. Interest is not payable on a current basis, but does accrue and is added to the principal monthly.

Operating Activities

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

During fiscal 2005, cash used in operating activities was approximately \$818,000 compared to \$528,000 in fiscal 2004. Operating costs increased due to increased health insurance costs, management bonuses, payment of board of director fees and annual retainers, increased legal fees and payments made to the District which were offset by us not expending any funds to repurchase contingent obligations as we did in fiscal 2004. Accrued interest on the note receivable of approximately \$17,000 was offset by accrued interest on notes payable of approximately \$34,000. In 2004, we repaid \$1.6 million of debt along with approximately \$2.0 million of accrued interest so the level of cash required for operations during fiscal 2006 should remain lower than in previous years. 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 the acquisition, development and maintenance of both the Rangeview and Paradise water assets and intend to exercise our option to acquire the next 20% of the Sky Ranch groundwater under the DGPA for \$50,000 in fiscal 2006. These investments include legal and engineering fees associated with adjudicating additional water through the Water Court system, as well as right-of-way permit fees to the Department of Interior Bureau of Land Management for our Paradise Water Supply. Additionally, with the anticipated start of construction at Sky Ranch, and the construction of the facilities required to provide water service to the Arapahoe County Fairgrounds, we anticipate cash required by investing activities to increase in fiscal 2006.

Cash provided by investing activities for fiscal 2005 was approximately \$198,000. During fiscal 2005, we maintained temporary investments of funds generated from the equity offering in fiscal 2004. Costs of approximately \$405,000 were capitalized to our water assets, which included approximately \$223,000 related to the start of construction of the water system required to provide water service to the Fairgrounds. During fiscal 2005, we received option payments totaling \$60,400 from the developer of Sky Ranch related to the potential use of Export Water. Cash used by investing activities for fiscal 2004, was approximately \$4.1 million which included the initial investment of funds from the equity offering. We capitalize certain acquisition, legal, engineering and permitting costs relating to the improvement of our water assets.

Financing Activities

Cash provided by financing during fiscal 2005 was approximately \$1.0 million compared to \$5.7 million in fiscal 2004. Significant financing items during fiscal 2005 and 2004 included the receipt of approximately \$677,000 related to exercises of stock options in 2005 and the receipt of approximately \$10.6 million from the sale of stock in the equity offering and from the exercising of warrants in 2004. In 2004, proceeds from the equity offering were partially offset by the repurchase of certain CAA interests for approximately \$2.8 million in cash and \$2.0 million of debt payments.

Impact of Recently Issued Accounting Pronouncements

In December 2004, the FASB issued Statement of Financial Accounting Standard No. 123 (revised 2004) *Share-Based Payment* ("SFAS 123R") which is a revision of SFAS 123 and addresses the accounting for employee stock options. SFAS 123R is effective for public companies that file as small business issuers for annual periods beginning after December 15, 2005 (SFAS 123R is effective for us beginning fiscal 2007 or September 1, 2006). SFAS 123R supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and amends SFAS No. 95, *Statement of Cash Flows*. Generally, the approach in SFAS 123R is similar to the approach described in SFAS 123. However, SFAS 123R requires that all share-based payments to employees, including grants of employee stock options, be recognized in the income statement based on their fair values. Pro forma disclosure is no longer an alternative. We have not yet completed our evaluation of the impact of SFAS 123R, but we expect the adoption to have a material effect on our financial statements. See "Note 2 – Summary of Significant Accounting Policies" in the accompanying financial statements for pro-forma disclosures required under SFAS 123.

Total Contractual Cash Obligations

Our contractual obligations with defined maturities consists entirely of our long-term debt with related parties. The total obligations to these related parties, including accrued interest, is \$1.46 million. Of this, \$877,000 is due in August 2007; \$552,000 is due in September 2007; and \$27,000 is due in October 2007. The holder of the notes due in August 2007 is a party to the CAA and has agreed that if the amount of principal and accrued interest on these notes is paid under the CAA prior to the maturity date of the notes, the notes will be cancelled.

In August 2005, we entered into an agreement with a contractor to build a 500,000 gallon water tower for use at the Fairgrounds. The contract calls for milestone payments over the next twelve months totaling approximately \$680,000, following a \$218,500 payment made in August 2005.

We are also contingently liable for payments to third parties totaling \$23.4 million upon the sale of Export Water. The timing of these payments is determined based on sales of Export Water. Therefore, it is unknown if and when these payments will ultimately be made.

Employees and Significant Customers

We currently have three full-time employees.

For the years ended August 31, 2005 and 2004, 98% and 96% of our revenues were from two customers, respectively.

Item 7. Financial Statements

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Report of Independent Registered Public Accounting Firm

The Board of Directors
Pure Cycle Corporation:

We have audited the accompanying balance sheet of Pure Cycle Corporation (the “Company”) as of August 31, 2005, and the related statements of operations, stockholders’ equity, and cash flows for the year then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company’s internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Pure Cycle Corporation as of August 31, 2005, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

/s/ ANTON COLLINS MITCHELL LLP

Denver, Colorado
October 14, 2005

Report of Independent Registered Public Accounting Firm

The Board of Directors
Pure Cycle Corporation:

We have audited the accompanying balance sheet of Pure Cycle Corporation (the Company) as of August 31, 2004, and the related statements of operations, stockholders' equity, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Pure Cycle Corporation as of August 31, 2004, and the results of its operations and its cash flows for the year then ended, in conformity with U.S. generally accepted accounting principles.

/s/ KPMG, LLP

Denver, Colorado
October 29, 2004

PURE CYCLE CORPORATION

BALANCE SHEETS

| | August 31, | |
|---|----------------------|----------------------|
| | 2005 | 2004 |
| ASSETS: | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 1,973,882 | \$ 1,574,201 |
| Marketable securities | 3,481,035 | 4,055,643 |
| Trade accounts receivable | 50,059 | 50,238 |
| Interest receivable | 21,788 | 24,516 |
| Prepaid expenses | 38,667 | 34,077 |
| Restricted cash | 174,890 | - |
| Total current assets | <u>5,740,321</u> | <u>5,738,675</u> |
| Investments in water and water systems, net | 19,871,321 | 19,473,121 |
| Property and equipment, net | 4,088 | - |
| Note receivable – Rangeview Metropolitan District, including accrued interest | 430,722 | 413,805 |
| Total assets | <u>\$ 26,046,452</u> | <u>\$ 25,625,601</u> |
| LIABILITIES: | | |
| Current liabilities: | | |
| Accounts payable | \$ 28,119 | \$ 2,946 |
| Payable to contingent obligation holders | 174,890 | - |
| Royalties payable to State Land Board | 34,522 | - |
| Accrued liabilities | 31,519 | 180,927 |
| Deferred revenues | 420,309 | 17,435 |
| Total current liabilities | <u>689,359</u> | <u>201,308</u> |
| Deferred construction funding | 397,235 | - |
| Long-term debt - related parties, including accrued interest | 1,454,921 | 1,420,964 |
| Participating Interests in Export Water supply | 8,152,202 | 8,214,275 |
| Amounts reimbursable to former officer | - | 2,465,555 |
| Total liabilities | <u>10,693,717</u> | <u>12,302,102</u> |
| Commitments and Contingencies | | |
| STOCKHOLDERS' EQUITY: | | |
| Preferred stock: | | |
| Par value \$.001 per share, 25 million shares authorized: | | |
| Series B – 432,513 shares issued and outstanding | | |
| (liquidation preference of \$432,513) | 433 | 433 |
| Common stock: | | |
| Par value 1/3 of \$.01 per share, 40 million shares authorized: | | |
| 14,329,981 and 13,316,135 shares issued and outstanding | 47,770 | 44,387 |
| Additional paid-in capital | 40,050,159 | 36,407,105 |
| Treasury stock, at cost, 73,154 shares of common stock | (554,939) | - |
| Accumulated comprehensive income | 3,453 | 14,834 |
| Accumulated deficit | (24,194,141) | (23,143,260) |
| Total stockholders' equity | <u>15,352,735</u> | <u>13,323,499</u> |
| Total liabilities and stockholders' equity | <u>\$ 26,046,452</u> | <u>\$ 25,625,601</u> |

See accompanying Notes to Financial Statements

PURE CYCLE CORPORATION

STATEMENTS OF OPERATIONS

| | For the Years Ended August 31, | |
|--|--------------------------------|-----------------------|
| | <u>2005</u> | <u>2004</u> |
| Revenues: | | |
| Metered water usage | \$ 152,247 | \$ 145,490 |
| Wastewater treatment fees | 57,453 | 55,050 |
| Sky Ranch options | 21,619 | - |
| Other | <u>3,335</u> | <u>4,416</u> |
| Total revenues | <u>234,654</u> | <u>204,956</u> |
| Expenses: | | |
| Water service operations | (16,471) | (16,759) |
| Wastewater service operations | (8,835) | (11,196) |
| Other | (2,858) | (2,889) |
| Depletion | <u>(743)</u> | <u>(795)</u> |
| Total cost of revenues | <u>(28,907)</u> | <u>(31,639)</u> |
| Gross margin | 205,747 | 173,317 |
| General and administrative expenses | (1,349,571) | (822,934) |
| Depreciation | <u>(7,148)</u> | <u>(4,948)</u> |
| Operating loss | (1,150,972) | (654,565) |
| Other income (expense): | | |
| Interest income | 149,611 | 42,683 |
| Interest expense - related parties | (33,957) | (173,931) |
| (Loss) gain on sales of marketable securities | (15,563) | 11,996 |
| Amortization of warrants | - | (75,600) |
| Extinguishment of contingent obligations | <u>-</u> | <u>(1,126,239)</u> |
| Net loss | \$ <u>(1,050,881)</u> | \$ <u>(1,975,656)</u> |
| Net loss per common share – basic and diluted | \$ <u>(.08)</u> | \$ <u>(0.22)</u> |
| Weighted average common shares outstanding – basic and diluted | <u>13,674,156</u> | <u>8,879,771</u> |

See accompanying Notes to Financial Statements

PURE CYCLE CORPORATION
STATEMENTS OF STOCKHOLDERS' EQUITY
YEARS ENDED AUGUST 31, 2005 AND 2004

| | Preferred Stock | | Common Stock | | Treasury Stock | | Additional | Accumulated | | Total |
|--|-----------------|-----------|--------------|-----------|----------------|--------------|-----------------|----------------------|-----------------|---------------|
| | Shares | Amount | Shares | Amount | Shares | Amount | Paid-in Capital | Comprehensive Income | Deficit | |
| Balance – August 31, 2003 | 10,487,513 | \$ 10,488 | 7,843,976 | \$ 26,146 | - | \$ - | \$ 25,512,427 | \$ - | \$ (21,167,604) | \$ 4,381,457 |
| Preferred stock converted to common stock | (10,055,000) | (10,055) | 1,737,648 | 5,792 | - | - | 4,263 | - | - | - |
| Equity offering less expenses – \$1.16 million | - | - | 1,026,263 | 3,421 | - | - | 8,063,459 | - | - | 8,066,880 |
| Warrants exercised | - | - | 2,182,147 | 7,274 | - | - | 1,628,525 | - | - | 1,635,799 |
| Stock options exercised | - | - | 485,589 | 1,619 | - | - | 872,444 | - | - | 874,063 |
| Contingent obligation acquisition | - | - | 40,512 | 135 | - | - | 325,987 | - | - | 326,122 |
| Unrealized gains on marketable securities | - | - | - | - | - | - | - | 14,834 | - | 14,834 |
| Net loss | - | - | - | - | - | - | - | - | (1,975,656) | (1,975,656) |
| Comprehensive loss | | | | | | | | | | (1,960,822) |
| Balance – August 31, 2004 | 432,513 | 433 | 13,316,135 | 44,387 | - | - | 36,407,105 | 14,834 | (23,143,260) | 13,323,499 |
| Reimbursement to former CEO | - | - | 300,000 | 1,000 | - | - | 2,414,000 | - | - | 2,415,000 |
| Warrants exercised | - | - | 29,714 | 99 | - | - | (99) | - | - | - |
| Stock options exercised | - | - | 684,132 | 2,284 | (73,154) | (554,939) | 1,229,153 | - | - | 676,498 |
| Unrealized losses on marketable securities | - | - | - | - | - | - | - | (11,381) | - | (11,381) |
| Net loss | - | - | - | - | - | - | - | - | (1,050,881) | (1,050,881) |
| Comprehensive loss | | | | | | | | | | (1,062,262) |
| Balance – August 31, 2005 | 432,513 | \$ 433 | 14,329,981 | \$ 47,770 | (73,154) | \$ (554,939) | \$ 40,050,159 | \$ 3,453 | \$ (24,194,141) | \$ 15,352,735 |

See accompanying Notes to Financial Statements

PURE CYCLE CORPORATION

STATEMENTS OF CASH FLOWS

| | For the Years Ended August 31, 2005 | 2004 |
|---|--|---------------------|
| Cash flows from operating activities: | | |
| Net loss | \$ (1,050,881) | \$ (1,975,656) |
| Adjustments to reconcile net loss to net cash used for operating activities: | | |
| Interest accrued on long-term debt – related parties | 33,957 | 173,932 |
| Loss (gain) on sales of marketable securities | 15,563 | (11,996) |
| Depreciation | 7,148 | 4,948 |
| Depletion | 743 | 795 |
| Interest added to note receivable – Rangeview Metropolitan District | (16,917) | (13,903) |
| Restricted cash | (174,890) | - |
| Amortization of warrants | - | 75,600 |
| Extinguishment of contingent obligations | - | 1,126,241 |
| Changes in operating assets and liabilities: | | |
| Trade accounts receivable | 179 | 17,449 |
| Interest receivable and prepaid expenses | (1,862) | (57,152) |
| Accounts payable and accrued liabilities | (124,235) | 132,102 |
| Deferred revenues | 492,933 | - |
| Net cash used for operating activities | <u>(818,262)</u> | <u>(527,640)</u> |
| Cash flows from investing activities: | | |
| Investments in water and water systems | (404,519) | (135,870) |
| Purchase of marketable securities | (5,424,071) | (8,076,016) |
| Sales and maturities of marketable securities | 5,971,735 | 4,047,203 |
| Purchase of property and equipment | (5,660) | - |
| Sky Ranch option payments received | 60,400 | 50,000 |
| Net cash provided by / (used for) investing activities | <u>197,885</u> | <u>(4,114,683)</u> |
| Cash flows from financing activities: | | |
| Proceeds from the sale of common and preferred stock, net | 676,498 | 10,576,743 |
| Construction funding | 397,235 | - |
| Reimbursement to former CEO | (50,555) | - |
| Payments to contingent liability holders | (3,120) | (50,000) |
| Payments to purchase contingent liabilities | - | (2,750,000) |
| Payments on long-term debt – related parties | - | (2,085,999) |
| Net cash provided by financing activities | <u>1,020,058</u> | <u>5,690,744</u> |
| Net increase in cash and cash equivalents | 399,681 | 1,048,421 |
| Cash and cash equivalents – beginning of year | 1,574,201 | 525,780 |
| Cash and cash equivalents – end of year | <u>\$ 1,973,882</u> | <u>\$ 1,574,201</u> |
| Supplemental disclosures of non-cash activities: | | |
| Restricted common stock issued to former CEO in satisfaction of reimbursement obligation | <u>\$ 2,415,000</u> | <u>\$ -</u> |
| Treasury stock accepted upon exercise of stock options with mature shares used as consideration | <u>\$ 554,939</u> | <u>\$ -</u> |
| Preferred stock converted to common stock | <u>\$ -</u> | <u>\$ 10,055</u> |
| Common stock issued to acquire contingent obligations | <u>\$ -</u> | <u>\$ 326,122</u> |

See accompanying Notes to Financial Statements

PURE CYCLE CORPORATION
NOTES TO FINANCIAL STATEMENTS
AUGUST 31, 2005 AND 2004

NOTE 1 – ORGANIZATION

Description of Business. Pure Cycle Corporation (the “Company”) was incorporated in Delaware in 1976. The Company owns water assets located in the Denver, Colorado metropolitan area and on the western slope of Colorado. The Company is currently using its water assets located in the Denver metropolitan area to provide water and wastewater services to customers located in its service area. The Company operates water and wastewater systems and provides services which include the design and construction of the systems as well as the operation and maintenance of the systems. The Company also owns water recycling technologies which are capable of processing wastewater into potable drinking water. The Company’s main focus is to provide water and wastewater service to customers within its service area and other areas in the Denver metropolitan area.

The Company believes that at August 31, 2005, it has sufficient working capital and financing sources to fund its operations for at least the next year. However, there can be no assurances that the Company will be successful in marketing the water from its primary water projects on terms that are acceptable to the Company. The Company’s ability to ultimately realize its investment in its primary water projects is dependent on its ability to successfully market the water, or in the event it is unsuccessful, to sell the underlying water assets. In the event increased sales are not achieved, the Company may incur additional short or long-term debt or seek to sell additional shares of the Company’s common or preferred stock or stock purchase warrants, as deemed necessary by the Company, to generate sufficient working capital.

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Revenue Recognition. The Company generates revenues mainly from three sources; (i) water and wastewater tap fees, (ii) construction fees, and (iii) monthly water usage fees and wastewater service fees. Emerging Issues Task Force Issue No. 00-21 *Revenue Arrangements with Multiple Deliverables* (“EITF 00-21”), governs how to identify when goods or services, or both, that are separately delivered but included in a single sales arrangement should be accounted for separately. Based on the criteria of EITF 00-21, the Company accounts for each of the items addressed in the service agreement separately.

The Company recognizes revenues from the sale of water and wastewater taps as income upon receipt if the facilities required to provide water or wastewater services are in place and operational. If the facilities are not in place and operational, the Company defers recognition of the tap fees until the facilities are completed and placed in operation. The Company defers construction fees received for assets that it will own and reflects them as deferred construction funding on the balance sheet. Deferred construction fees are recognized as revenue over the estimated service period which is also the estimated useful life of the assets constructed. The Company recognizes water usage revenues upon delivering water to customers. The Company recognizes wastewater processing revenues based on flat fees assessed per single family equivalent (“SFE”) unit served. An SFE is defined in the Rangeview Metropolitan District’s (the “District” – described in Note 3) Rules and Regulations as the amount of water required each year by a family of four persons living in a single family house on a standard sized lot.

Costs to construct the Wholesale Facilities and Special Facilities are capitalized as incurred, including interest, if the costs meet the Company’s capitalization criteria, which are then depreciated over their estimated useful lives. Costs of delivering water and providing wastewater service to customers are recognized as incurred.

The Company did not recognize any tap fee revenue or construction revenue during the years ended August 31, 2005 and 2004. As of August 31, 2005, the Company has deferred recognition of \$375,894 of tap fee revenue for tap sales to Arapahoe County and \$44,415 of option payments received from Sky Ranch, both of which are more fully explained in Note 3.

Use of Estimates. The preparation of financial statements in conformity with Accounting Principles Generally Accepted in the United States of America (“GAAP”) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

PURE CYCLE CORPORATION
NOTES TO FINANCIAL STATEMENTS
AUGUST 31, 2005 AND 2004

Cash and Cash Equivalents. Cash and cash equivalents include all highly liquid debt and equity instruments with original maturities of three months or less. The Company's cash equivalents are comprised of money market funds, investments in debt securities and investments in commercial paper. As of August 31, 2005, the Company has no investments in equity instruments.

Restricted Cash. Restricted cash is comprised of (i) \$174,890 of proceeds received by the Company from Arapahoe County for Export Water sales (see Notes 3 and 4), that are to be remitted to an escrow agent and paid to external parties as required by the Comprehensive Amendment Agreement No. 1 (the "CAA"), and (ii) \$15,000 of proceeds received by the Company from Sky Ranch (see Notes 3 and 4) that are to be remitted to an escrow agent and paid to external parties as required by the CAA.

Financial Instruments. Financial instruments that potentially subject the Company to concentrations of credit risk consist primarily of cash equivalents, investments in marketable securities and notes payable – related parties. The Company places its cash equivalents and investments with a high credit-quality financial institution. The Company invests its excess cash primarily in money market instruments, commercial paper obligations, corporate bonds and US government treasury obligations. To date, the Company has not experienced significant losses on any of these investments. The notes payable – related parties bear interest at rates that approximate market.

Cash Flows. During fiscal 2005 and 2004, respectively, the Company paid \$0 and \$485,999 of interest. No cash was paid for income taxes in either fiscal 2005 or 2004. See Note 7 for discussion regarding non-cash exchange of common stock for warrants.

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 August 31, 2005 or 2004.

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

The following is a summary of marketable securities at August 31, 2005:

| | Cost Basis | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
|---------------------------------|--------------|------------------------------|-------------------------------|-------------------------|
| Commercial paper | \$ 1,165,487 | \$ - | \$ - | \$ 1,165,487 |
| U.S. government debt securities | 1,096,661 | 2,723 | (3,973) | 1,095,411 |
| U.S. corporate debt securities | 2,380,921 | 11,253 | (6,550) | 2,385,624 |
| Total investments | 4,643,069 | 13,976 | (10,523) | 4,646,522 |
| Less cash equivalents | 1,165,487 | - | - | 1,165,487 |
| Total marketable securities | \$ 3,477,582 | \$ 13,976 | \$ (10,523) | \$ 3,481,035 |

The following is a summary of marketable securities at August 31, 2004:

| | Cost Basis | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
|---------------------------------|--------------|------------------------------|-------------------------------|-------------------------|
| Commercial paper | \$ 3,262,616 | \$ - | \$ - | \$ 3,262,616 |
| U.S. government debt securities | 1,095,862 | 2,646 | - | 1,098,508 |
| U.S. corporate debt securities | 4,151,225 | 13,254 | (1,066) | 4,163,413 |
| Total investments | 8,509,703 | 15,900 | (1,066) | 8,524,537 |
| Less cash equivalents | 4,467,789 | 1,105 | - | 4,468,894 |
| Total marketable securities | \$ 4,041,914 | \$ 14,795 | \$ (1,066) | \$ 4,055,643 |

PURE CYCLE CORPORATION
NOTES TO FINANCIAL STATEMENTS
AUGUST 31, 2005 AND 2004

In fiscal 2005, gross realized losses totaled \$15,563, while gross realized gains totaled \$11,996 in fiscal 2004. The aggregate fair value of investments with unrealized gains as of August 31, 2005 and 2004 was \$3,257,837 and \$4,755,465, respectively. The aggregate fair value of investments with unrealized losses as of August 31, 2005 and 2004 was \$1,388,685 and \$506,456, respectively. The investments that are in a net loss position are deemed to be temporary losses based on the nature of the corporate bond markets and the significant fluctuations that have occurred in the markets over the past several years. The Company actively monitors the performance of its investments and adopted a new investment policy in fiscal 2005, to more closely align its investment portfolio with its expected capital requirements. All losses incurred during 2005 were the result of the Company shortening its average maturity in its investment portfolio to allow it more flexibility regarding anticipated capital needs in the short-term and to allow it to capitalize on interest rates that have continued to rise since the equity offering in 2004, when the majority of the investments were made.

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

Long-Lived Assets. The Company reviews its long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future undiscounted net cash flows expected to be generated by the eventual use of the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceed the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell. The Company believes there are no impairments in the carrying amounts of its long-lived assets at August 31, 2005.

Water and Wastewater Systems. The Company capitalizes design and construction costs related to construction activities as water or wastewater systems, and it capitalizes certain legal, engineering and permitting costs relating to the adjudication and improvement of its water assets.

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 are depreciated on a straight line basis over their estimated useful lives of 30 years.

Stock-Based Compensation. The Company accounts for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board (APB) No. 25, *Accounting for Stock Issued to Employees*. The Company has adopted the disclosure requirements of Statement of Financial Accounting Standards (SFAS) No. 123, *Accounting for Stock-Based Compensation* as specified in SFAS No. 148, *Accounting for Stock-Based Compensation-Transition and Disclosure-an amendment of SFAS No. 123*. The pro forma disclosure of net loss and loss per share required by SFAS No. 123 is shown below.

| | 2005 | 2004 |
|---|----------------|----------------|
| Net loss, as reported | \$ (1,050,881) | \$ (1,975,656) |
| Add back stock-based employee compensation expense included in reported net loss | - | - |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all options and warrants | (168,000) | (31,000) |
| Pro forma net loss | \$ (1,218,881) | \$ (2,006,656) |
| Weighted average common shares outstanding – basic and diluted | 13,674,156 | 8,879,771 |
| Pro forma net loss per share | \$ (.09) | \$ (.23) |

PURE CYCLE CORPORATION
NOTES TO FINANCIAL STATEMENTS
AUGUST 31, 2005 AND 2004

The fair value of each stock option is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions: 0% dividend yield; 116% and 113% volatility for options granted in 2005 and 2004, respectively; risk free rates between 3.5% and 4.1%; and expected lives of six years. In April 2005, 12,500 options were granted to non-employee directors under the 2004 Incentive Plan. Of the options granted, 10,000 vest one year after the grant date and 2,500 vest at the second anniversary date of the grants.

The Black-Scholes option-pricing model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option-pricing models require the use of highly subjective assumptions, including the expected stock price volatility. Because the Company's employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective assumptions can materially affect the fair value estimates, in management's opinion, the existing models do not necessarily provide a reliable measure of fair value of its employee stock-based compensation.

In December 2004, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standard No. 123 (revised 2004) *Share-Based Payment* ("SFAS 123R") which is a revision of SFAS 123 and addresses the accounting for employee stock options. SFAS 123R is effective for public companies, that file as small business issuers, for annual periods beginning after December 15, 2005 (SFAS 123R is effective for the Company beginning September 1, 2006), supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and amends SFAS No. 95 *Statement of Cash Flows*. Generally, the approach in SFAS 123R is similar to the approach described in SFAS 123. However, SFAS 123R requires that all share-based payments to employees, including grants of employee stock options, be recognized in the income statement based on their fair values. Pro forma disclosure is no longer an alternative. The Company has not yet completed its evaluation of the impact of SFAS 123R, but the Company expects the adoption to have a material effect on its financial statements.

Income Taxes. Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryovers. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

Accumulated Comprehensive Income. In addition to net loss, comprehensive income includes the cumulative unrecognized changes in the fair value of marketable securities that are classified as available-for-sale.

Reverse Stock Split. Effective April 26, 2004, stockholders approved a ten-for-one reverse stock split. Subsequent to the approval, every ten shares of the Company's common stock were replaced with one share of its common stock. Accordingly, all share and per share amounts for all periods presented have been restated to reflect the reverse split.

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 1,523,391 and 2,234,305 common share equivalents as of August 31, 2005 and 2004, respectively, have been excluded from the calculation of loss per common share as their effect is anti-dilutive.

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

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NOTE 3 – WATER, WATER SYSTEMS AND SERVICE AGREEMENTS

The Company's water and water systems consist of the following costs and accumulated depreciation and depletion as of August 31:

| | 2005 | | 2004 | |
|---|---------------|--|---------------|--|
| | Costs | Accumulated Depreciation and Depletion | Costs | Accumulated Depreciation and Depletion |
| Rangeview water supply | \$ 13,885,213 | \$ (2,913) | \$ 13,786,125 | \$ (2,170) |
| Paradise water supply | 5,515,133 | - | 5,498,124 | - |
| Construction in progress | 222,500 | - | - | - |
| Rangeview water system | 167,720 | (19,692) | 151,798 | (14,116) |
| Sky Ranch water supply | 100,000 | - | 50,000 | - |
| Water supply – other | 3,360 | - | 3,360 | - |
| Totals | \$ 19,893,926 | \$ (22,605) | \$ 19,489,407 | \$ (16,286) |
| Net Investments in water and water systems | \$ 19,871,321 | | \$ 19,473,121 | |

Depletion and Depreciation. The Company recorded \$743 and \$795 of depletion related to the Rangeview Water Supply in 2005 and 2004, respectively, and \$5,576 and \$4,948 of depreciation related to the Rangeview Water Systems in 2005 and 2004, respectively. No depletion is taken against the Paradise Water Supply or Sky Ranch Water Supply as these assets were unutilized through 2005.

Rangeview Water Supply, Water System and Construction in Progress. The Rangeview water supply and water system represents the costs of assets acquired or constructed related to the water used to supply water services to customers located on and off the Lowry Range Property. The recorded costs of the Rangeview Water Supply includes payments to the sellers of the Rangeview Water Supply, and certain direct costs relating to improvements to the asset including legal and engineering fees. The recorded costs of the Rangeview Water System includes design and construction costs incurred to construct the facilities required to provide water and wastewater services. The costs incurred to construct the water system used to supply water to the new Arapahoe County Fairgrounds and Regional Park (the "Fairgrounds") is currently recorded as construction in progress and will be included with the Rangeview Water Systems upon completion.

Rangeview Agreements

The Company acquired the Rangeview Water Supply beginning in 1996 when it (i) entered into the Agreement for Sale of Export Water with the Rangeview Metropolitan District (the "District"), a quasi-municipal political subdivision of the State of Colorado; (ii) the District entered into the Amended and Restated Lease Agreement with the State of Colorado Board of Land Commissioners (the "State Land Board"), which owns the Lowry Range Property; and (iii) the Company entered into the Service Agreement with the District for the provision of water service to the Lowry Range Property (collectively these agreements are referred to as the "Water Privatization Agreements").

Pursuant to the Water Privatization Agreements, the Company will design, construct, operate and maintain the District's water system to provide water service to the District's customers on the Lowry Range Property. The Water Privatization Agreements dedicated 17,620 acre-feet of water per year for use specifically on the Lowry Range Property. Additionally, the Water Privatization Agreements provide for the Company to use surface reservoir storage capacity in providing water service to customers within the Lowry Range Property. In exchange for providing water service to customers on the Lowry Range Property the Company will receive 95% of all amounts received by the District relating to water services, after the District pays the required royalties to the State Land Board totaling 12% of gross revenues received from water sales.

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Rates and charges for tap fees and usage or monthly fees are governed by the Company's rates and charges for all water and wastewater services under the terms of the Water Privatization Agreements. These rates and charges are reviewed annually and are the average of similar rates and charges of three surrounding municipal water and wastewater service providers. These represent gross fees and to the extent that water service is provided using Export Water, the Company is required to pay royalties to the State Land Board ranging from 10% to 50% of the net revenue after deducting certain costs.

The Company will also design, finance, construct, operate and maintain the District's wastewater system to provide wastewater service to customers within its service area pursuant to the Wastewater Service Agreement between the Company and the District. In exchange for providing wastewater service for the District's customers, the Company will receive 100% of the District's wastewater tap fees and 90% of the District's wastewater usage fees.

Lowry Range Water and Export Water

The Rangeview Water Supply is a combination of tributary surface water and storage rights and nontributary groundwater rights associated with the Lowry Range Property. The Company owns the rights to use 1,650 acre-feet of tributary surface water, together with 10,000 acre-feet of non-tributary groundwater, which can be exported off the Lowry Range Property to serve area users. The Company has the exclusive rights to use an additional 1,660 acre-feet of tributary surface water together with approximately 15,960 acre-feet of nontributary groundwater to serve customers on the Lowry Range Property. The Export Water, together with water that is owned by the State Land Board the Company has contracted to utilize under the Water Privatization Agreements, totals over 29,270 acre-feet of water per year. Additionally, the Company has the option with the State Land Board to exchange an aggregate gross volume of 165,000 acre-feet of groundwater for 1,650 acre-feet per year of adjudicated surface water.

Based on independent engineering estimates, the 17,620 acre-feet of water designated for use on the Lowry Range Property is capable of providing water service to approximately 46,500 SFE units, and the 11,650 acre-feet of Export Water owned by the Company can serve approximately 33,600 SFE units throughout the Denver metropolitan region.

On the Lowry Range Property, the Company will operate both the water and the wastewater systems during the contract period and the District will own both systems. After 2081, ownership of the water system servicing customers on the Lowry Range Property will revert to the State Land Board, with the District retaining ownership of the wastewater system. The Company owns the Export Water and will use it to provide water and wastewater services to customers off the Lowry Range Property. The Company will also own all the facilities required to extend water and wastewater services off the Lowry Range Property. The Company plans to contract with third parties for the construction of these facilities.

The Company delivered approximately 52.3 million and 56.3 million gallons of Rangeview water to customers on the Lowry Range Property in fiscal 2005 and 2004, respectively.

Arapahoe County Fairgrounds Agreement for Water Service

Effective August 3, 2005, the Company entered into an Agreement for Water Service (the "County Agreement") with Arapahoe County (the "County") to design and construct a water system for, and provide water services to, the new Fairgrounds. Pursuant to the County Agreement: (i) the County purchased water taps for 38.5 SFEs for \$567,490, or \$14,740 per tap; (ii) the Company agreed to design and construct the required Special Facilities, for which the County agreed to provide funding of \$1,245,168; and (iii) the Company agreed to acquire rights to approximately 363 acre-feet of groundwater from the County for \$293,013. As of August 31, 2005, the Water Rights Deed has not been transferred to the Company, and therefore, the cost of this water has not been capitalized on the accompanying balance sheet).

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Pursuant to the County Agreement, in August 2005 the Company received a net cash payment of \$514,552 and the rights to 27 acre-feet of dedicated groundwater valued at \$52,938, pending transfer of the Water Rights Deed. Since the Company will utilize Export Water to provide water service to the Fairgrounds, the sale of the water taps generated a royalty payment to the State Land Board. The agreement with the State Land Board requires royalty payments on Export Water sales based on net revenues. Net revenues are defined as proceeds from the sale of Export Water less direct and indirect costs, including reasonable overhead charges, associated with the withdrawal, treatment and delivery of Export Water. Based on this, in September 2005, the Company made a royalty payment to the State Land Board of \$34,522, which is 10% of the net revenues or net tap fees received from the County.

In addition, tap fees under service agreements in which Export Water will be utilized, are subject to the CAA, which is described in more detail in Note 4. Net tap fees subject to the CAA totaling \$532,968, which are the tap fees received from the County less the \$34,522 State Land Board royalty, were distributed to the escrow agent as required by the CAA in September 2005. Based on the 2004 CAA acquisitions the Company made, the Company received \$373,078, or 70%, of the distribution and external parties received \$159,890, or 30%. The \$159,890 paid to third parties in September 2005, is reflected in the balance sheet as *Payable to contingent obligation holders*.

The tap fees retained by the Company will be used to fund construction of the Wholesale Facilities required to extend water service to the Fairgrounds. In accordance with GAAP, as of August 31, 2005, \$375,894 of tap fees received from the County are deferred and will be recognized as revenue when the Wholesale Facilities are placed into service. The amount deferred at August 31, 2005 is comprised of the tap fees received by the Company of \$567,490, decreased by (i) the tap fee credits for the purchase of the groundwater from the County of \$52,938 (which will be recorded as additional deferred revenue upon satisfactory delivery of the Water Rights Deed); (ii) royalties to the State Land Board of \$34,522; and (iii) 35% of the total payments made to external CAA holders (which is more fully described in Note 4) or \$55,754.

Pursuant to the County Agreement, the County is providing funding of \$1,245,168 for the design and construction of the Special Facilities. In August 2005, the County made an initial payment of \$397,235, and will make monthly payments of approximately \$6,850 for 10 years following acceptance of the construction (this amount includes interest at 6% per annum). The remaining \$240,075 will be paid by the Company extending credits to the County in exchange for the remaining 336 acre-feet of water purchased from the County valued at \$240,075 (consistent with the 27 acre-feet noted above, upon satisfactory receipt of the Water Rights Deed the Company will capitalize the value of this water and record an additional \$240,075 of deferred construction funding). In accordance with GAAP, construction funding of \$397,235 provided by the County has been deferred and will be recognized as revenue over the expected service period, which is also the estimated useful life of the Special Facilities being constructed with the funds.

In August 2005, the Company entered into a contract with a third party to construct a 500,000 gallon water tank for use at the Fairgrounds. The water tank will cost approximately \$900,000 which is payable based on contractual milestones over the next twelve months. In August 2005, the Company made the initial payment of \$218,500 (which is recorded as construction in progress as of August 31, 2005). No other construction contracts have been entered into as of the date of this filing. However, the Company anticipates all construction activities to be performed by third party contractors.

Sky Ranch Water Supply and Water Service Agreements

On October 31, 2003, and May 14, 2004, the Company entered into two Water Service Agreements (collectively the "Sky Ranch Agreements") with the developer of approximately 950 acres of property located 4 miles north of the Lowry Range Property along Interstate 70 known as Sky Ranch. Pursuant to the Sky Ranch Agreements the Company will provide water for all homes and buildings to be constructed at Sky Ranch, which could go as high as 4,850 SFE units. The developer is obligated to purchase a minimum of 400 water taps from the Company before occupancy of the first house in Sky Ranch and a minimum of 310 annually thereafter. This tap purchase schedule is designed to provide the Company with adequate funds with which to construct the Wholesale Facilities required to provide water service. As additional water taps are acquired due to continued development of Sky Ranch, the Company will expand the infrastructure to meet demand as necessary. Based on discussions with

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the developer of Sky Ranch, we anticipated the developer purchasing the initial taps during the Company's second quarter of fiscal 2005. The Company has not received any payments for tap purchases from the developer and the Company continues to discuss the timing of tap purchases and expected start date of the project with the developer. The developer has informed the Company that it is actively engineering the final design of the project and is marketing lots to several national home builders with operations in the Denver area. Based on these discussions, the Company has begun the design and engineering of the water facilities but will not initiate construction until the Company receives notice from the developer to proceed together with payment for the initial tap purchases.

As part of the Sky Ranch Agreements, the developer dedicated approximately 537 acre-feet of water to the Company in exchange for a \$3,400 per tap credit for the first 767 water taps purchased. In lieu of the developer receiving these credits the Company will utilize the \$3,400 per tap to fund construction of certain Special Facilities required to be constructed in order for the Company to provide water service to Sky Ranch. As of August 31, 2005, this water has not been dedicated to the Company because Sky Ranch has not yet purchased any water taps.

On October 31, 2003 the Company entered into the Denver Groundwater Purchase Agreement (the "DGPA") with the developer of Sky Ranch. The DGPA provides the Company the option to purchase a total of 223 acre-feet of adjudicated decreed water rights owned by the developer for five payments of \$50,000 each, totaling \$250,000. Under the DGPA, the Company can acquire 44.6 acre-feet of water per year (or 20% of the total 223 acre-feet) for \$50,000. On March 26, 2004, and May 26, 2005, the Company exercised these options and purchased a total of 89.2 acre-feet of Denver aquifer groundwater for payments totaling \$100,000. The Company anticipates exercising the remaining options over the next three years to complete the purchase of the remaining 133.8 acre-feet of Denver aquifer groundwater from Sky Ranch for payments totaling \$150,000.

The Company plans to initially develop the 760 acre-feet of water beneath the Sky Ranch property which is being dedicated by the developer of Sky Ranch and purchased from the developer of Sky Ranch under the DGPA. The purchased water is sufficient to provide water service to approximately 1,500 taps. Any taps purchased by Sky Ranch in excess of 1,500 are subject to royalty payments to the State Land Board and payments to the CAA holders.

The Sky Ranch Agreements provide the developer the right to exercise options to use a combined 1,200 acre-feet of Export Water per year at Sky Ranch after a defined number of taps have been purchased for use at Sky Ranch unless the developer allows the options to expire. The Sky Ranch Agreements call for two options (i) annual installments of \$50,000 over five years (the "Sky Ranch Option"), and (ii) annual installments of \$10,400 over five years (the "Hills Option"). Option fees received before the options are exercised or allowed to expire will not be refunded and are deferred and recognized into income ratably until the next option payment is due.

In August 2005, the developer remitted the second \$50,000 Sky Ranch Option payment (the first was received in fiscal 2004), which was distributed in order of priority to the CAA holders. Of this distribution, the Company received \$35,000 in September 2005, and outside parties received \$15,000. The Company received a distribution because it had repurchased certain CAA interests in fiscal 2004. Of the amounts paid to the outside parties, \$5,231 was allocated to the Participating Interests in Export Water supply liability and \$9,769 reduced the contingency under the CAA. In February 2005, the developer remitted the first \$10,400 Hills Option payment which was distributed in order of priority to the CAA holders. Of this distribution, the Company received \$7,280 and outside parties received \$3,120. Of the amounts paid to the outside parties, \$1,088 was allocated to the Participating Interests in Export Water supply liability and \$2,032 reduced the contingency under the CAA.

The Company expects to dedicate approximately 1,200 acre-feet, or 10%, of the Export Water supply (which is about 4.2% of the Company's overall Rangeview Water Supply) for this project.

Paradise Water Supply. In 1987, the Company acquired water, water wells, and related assets from Paradise Oil, Water and Land Development, Inc., which constitute the Paradise water supply. The recorded costs of the Paradise water supply include the costs to acquire the Paradise water supply, as well as certain direct legal and engineering costs relating to improvements to the asset. The Paradise water supply includes 70,000 acre-feet of tributary Colorado River decreed water, a right-of-way permit from the United States Department of the Interior, Bureau of Land Management, for the construction of a 70,000 acre-foot dam and reservoir across federal lands, and

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four water wells ranging in depth from 900 feet to 1,800 feet. The water wells are capable of producing approximately 7,500 - 9,400 gallons per minute or approximately 14,000 acre-feet per well per year with an artesian pressure of approximately 100 pounds per square inch. Due to the strict regulatory requirements for constructing an on-channel reservoir, completing this conditional storage right at its decreed location would be difficult. As a result, there can be no assurance that the Company will ever be able to make use of this asset or sell the water profitably. Every six years the Paradise water supply is subject to a Finding of Reasonable Diligence review by the Water Court and the State Engineer to determine if the Company is diligently pursuing the development of the water rights. During fiscal 2005, the State Engineer began this review. At this time the Company is unable to estimate when the review will be complete or the final outcome of the review. An unfavorable outcome could include the State Engineer and Water Court canceling the conditional rights, which would have a material adverse effect on the financial statements. Since the Company acquired the Paradise Water Supply in 1987, it has received a satisfactory Finding of Reasonable Diligence at each of these reviews.

In accordance with FASB Statement of Financial Accounting Standard No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* ("SFAS 144"), at least annually, the Company reviews its long-term assets, including the Paradise water supply, for indicators of impairment. Consistent with SFAS 144, the Company compares the carrying amount of the Paradise water supply to the sum of the undiscounted cash flows from the expected eventual use of the asset. Assessment of the recoverability of the carrying value of the Paradise water supply assumes revenues from water tap sales and monthly metered water usage fees offset by wholesale development costs, which are based on engineering estimates, over a 35 year development horizon. Based on the latest annual assessment (last test performed as of August 31, 2005), because the fair value exceeded the carrying value of the Paradise water supply no impairment was found to exist.

NOTE 4 – PARTICIPATING INTERESTS IN EXPORT WATER

The Company commenced the purchase of its principal water assets through a Water Commercialization Agreement ("WCA"), an agreement with a related investor (the "LCH Agreement") and the sale of 432,513 shares of Series B Preferred Stock. The WCA was entered into in 1990 and amended in 1991 and 1992 and again in 1996 by the signing of the CAA. The parties to the WCA and CAA agreements provided the Company approximately \$11.1 million of financing to acquire the Rangeview Water Supply. This amount (which has been reduced by the transactions described below) is presented on the accompanying balance sheet as *Participating Interests in Export Water supply*, a liability. In addition to repaying the initial \$11.1 million of funding, the CAA provided that the Company would pay the parties to the CAA an additional \$20.9 million of proceeds from Export Water sales (of which, \$218,500 was to be maintained by the Company). Under the CAA, these funds are to be repaid strictly with proceeds from the sale of Export Water. Therefore, before the 2004 acquisitions as described below, the first \$32.0 million received from the sale of Export Water were required to be paid to the CAA holders.

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

During 2004, the Company acquired the rights to approximately \$8.2 million of CAA obligations in exchange for cash payments of \$2.75 million and the issuance of 40,512 shares of restricted common stock. As a result of these transactions, the Company, rather than external CAA holders, now has the rights to retain \$8.4 million of the initial \$32.0 million of proceeds from the sale of Export Water. The acquisition of these CAA obligations reduces the long term impact of the CAA and provides the Company with additional cash flows to fund operations and pursue other business opportunities that may arise.

The CAA includes contractually established priorities, and the rights the Company acquired includes \$5.6 million in the highest priority level with the remaining \$2.8 million at various other priority levels. Based on the

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original accounting treatment for the CAA, the Company recorded an extinguishment charge of approximately \$217,000 related to this transaction in the year ended August 31, 2004.

As described above, as proceeds are received related to the sale of Export Water, the Company remits the payments to the escrow agent and records the portion payable to third parties as either a reduction of the Participating Interests account or as a reduction of the contingency, based on the percentages calculated at the signing of the CAA. In 2005 and 2004, the Company received option payments from Sky Ranch and tap fees from the County which are related to Export Water sales, and therefore these amounts were remitted to the escrow agent for payment to the CAA holders. The transactions impacting the CAA in fiscal 2005 and 2004 are:

| | Export Water Proceeds Received | Amounts Retained by Pure Cycle | Total Third Party Obligations | Participating Interests Liability | Contingency |
|----------------------------|---|--------------------------------------|-------------------------------------|---|---------------|
| Original balances | \$ - | \$ 218,500 | \$ 31,807,732 | \$ 11,090,630 | \$ 20,717,102 |
| Sky Ranch option payment | 50,000 | - | (50,000) | (17,435) | (32,565) |
| Fiscal 2004 acquisitions | - | 8,199,333 | (8,199,333) | (2,858,920) | (5,340,413) |
| Balance at August 31, 2004 | 50,000 | 8,417,833 | 23,558,399 | 8,214,275 | 15,344,124 |
| Sky Ranch option payments | 60,400 | (42,280) | (18,120) | (6,319) | (11,801) |
| Arapahoe County tap fees * | 532,968 | (373,078) | (159,890) | (55,754) | (104,136) |
| Balance at August 31, 2005 | \$ 643,368 | \$ 8,002,475 | \$ 23,380,389 | \$ 8,152,202 | \$ 15,228,187 |

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

The LCH Agreement and Preferred Stock. Pursuant to the LCH Agreement, the Company agreed to pay the next \$4.0 million of proceeds from Export Water sales to LCH, Inc. a party related to the Company's former CEO, Thomas Clark. Further, the next \$433,000 of proceeds from Export Water sales were required to be paid to the holders of the Series B Preferred Stock. Accordingly, the Company would only be entitled to retain 100% of the proceeds from Export Water sales after paying \$36.5 million under the CAA and LCH agreements and to the holders of the Series B Preferred Stock.

On August 31, 2004 the Company entered into the Settlement Agreement with LCH, whereby LCH released the Company from its obligations under the LCH Agreement in consideration of the Company's former CEO surrendering 306,279 shares of common stock (which were pledged as collateral against notes payable to LCH), and the Company repaying the \$950,000 of notes payable to LCH. The 306,279 shares were designated to repay \$1,557,110 of accrued interest payable to LCH and to acquire the \$4.0 million of contingent obligations, which represents the Company's obligations under the LCH Agreement extending the \$32.0 million of obligations under the CAA to \$36.0 million. To return Mr. Clark to his original position, in January 2005, the Company paid Mr. Clark \$50,555 in cash and issued him 300,000 shares of restricted common stock, which totaled \$2,465,555 (the same consideration Mr. Clark surrendered to LCH). Based on the original accounting treatment for this contingent obligation, the Company recorded an extinguishment charge of \$909,040 related to this transaction in the year ended August 31, 2004.

In the aggregate, during 2004, the Company acquired \$12.2 million of obligations and repaid \$2.5 million of debt and accrued interest for cash payments of \$3.75 million and the issuance of 340,512 shares of restricted common stock (these figures include the \$50,555 paid, and 300,000 shares issued, to Mr. Clark in January 2005). In total, under the CAA, the Company will now retain \$12.4 million of the initial \$36.5 million of proceeds from the sale of Export Water.

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 not entitled to payment of any dividend and have no contractual recourse against the Company.

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NOTE 5 – ACCRUED LIABILITIES

At August 31, 2005, the Company had accrued liabilities of \$31,518, of which \$23,000 is for professional fees, \$4,000 relates to construction invoices for the County Agreement, and the remainder is for operating payables. At August 31, 2004, the Company had accrued liabilities of \$180,927 of which \$45,000 were for professional fees, approximately \$126,000 were for legal fees and the remainder were for operating payables.

NOTE 6 - LONG-TERM DEBT

Long-term debt, including accrued interest, at August 31, is comprised of the following:

| | 2005 | 2004 |
|---|--------------|--------------|
| Notes payable to a related party, due August 2007, interest at the Applicable Federal Rate for short-term obligations (3.58% at August 31, 2005), unsecured (1) | \$ 876,718 | \$ 864,121 |
| Notes payable to the former CEO's estate, due September 2007, interest at 8.36% and 9.01%, unsecured | 551,661 | 530,301 |
| Note payable to the former CEO's estate, due October 2007, non-interest bearing, unsecured | 26,542 | 26,542 |
| Total long-term debt | \$ 1,454,921 | \$ 1,420,964 |

- (1) The holder of these notes is a party to the CAA and has agreed that if the amounts due to this party under the CAA are paid prior to the maturity date of the notes, the notes will be cancelled.

Aggregate maturities of long-term debt are as follows:

| Year Ending August 31, | Amount |
|------------------------|--------------|
| 2007 | \$ 876,718 |
| 2008 | 578,203 |
| Total | \$ 1,454,921 |

NOTE 7 - STOCKHOLDERS' EQUITY

Preferred and Common Stock. During the year ended August 31, 2004, the Company issued the following shares of common stock upon the conversion of preferred stock: 645,500 shares of common stock upon conversion of 6,455,000 shares of Series D Preferred Stock; 200,000 shares of common stock upon conversion of 2,000,000 shares of Series D-1 Preferred Stock; 888,888 shares of common stock upon conversion of 1,600,000 shares of Series A-1 Preferred Stock. No conversions were completed during the year ended August 31, 2005.

The non-voting Series B Preferred Stock have a preference in liquidation of \$1.00 per share less any dividends previously paid. Additionally, the Series B Preferred Stock are redeemable at the discretion of the Company for \$1.00 per share less any dividends previously paid. In the event that the Company's proceeds from sale or disposition of Export Water rights exceeds \$36,026,232, the Series B Preferred Stock holders will receive the next \$433,000 of proceeds in the form of a dividend.

Stock Options. The Company maintains two stock option plans, the 2004 Incentive Plan which was approved by stockholders in April 2004, and the Equity Incentive Plan which was approved by stockholders in June 1992, (collectively the "Option Plans") for executives, eligible employees and non-employee directors. Under the Option Plans, options to purchase shares of stock can be granted with exercise prices and vesting periods determined by the Compensation Committee of the Board and are exercisable over periods of up to ten years. The Company has 1.6 million and 1.2 million shares of common stock reserved for issuance under the 2004 Incentive Plan and the Equity Incentive Plan, respectively. Of these amounts, 1,522,500 options can still be granted under the 2004 Incentive

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Plan. The Equity Incentive Plan expired in 2002 and no additional options can be granted under this plan. Additionally, the Company granted 300,000 options to its President under an employment agreement outside of the Option Plans in 2001.

A summary of the status of the Company's Option Plans and other compensatory options as of August 31, and changes during the years then ended, is presented below:

| | 2005 | | 2004 | |
|-------------------------------------|-----------|---------------------------------------|-----------|---------------------------------------|
| | Shares | Weighted Average Exercise Price | Shares | Weighted Average Exercise Price |
| Outstanding at beginning of year | 2,179,411 | \$ 1.99 | 2,600,000 | \$ 1.80 |
| Granted | 12,500 | \$ 7.21 | 65,000 | \$ 8.23 |
| Exercised | (684,132) | \$ 1.80 | (485,589) | \$ 1.80 |
| Outstanding at end of year | 1,507,779 | \$ 2.12 | 2,179,411 | \$ 1.99 |
| Options exercisable at year end | 1,462,779 | \$ 1.94 | 2,126,911 | \$ 1.84 |

The following table summarizes information about stock options outstanding at August 31, 2005, with exercise prices equal to the fair market value on the date of grant and no restrictions on exercisability after vesting:

| Options Outstanding | | | Options Exercisable | | |
|--------------------------------|-----------------------|--|---|-----------------------|--|
| Range of Exercise Prices | Number Outstanding | Weighted- average Remaining Contractual Life (in years) | Weighted- average Exercise Price | Number Exercisable | Weighted Average Exercise Price |
| \$1.80 | 1,430,279 | 2.00 | \$1.80 | 1,430,279 | \$1.80 |
| \$7.00-\$8.00 | 62,500 | 9.49 | \$7.84 | 25,000 | \$8.00 |
| \$9.00 | 15,000 | 8.67 | \$9.00 | 7,500 | \$9.00 |
| \$1.80 to \$9.00 | 1,507,779 | 6.42 | \$2.12 | 1,462,779 | \$1.94 |

In April of 2005, 12,500 options were granted to non-employee directors under the 2004 Incentive Plan. Of the options granted, 10,000 vest one year after the grant date and 2,500 vest at the second anniversary date of the grant.

The exercise price for 308,299 of the options exercised in fiscal 2005 was paid for by the option holders utilizing 73,154 shares of common stock held by the respective option holder more than six months with a market value at the dates of exercise totaling \$554,939, which is shown as Treasury Stock on the accompanying balance sheet.

Warrants. At August 31, 2003, the Company had outstanding warrants to purchase 2,440,284 shares of common stock. In fiscal 2004, in resolution of a dispute, warrants to purchase 160,000 shares of common stock that the Company believed had expired in 1997 were determined to not have expired. Giving effect to this settlement, the Company had outstanding warrants to purchase 2,600,284 of common stock at that date.

Concurrent with the public offering in June 2004, selling shareholders exercised 908,778 outstanding warrants for 908,778 shares of common stock at an exercise price of \$1.80 per share, which resulted in proceeds to the Company of \$1,635,800.

Following the public offering in June 2004, the Company had outstanding warrants to purchase 1,691,506 shares of common stock. On March 18, 2005, and August 31, 2004, the Company agreed to amend certain outstanding warrants to provide a net exercise provision whereby the warrant holders could exercise their warrants by using the underlying shares of common stock at the current market price as payment of the exercise price in lieu

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of cash. All but two of the remaining warrant holders entered into such amendments and exercised warrants to purchase 39,282 and 1,636,612 shares of common stock in fiscal 2005 and 2004, respectively. As a result, the Company issued 29,714 and 1,273,369 shares of common stock upon such exercises in 2005 and 2004, respectively. The remaining warrants outstanding do not contain a net exercise provision. In 2001, the expiration date for 210,000 of the warrants exercised in 2004, was extended to 2007, and related to this, the Company was amortizing the \$126,000 fair value of the warrants until 2007. However, since the warrants were exercised during the year ended August 31, 2004, the remaining unamortized balance of \$50,000 was recorded as additional amortization expense in 2004.

As of August 31, 2005, the Company has outstanding warrants to purchase 15,612 shares of common stock at an exercise price of \$1.80 per share. These warrants expire six months from the earlier of (i) the date all of the Export Water is sold or otherwise disposed of, (ii) the date the CAA is terminated with respect to the original holder of the warrant, or (iii) the date on which the Company makes the final payment pursuant to Section 2.1(r) of the CAA.

NOTE 8 - SIGNIFICANT CUSTOMERS

The Company had accounts receivable from two significant customers totaling approximately \$47,856 and \$32,364, as of August 31, 2005 and 2004, respectively. The same customers accounted for approximately 98% and 96%, respectively, of the Company's revenues during the year ended August 31, 2005 and 2004.

NOTE 9 - INCOME TAXES

There is no provision for income taxes because the Company has incurred operating losses. Deferred income taxes reflect the tax effects of net operating loss carryforwards and temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the Company's deferred tax assets as of August 31 are as follows:

| | 2005 | 2004 |
|---|--------------|--------------|
| Deferred tax assets: | | |
| Net operating loss carryovers | \$ 3,472,500 | \$ 2,406,100 |
| Depreciation and depletion of water and water systems | 77,900 | 712,700 |
| Valuation allowance | (3,548,900) | (3,118,800) |
| Net deferred tax asset | 1,500 | - |
| Deferred tax liabilities: | | |
| Depreciation on property and equipment | (1,500) | - |
| Net deferred assets | \$ - | \$ - |

The Company has recorded a valuation allowance equal to the excess of the deferred tax assets over the deferred tax liability as the Company is unable to reasonably determine if it is more likely than not that deferred tax assets will ultimately be realized.

Income taxes computed using the federal statutory income tax rate differs from our effective tax rate primarily due to the following for the years ended August 31:

| | 2005 | 2004 |
|---|--------------|--------------|
| Expected benefit from federal income taxes at statutory rate of 34% | \$ (357,300) | \$ (667,300) |
| State taxes, net of federal benefit | (34,700) | (64,800) |
| Expiration of net operating losses | 176,900 | 365,800 |
| Permanent differences | (215,000) | 200 |
| Change in valuation allowance | 430,100 | 366,100 |
| Total income tax expense | \$ - | \$ - |

PURE CYCLE CORPORATION
NOTES TO FINANCIAL STATEMENTS
AUGUST 31, 2005 AND 2004

At August 31, 2005, the Company has approximately \$7,050,000 of net operating loss carryovers available for income tax purposes which expire between fiscal 2006 and 2025. Utilization of these net operating loss carryforwards may be subject to substantial annual ownership change limitations provided by the Internal Revenue Code. Such an annual limitation could result in the expiration of the net operating loss carryforwards before utilization.

Net operating loss carryforwards of approximately \$474,000 and \$981,000 expired during the years ended August 31, 2005 and 2004, respectively.

NOTE 10 – INFORMATION CONCERNING BUSINESS SEGMENTS

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

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

Until the signing of the County Agreement in August 2005, and since development has not begun on either the Lowry Range Property or Sky Ranch, the Company did not recognize any construction revenues or expenses during the years ended August 31, 2005 or 2004. In August of 2005, the Company began the construction of a 500,000 gallon water tank which will be used to extend water service to the Fairgrounds, which is being funded by the construction fees charged to the County pursuant to the County Agreement. Therefore, as of August 31, 2005, with the exception of the \$222,500 recorded as construction in progress (see Note 3), the results of operations and balance sheet information presented relate entirely to the water and wastewater service provider segment.

NOTE 11 – RELATED PARTY TRANSACTIONS

As further described in Note 4, at August 31, 2004 the Company entered into the Settlement Agreement with LCH, Inc. Pursuant to the Settlement Agreement the Company's former CEO surrendered stock to LCH which had been pledged as collateral against certain notes payable the Company had with LCH. In January 2005, the Company paid its former CEO \$50,555 in cash and issued him 300,000 shares of restricted common stock as reimbursement for the shares he surrendered on the Company's behalf.

From time to time since 1987, the former CEO loaned funds to the Company to cover operating expenses. These funds are reported as unsecured debt (see Note 6) with interest at 8.36% and 9.01% per annum and are payable in October, 2007.

In 1996 and 1997, the Company entered into loan agreements with five related parties and a director. The loan balances and accrued interest to such persons were repaid during the year ended August 31, 2004. In connection with these loan agreements, the Company issued warrants to such persons to purchase 402,300 shares of common stock with an exercise price of \$1.80 per share. These warrants were exercised during the year ended August 31, 2004 (see Note 7).

In 1995, the Company extended a loan to the District, a related party. The loan provided for borrowings of up to \$250,000 is unsecured, bears interest based on the prevailing prime rate plus 2% (8.0% at August 31, 2005) and matures on December 31, 2005. The \$430,722 balance of the note receivable at August 31, 2005, includes borrowings of \$229,310 and accrued interest of \$201,412. The Company intends to extend the due date to December 31, 2006 and accordingly the note has been classified as non-current.

Effective September 1, 2004, the Company leases space for its corporate office from its former CEO, Mr. Clark, which is now being leased from the estate of Mr. Clark. The Company leases the space under a month-to-

PURE CYCLE CORPORATION
NOTES TO FINANCIAL STATEMENTS
AUGUST 31, 2005 AND 2004

month lease for \$1,000 per month. Prior to September 1, 2004, the Company occupied this office space from its former CEO at no cost to the Company.

Beginning in fiscal 2004, employees of the Company were covered under health insurance plans of a company owned by the former CEO. Effective August 1, 2005, the Company converted to its own health insurance plan. During the years ended August 31, 2005 and 2004, respectively, the Company reimbursed the related party \$32,699 and \$15,206 related to these health plans.

Item 8. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None.

Item 8A. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Our disclosure controls and procedures are designed to ensure that information required to be disclosed in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission, and that such information is accumulated and communicated to management, to allow timely decisions regarding required disclosure. We necessarily apply judgment in assessing the costs and benefits of such controls and procedures that, by their nature, can only provide reasonable assurance regarding management's control objectives. The President and CFO has reviewed the effectiveness of our disclosure controls and procedures as of August 31, 2005, and based on this evaluation has concluded that the disclosure controls and procedures were effective as of such date.

Changes in Internal Controls

There have been no significant changes in our internal controls or in other factors that could significantly affect these controls subsequent to the date of the evaluation referred to above.

Item 8B. Other Information

We will be holding our Annual Meeting of Stockholders on January 17, 2006 at 2 PM Mountain time. The Meeting will be held at the offices of Davis Graham and Stubbs, LLP, 1550 17th Street, Suite 500, Denver, Colorado 80202. Any nominations for director or other matters that shareholders wish to have considered at the meeting must be received in writing by our corporate Secretary, at our office located at the address noted on the cover page, before December 2, 2005.

PART III

Item 9. Directors, Executive Officers, Promoters and Control Persons; Compliance with Section 16(a) of the Exchange Act

The following table sets forth the names, ages and titles of the persons who are currently our directors and executive officers, along with other positions they hold with us.

| Name | Age | Position |
|---------------------|------------|--|
| Mark W. Harding | 42 | Director, President and CFO |
| Harrison H. Augur | 63 | Chairman of the Board |
| Richard L. Guido | 61 | Director |
| Peter C. Howell | 56 | Director |
| George M. Middlemas | 59 | Director |
| Thomas P. Clark | deceased | Former Director (passed away June, 2005) and former CEO (retired November, 2004) |

Further information concerning our directors, executive officers and our Code of Ethics, is contained in our definitive Proxy Statement pursuant to Regulation 14A promulgated under the Securities Exchange Act of 1934 for the 2006 Annual Meeting of Stockholders and is incorporated herein by reference, which is expected to be filed on or about December 12, 2005.

Item 10. Executive Compensation

Information concerning this item is contained in our definitive Proxy Statement pursuant to Regulation 14A promulgated under the Securities Exchange Act of 1934 for the 2006 Annual Meeting of Stockholders and is incorporated herein by reference, which is expected to be filed on or about December 12, 2005.

Item 11. Security Ownership of Certain Beneficial Owners and Management

Information concerning this item is contained in our definitive Proxy Statement pursuant to Regulation 14A promulgated under the Securities Exchange Act of 1934 for the 2006 Annual Meeting of Stockholders and is incorporated herein by reference, which is expected to be filed on or about December 12, 2005.

Item 12. Certain Relationships and Related Transactions

Information concerning this item is contained in our definitive Proxy Statement pursuant to Regulation 14A promulgated under the Securities Exchange Act of 1934 for the 2006 Annual Meeting of Stockholders and is incorporated herein by reference, which is expected to be filed on or about December 12, 2005.

Item 13. Exhibits

(a) Exhibits

- 3.1 Amended and Restated Certificate of Incorporation - Incorporated by reference from Exhibit 3.1 to Amendment No. 2 to Registration Statement on Form SB-2, filed June 10, 2004, Registration No. 333-114568
- 3.2 Amended and Restated Bylaws of Registrant - Incorporated by reference from Exhibit 3.2 to Amendment No. 2 to Registration Statement on Form SB-2, filed June 10, 2004, Registration No. 333-114568-.
- 4.1 Specimen Stock Certificate - Incorporated by reference to Registration Statement No. 2-62483.
- 10.1 Letter Agreement dated August 31, 1987 between Pure Cycle Corporation and Paradise Oil, Water & Land Development, Inc. Incorporated by reference from Current Report on Form 8-K filed with the SEC on August 5, 1988.
- 10.2 Right of First Refusal Agreement dated August 12, 1992 between INCO Securities Corporation and Richard F. Myers, Mark W. Harding, Thomas P. Clark, Thomas Lamm and Rowena Rogers. Incorporated by Reference from Registration Statement on Form SB-2, filed April 19, 2004, Registration No. 333-114568.
- 10.3 Equity Incentive Plan. Incorporated by reference from Proxy Statement for Annual Meeting held April 2, 1993.
- 10.4 2004 Equity Incentive Plan. Incorporated by reference from Proxy Statement for Annual Meeting held April 12, 2004
- 10.5 Service Agreement, dated April 11, 1996, by and between Pure Cycle Corporation and the Rangeview Metropolitan District. Incorporated by reference from Quarterly Report on Form 10-QSB for the period ended May 31, 1996.
- 10.6 Wastewater Service Agreement, dated January 22, 1997, by and between Pure Cycle Corporation and the Rangeview Metropolitan District. Incorporated by reference from the Annual Report on Form 10-KSB for the fiscal year ended August 31, 1997.
- 10.7 Comprehensive Amendment Agreement No. 1, dated April 11, 1996, by and among ISC, the Company, the Bondholders, Gregory M. Morey, Newell Augur, Jr., Bill Peterson, Stuart Sundlun, Alan C. Stormo,

Beverlee A. Beardslee, Bradley Kent Beardslee, Robert Douglas Beardslee, Asra Corporation, International Properties, Inc., and the Land Board. Incorporated by reference from Quarterly Report on Form 10-QSB for the period ended May 31, 1996.

- 10.8 Settlement Agreement and Mutual Release dated April 11, 1996 by and among the State Land Board and the District, Pure Cycle Corporation, INCO Securities Corporation, Apex Investment Fund II, L.P., Landmark Water Partners, L.P., Landmark Water Partners II, L.P., Environmental Venture Fund, L.P., Environmental Private Equity Fund II, L.P., The Productivity Fund II, L.P., Proactive Partners, L.P., Warwick Partners, L.P., Auginco, Anders C. Brag, Amy Leeds, and D.W. Pettyjohn, and OAR, Incorporated, Willard G. Owens and H.F. Riebesell, Jr. Incorporated by reference from Quarterly Report on Form 10-QSB for the fiscal quarter ended May 31, 1996).
- 10.9 Agreement for Sale of Export Water dated April 11, 1996 by and among the Company and the District. Incorporated by reference from Quarterly Report on Form 10-QSB for the fiscal quarter ended May 31, 1996).
- 10.10 Water Service Agreement for the Sky Ranch PUD dated October 31, 2003 by and between Airpark Metropolitan District, Icon Investors I, LLC, the Company and the District. Incorporated by reference from Registration Statement on Form SB-2, filed April 19, 2004, Registration No. 333-114568.
- 10.11 Non-Statutory Stock Option Agreement dated April 19, 2001 between the Company and Mark W. Harding. Incorporated by reference from Registration Statement on Form SB-2, filed April 19, 2004, Registration No. 333-114568.
- 10.12 Amendment to Water Service Agreement for the Sky Ranch PUD dated January 6, 2004. Incorporated by Reference from Amendment No. 1 to Registration Statement on Form SB-2, filed June 7, 2004, Registration No. 333-114568.
- 10.13 Amendment to Water Service Agreement for the Sky Ranch PUD dated January 30, 2004. Incorporated by Reference from Amendment No. 1 to Registration Statement on Form SB-2, filed June 7, 2004, Registration No. 333-114568.
- 10.14 Amendment to Water Service Agreement for the Sky Ranch PUD dated January 30, 2004 pertaining to amendment of the Option Agreement for Export Water. Incorporated by Reference from Amendment No. 1 to Registration Statement on Form SB-2, filed June 7, 2004, Registration No. 333-114568.
- 10.15 Amendment to Water Service Agreement for the Sky Ranch PUD dated March 5, 2004. Incorporated by Reference from Amendment No. 1 to Registration Statement on Form SB-2, filed June 7, 2004, Registration No. 333-114568.
- 10.16 Amended and Restated Lease Agreement between the State Land Board and the District dated April 4, 1996. Incorporated by Reference from Amendment No. 1 to Registration Statement on Form SB-2, filed June 7, 2004, Registration No. 333-114568.
- 10.17 Bargain and Sale Deed among the State Land Board, the District and the Company dated April 11, 1996. Incorporated by Reference from Amendment No. 1 to Registration Statement on Form SB-2, filed June 7, 2004, Registration No. 333-114568.
- 10.18 Mortgage Deed, Security Agreement, and Financing Statement between the State Land Board and the Company dated April 11, 1996. Incorporated by Reference from Amendment No. 1 to Registration Statement on Form SB-2, filed June 7, 2004, Registration No. 333-114568.
- 10.19 Water Service Agreement for the Hills at Sky Ranch Water dated May 14, 2004 among Icon Land II, LLC, a Colorado limited liability company, the Company, and the District. Incorporated by reference from the Current Report on Form 8-K filed with the SEC on May 21, 2004.

- 10.20 Purchase and Sale Agreement dated as of August 31, 2004 between Pure Cycle Corporation and Proactive Partners, L.P. incorporated by reference from Form 8-K filed on November 12, 2004.
- 10.21 Settlement Agreement dated as of August 31, 2004 among Pure Cycle Corporation, Thomas P. Clark and LCH, Inc. incorporated by reference from Form 8-K filed on November 12, 2004.
- 10.22 Purchase and Sale Agreement dated as of August 31, 2004 among Pure Cycle Corporation, OAR Incorporated and Willard G. Owens incorporated by reference from Form 8-K filed on November 12, 2004.
- 10.23 Form of Amendment to Warrant incorporated by reference from Form 8-K filed on November 12, 2004.
- 10.24 Agreement for Water Service dated August 3, 2005 among Pure Cycle Corporation, Rangeview Metropolitan District and Arapahoe County incorporated by reference from Form 8-K filed on August 4, 2005.
- 14 Code of Ethics Adopted February 13, 2004 incorporated by reference from our Proxy Statement for the Annual Meeting held April 12, 2004.
- 16.1 Letter from KPMG to the Securities and Exchange Commission, dated December 17, 2004, incorporated by reference from form 8-K filed on December 17, 2005.
- 23.1 Consent of KPMG, LLP *
- 31.1 Certification under Section 302 of the Sarbanes-Oxley Act of 2002. *
- 32.1 Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. *

* Filed herewith

Item 14. Principal Accountant Fees and Services

Information concerning this item is contained in our definitive Proxy Statement pursuant to Regulation 14A promulgated under the Securities Exchange Act of 1934 for the 2006 Annual Meeting of Stockholders and is incorporated herein by reference, which is expected to be filed on or about December 12, 2005.

Signatures

In accordance with Section 13 or 15(d) of the Securities Exchange Act, the Registrant has caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

PURE CYCLE CORPORATION

By: /s/ Mark W. Harding
Mark W. Harding, President and Chief Financial Officer

In accordance with the Securities Exchange Act, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated:

| <u>Signature</u> | <u>Title</u> | <u>Date</u> |
|---|---|-------------------|
| <u>/s/ Harrison H. Augur</u> Harrison H. Augur | Chairman, Director | November 28, 2005 |
| <u>/s/ Mark W. Harding</u> Mark W. Harding | President, Chief Financial Officer and Director | November 28, 2005 |
| <u>/s/ Richard L. Guido</u> Richard L. Guido | Director | November 28, 2005 |
| <u>/s/ Peter C. Howell</u> Peter C. Howell | Director | November 28, 2005 |
| <u>/s/ George M. Middlemas</u> George M. Middlemas | Director | November 28, 2005 |

EXHIBIT 23.1

Consent of Independent Registered Public Accounting Firm

The Board of Directors
Pure Cycle Corporation:

We consent to the incorporation by reference in the registration statement (No. 333-114568) on Form S-8 of Pure Cycle Corporation of our report dated October 29, 2004, with respect to the balance sheet of Pure Cycle Corporation as of August 31, 2004, and the related statements of operations, stockholders' equity, and cash flows for the year then ended, which report appears in the August 31, 2005 annual report on Form 10-KSB of Pure Cycle Corporation.

/s/ KPMG, LLP

Denver, Colorado
November 25, 2005

Pure Cycle Corporation Proxy Statement

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PURE CYCLE CORPORATION
8451 Delaware Street
Thornton, Colorado 80260
(303) 292-3456

NOTICE OF ANNUAL MEETING OF STOCKHOLDERS
To be held on January 17, 2006

TO OUR STOCKHOLDERS:

You are cordially invited to attend an Annual Meeting of the Stockholders of PURE CYCLE CORPORATION. The Meeting will be held at 1550 Seventeenth Street, Suite 500, Denver, Colorado 80202, at the offices of Davis, Graham & Stubbs, on January 17, 2006 at 2 p.m. Mountain Time for the following purposes:

1. To elect a board of five directors to serve until the next Annual Meeting of Stockholders, or until their successors are elected and have qualified.
2. To ratify the appointment of Anton Collins Mitchell LLP as the independent registered public accounting firm for the 2006 fiscal year.
3. To transact such other business as may properly come before the Meeting or any adjournment(s) thereof.

Only stockholders of record as of 5:00 p.m. Mountain Time on December 1, 2005 will be entitled to notice of or to vote at this Meeting or any adjournment thereof.

WHETHER OR NOT YOU PLAN TO ATTEND, PLEASE DATE AND SIGN THE ENCLOSED PROXY AND RETURN IT PROMPTLY IN THE ACCOMPANYING POSTAGE-PAID ENVELOPE. STOCKHOLDERS WHO ATTEND THE MEETING MAY REVOKE THEIR PROXIES AND VOTE IN PERSON IF THEY SO DESIRE.

BY ORDER OF THE BOARD OF DIRECTORS

/s/ Scott E. Lehman
Scott E. Lehman, Secretary

December 12, 2005

PURE CYCLE CORPORATION
8451 Delaware Street
Thornton, Colorado 80260
(303) 292-3456

PROXY STATEMENT
FOR THE
ANNUAL MEETING OF STOCKHOLDERS
To be held on January 17, 2006

ABOUT THE MEETING

This proxy statement is furnished to stockholders in connection with the solicitation of proxies by the board of directors of PURE CYCLE CORPORATION (the “Company”) for use at the Annual Meeting of stockholders of the Company (the “Meeting”) to be held at 1550 Seventeenth Street, Suite 500, Denver, Colorado 80202, at the offices of Davis, Graham & Stubbs on January 17, 2006 at 2 p.m. Mountain Time or at any adjournment thereof.

Proxies were first mailed to stockholders on or about December 12, 2005 and will be solicited chiefly by mail. The cost of soliciting proxies is being paid by the Company. In addition to the mailings, the Company’s officers, directors and other regular employees may, without additional compensation, solicit proxies personally or by other appropriate means.

What is the purpose of the Meeting?

At the Meeting, stockholders are asked to act upon the matters outlined above in the Notice of Annual Meeting of Stockholders and as described in this proxy statement. The matters to be considered are the election of directors, ratification of the appointment of the Company’s independent auditors for the fiscal year ending August 31, 2006, and such other matters as may properly come before the meeting. Additionally, management will be available to respond to appropriate questions.

Who is entitled to vote at the meeting?

Only stockholders of record as of 5 p.m. Mountain Time on December 1, 2005 (the Record Date), are entitled to vote on matters presented at the Meeting. If you were a stockholder on that date, you will be entitled to vote all of the shares that you held, on that date, at the Meeting, or any postponements or adjournments thereof. On December 1, 2005, 14,443,994 shares of the Company’s 1/3 of \$.01 par value common stock (“common stock”) were issued and outstanding.

What are the voting rights of the stockholders entitled to vote?

Each outstanding share of the Company’s common stock will be entitled to one vote on each matter acted upon. There is no cumulative voting.

How do I vote my shares without attending the Meeting?

Whether you hold shares directly as the stockholder of record or beneficially in street name, you may direct how your shares are voted without attending the Meeting. If you are the stockholder of record, you may vote your shares by completing, signing and dating the enclosed proxy card and then mailing it to the Company’s transfer agent in the pre-addressed envelope provided. You may also vote your shares by phone by calling the Company’s transfer agent at the number listed on the proxy card. If your shares are held beneficially in street name, you may vote your shares by following the instructions provided by your broker.

May I revoke or change my vote?

A proxy may be revoked by a stockholder at any time prior to the exercise thereof by written notice to the Secretary of the Company, by submission of another proxy bearing a later date or by attending the Meeting and voting in person.

Is my vote confidential?

Proxy instructions, ballots and voting tabulations that identify individual stockholders are handled in a manner that protects your voting privacy. Your vote will not be disclosed within the Company or to third parties, except: (1) as necessary to meet applicable legal requirements, (2) to allow for the tabulation of votes and certification of the vote, and (3) to facilitate a successful proxy solicitation. Occasionally stockholders provide written comments on their proxy cards, which are forwarded to management of the Company.

What is the voting requirement to approve each of the proposals?

The election of directors requires the affirmative vote of a plurality of the votes cast by shares represented in person or by proxy and entitled to vote for the election of directors. This means that the nominees receiving the most votes, by those eligible to vote, will be elected. You may vote “FOR” all of the nominees or your vote may be “WITHHELD” with respect to one or more of the nominees; however, a “withheld” vote or a broker “non-vote” (defined below) will have no effect on the outcome of the election.

An affirmative vote of the majority of the shares of common stock represented and entitled to vote at the Meeting, assuming a quorum is present, is necessary for the approval of proposal 2 and other matters. For proposal 2, and any other business matters to be voted on, you may vote “FOR,” “AGAINST,” or you may “ABSTAIN.” For the purpose of determining whether a proposal (except for the election of directors) has received a majority vote, abstentions will be included in the vote totals. An abstention has the same effect as a negative vote. Broker non-votes will not be included in the vote totals and, therefore, will have no effect on the vote.

A broker “non-vote” occurs when a nominee holding shares for a beneficial owner does not vote on a particular proposal because the nominee does not have discretionary voting power with respect to that item and has not received voting instructions from the beneficial owner.

If no specification is made, then the shares will be voted “FOR” the directors nominated by the board of directors and “FOR” Proposal 2 and otherwise, in accordance with the recommendations of the board of directors.

What constitutes a quorum?

The presence, in person or by proxy, of the holders of a majority of the outstanding shares of common stock constitutes a quorum at the Meeting for the election of directors and for the other proposals. Abstentions and broker “non-votes” are counted for the purposes of determining whether a quorum is present at Meeting.

What happens if additional matter are presented at the Meeting?

Other than the two items of business described in this proxy, the Company is not aware of any other business to be acted upon at the Meeting. If you grant a proxy, the persons named as proxy-holders, Mark W. Harding and Harrison H. Augur, will have the discretion to vote your shares on any additional matter properly presented for a vote at the Meeting. If for any unforeseen reason any of our director nominees are not available for election at the date of the Meeting, then the named proxy-holders will vote your shares for such other candidates as may be nominated by the board.

What if multiple stockholders share the same address?

The Company has adopted a procedure approved by the Securities and Exchange Commission (the “SEC”), called “householding,” which reduces printing costs and postage fees. Under this procedure, stockholders of record who have the same address and last name will receive only one copy of the annual report and proxy statement unless one or more of these stockholders notify the Company that they wish to continue receiving individual copies. Stockholders who do not participate in householding will continue to receive separate proxy cards.

If a stockholder of record residing at such an address wishes to receive a separate document in the future, he or she may contact our transfer agent at Computershare Investor Services, 350 Indiana St., Suite #800, Golden, CO 80401, telephone (303) 262-0600, or write to the Company’s Secretary at the Company’s address set forth above. Eligible stockholders of record receiving multiple copies of the annual report and proxy statement can request householding by contacting the Company in the same manner. If shares are owned through a bank, broker or other nominee, the holder can request householding by contacting the nominee.

Where can I find the voting results of the Meeting?

The Company intends to announce preliminary results at the Meeting and will publish final results in the Form 10-Q for the quarter ending February 28, 2006.

VOTING SECURITIES AND PRINCIPAL HOLDERS THEREOF

The following table sets forth, as of December 1, 2005, the beneficial ownership of the Company's issued and outstanding common stock by (i) each person who owns of record (or is known by the Company to own beneficially) 5% or more of the common stock, (ii) each director of the Company and each nominee for director, (iii) each executive officer and (iv) all directors and executive officers as a group. Except as otherwise indicated, the Company believes that each of the beneficial owners of the stock listed has sole investment and voting power with respect to such shares, based on information filed by such person with the Securities and Exchange Commission or based on information provided by such stockholders to the Company.

| COMMON STOCK | | |
|--|-------------------------------|--------------------------------------|
| Name and Address of Beneficial Owner | Number of Common Stock Shares | Percent of Outstanding Common Shares |
| Mark W. Harding 8451 Delaware St. Thornton, CO 80260 | 887,500 (1) | 5.8% |
| Harrison H. Augur P.O. Box 4389 Aspen, CO 81611 | 83,611 (2) | * |
| Richard L. Guido 121 Antebellum Dr. Meridianville, AL 35759 | 2,500 (3) | * |
| Peter C. Howell 15289 Russell Road Chagrin Falls, OH 44022 | - | - |
| George M. Middlemas 225 W. Washington, #1500 Chicago, IL 60606 | 35,833 (4) | * |
| All officers and directors as a group (5 persons) | 1,009,444 (5) | 6.6% |
| TPC Ventures, LLC 8451 Delaware Street Thornton, CO 80260 | 1,909,705 (6) | 13.2% |
| Par Capital Management, Inc. Par Investment Partners, L.P. Par Group, L.P. One International Place, Suite 2401 Boston, MA 02110 | 1,856,739 | 12.9% |
| Apex Investment Fund II L.P. 225 W. Washington, #1500 Chicago, IL 60606 | 845,686 (7) | 5.9% |

* Less than 1%

- (1.) Includes 764,167 shares purchasable by Mr. Harding under currently exercisable options.
- (2.) Includes 2,500 shares purchasable by Mr. Augur under currently exercisable options. Includes 10,000 shares of common stock held by Patience Partners, L.P., a limited partnership in which a foundation controlled by Mr. Augur

is a 60% limited partner and Patience Partners, LLC is a 40% general partner. Patience Partners LLC is a limited liability company in which Mr. Augur owns a 50% membership interest.

- (3.) Includes 2,500 shares purchasable by Mr. Guido under currently exercisable options.
- (4.) Includes 2,500 shares purchasable by Mr. Middlemas under currently exercisable options. By virtue of his position with Apex, Mr. Middlemas is deemed to be the indirect beneficial owner of 845,686 shares owned by Apex. Mr. Middlemas disclaims beneficial ownership of these shares.
- (5.) Includes 771,667 shares purchasable by directors and officers under currently exercisable options and 10,000 shares of common stock held by Patience Partners, L.P., as described in note 2 above.
- (6.) By reason of his role as manager of TPC Ventures, LLC, Ryan T. Clark is deemed the indirect beneficial owner of these shares.
- (7.) Apex is controlled through one or more partnerships. The persons who have or share control of Apex after looking through one or more intermediate partnerships are referred to herein as "ultimate general partners." The ultimate general partners of Apex are: First Analysis Corporation, a Delaware corporation ("FAC"), Stellar Investment Co. ("Stellar"), a corporation controlled by James A. Johnson ("Johnson"); George M. Middlemas ("Middlemas"); and Chartwell Holdings Inc. ("Chartwell"), a corporation controlled by Paul J. Renze ("Renze").

The business address of FAC, Stellar, Johnson, Middlemas, and Maxwell is 225 W. Washington Street, Suite 1550, Chicago, Illinois 60606. The business address of Renze and Chartwell is 20 N Wacker Dr., Suite 2200, Chicago, IL 60606.

In addition to being the ultimate general partner of Apex, FAC is also the ultimate general partner or liquidating trustee of Environmental Private Equity Fund II, L.P. ("EPEF"), Environmental Venture Fund Liquidating Trust ("EVF") and the Productivity Fund II Liquidating Trust ("PF II"), all of whom own the Company's common stock but are less than 5% owners (with Apex this group is collectively referred to as the "Apex Partnerships"). Due to these relationships, FAC may be deemed to be the indirect beneficial owner of 1,838,473 shares of the common stock held directly by Apex, EPEF, EF and PF II, which represents 12.7% of our outstanding common stock. By reason of his status as the stockholder of FAC, F. Oliver Nicklin, Jr. may also be deemed to be the indirect beneficial owner of such shares.

By reason of their status as ultimate general partners of Apex, Stellar (and through Stellar, Johnson), Middlemas and Chartwell (and through Chartwell, Renze) may be deemed to be the indirect beneficial owners of 845,686 shares of common stock, or 5.9% of our outstanding stock. When these shares are combined with his personal holdings of 35,833 (including 2,500 shares purchasable under currently exercisable options) shares of common stock, Middlemas may be deemed to be the beneficial owner (directly with respect to his shares and indirectly as to the balance) of 881,519 shares of common stock, or 6.1% of the total outstanding stock.

By reason of his status as ultimate general partner of EPEF and liquidating trustee of PF II, Maxwell may be deemed to be the indirect beneficial owner of 667,783 shares of common stock, or 4.6% of such shares.

Each of the Apex Partnerships disclaims beneficial ownership of all shares of common stock described herein except those shares that are owned directly by that entity. We understand that each of the other persons named as an officer, director, partner or other affiliate of any Apex Partnership herein disclaims beneficial ownership of all the shares of common stock described herein.

Each of the Apex Partnerships disclaims the existence of a "group" among any or all of them and further disclaims the existence of a "group" among any or all of them and any or all of the other persons named as an officer, director, partner or those affiliate of any of them, in each case within the meaning of Section 13(d) (3) of the 1934 Act.

DIRECTORS AND EXECUTIVE OFFICERS

The following table sets forth the names, ages and titles of the persons who are currently our directors and executive officers, along with other positions they hold with us.

| Name | Age | Position |
|-----------------------------|----------|--|
| Mark W. Harding | 42 | Director, President and CFO |
| Harrison H. Augur (1)(2)(3) | 63 | Chairman of the Board |
| Richard L. Guido (1)(2)(3) | 61 | Director |
| Peter C. Howell (1)(3) | 56 | Director |
| George M. Middlemas (2) | 59 | Director |
| Thomas P. Clark | deceased | Former Director (passed away June, 2005) and former CEO (retired November, 2004) |

- (1) Member of the Audit Committee.
- (2) Member of the Compensation Committee.
- (3) Member of the Nominating and Corporate Governance Committee

Board Committees:

Audit Committee – Messrs. Augur, Middlemas and Guido were members of the Audit Committee until April 18, 2005, when Mr. Howell was appointed to the Audit Committee and was appointed the Audit Committee Chairman. At that time, Mr. Middlemas stepped down from the Audit Committee. The Board has determined that the Audit Committee members, as so reconstituted, meet the independence standards of NASDAQ. In addition, the board has determined that at least one member of the Audit Committee is a financial expert. That person, Mr. Howell, meets the SEC criteria of Audit Committee financial expert by reason of his education and his experiences in acquisitions and financial reporting.

The functions to be performed by the Audit Committee include the appointment, retention, compensation and oversight of the Company's independent auditors, including pre-approval of all audit and non-audit services to be performed by such auditors. The Company adopted an Audit Committee Charter, which is incorporated by reference from the Proxy Statement for the Annual Meeting held April 12, 2004. The Audit Committee Charter is also available on the Company's website at www.purecycwater.com. The Audit Committee met six times during the fiscal year ended August 31, 2005; all members of the Audit Committee attended all meetings.

Compensation Committee – The Compensation Committee consists of Mr. Middlemas (Chairman), Mr. Augur and Mr. Guido. The functions to be performed by the Compensation Committee include establishing the compensation of officers and directors and administering management incentive compensation plans. The Compensation Committee held one meeting during the year ended August 31, 2005, and all members of the committee were present.

Nominating and Corporate Governance Committee – Effective April 18, 2005 the board appointed a Nominating and Corporate Governance Committee (the "Nominating Committee") consisting on Messrs. Guido (Chairman), Howell and Augur. The board of directors has determined that the members of the Nominating Committee meet the independence standards of NASDAQ. In selecting nominees for the board, the Nominating Committee is seeking a board with a variety of experiences and expertise, and in selecting nominees it will consider business experience in the industry in which the Company operates, financial expertise, independence from the Company, experience with publicly traded companies, experience with relevant regulatory matters in which the Company is involved, and a reputation for integrity and professionalism. Nominees must be at least 21 years of age and less than 70. The Nominating Committee will consider nominations for director made by stockholders of record entitled to vote. In order to make a nomination for election at the 2007 annual meeting, a stockholder must provide notice, along with supporting information regarding such nominee, to the Company's Secretary by August 14, 2006. The Nominating Committee evaluates nominees recommended by stockholders utilizing the same criteria it uses for other nominees. The Company has adopted a Nominating Committee Charter which is available on its website at www.purecycwater.com. The Nominating Committee held one meeting during the fiscal year ended August 31, 2005, and all members of the committee were present.

Stockholder Communications – The board of directors has adopted a policy for stockholders to send communications to the board. Stockholders wishing to send communications to the board may contact Mark W.

Harding, President of Pure Cycle, at the Company's principal place of business. All such communications shall be shared with the members of the board, or if applicable, a specified committee or director. All directors are expected to attend the Meeting. All but one board member attended the 2005 Annual Meeting.

Board meetings held – During the fiscal year ended August 31, 2005, the board of directors held eight meetings. All board members were present at each of the meetings with the exception of one board member who was absent from two meetings.

Relationship of Directors and Officers – None of the current directors or officers, or nominees for director, is related to any other officer or director of the Company or to any nominee for director.

Terms of Directors and Officers – All directors are elected for one-year terms which expire at the annual meeting of stockholders or until their successors are elected and qualified. The Company's officers are elected annually by the board of directors and hold office until their successors are elected and qualified.

Compensation of Directors – Until February 13, 2004, directors did not receive any compensation for serving on the board. Effective February 13, 2004, the board approved the following compensation arrangement for non-employee directors: Each non-employee director will receive a payment of \$10,000 for each full year in which he or she serves as a director, with an additional payment of \$1,000 for each committee on which he or she serves, and \$1,000 for serving as chairman of the board. An additional \$500 will be paid to each director for attendance at each board meeting and, if committee meetings are held separate from board meetings, \$500 will be paid for attendance at such committee meetings.

In addition to cash compensation, as part of the 2004 Equity Incentive Plan approved by stockholders at the 2004 Annual Meeting, each non-employee director receives an option to purchase 5,000 shares of common stock upon initial election or appointment to the board (which vest one half at each of the first and second anniversary dates of the grant), and an option to purchase 2,500 shares for each subsequent full year in which he or she serves as a director, which options vest one year from the date of grant.

Compensation of Officers – The following table sets forth information concerning the compensation received by or awarded to the Company's former Chief Executive Officer and the Company's President and Chief Financial Officer for the fiscal years ended August 31, 2005, 2004 and 2003:

| Compensation Table | | | | | | | | |
|--------------------------------------|---------------------|-----------------------|----------------------|--|---|---|--------------------------------|------------------------|
| Name and Principal Position (a) | Annual Compensation | | | | Long Term Compensation | | | |
| | Fiscal Year (b) | Salary (\$) (c) | Bonus (\$) (d) | Other Annual Compensation (\$) (e) | Awards Restricted Stock Award(s) (\$) (f) | Securities Underlying Options/SARS (\$) (g) | Payouts LTIP (\$) (h) | All Other Compensation |
| Mark W. Harding President and CFO | 2005 | 200,000 | 150,000 | - | - | - | - | - |
| | 2004 | 80,000 | 120,000 | - | - | - | - | - |
| | 2003 | 80,000 | - | - | - | - | - | - |
| Thomas P. Clark Former CEO (1) | 2005 | 45,000 | - | - | - | - | - | - |
| | 2004 | 60,000 | 50,000 | - | - | - | - | - |
| | 2003 | 60,000 | - | - | - | - | - | - |

(1) Mr. Clark resigned as our CEO in November of 2004, but remained an employee. Mr. Clark passed away in June 2005.

Mr. Harding's 2005 bonus was determined by the Compensation Committee based on the performance of Mr. Harding in negotiating the Arapahoe County Agreement for Water Service, his continued commitment to the success of the Company and his efforts in marketing the Company to the investing public.

Option/SAR Grants in the Last Fiscal Year – No option grants were made to executive officers in the last fiscal year.

Aggregate Option/SAR Exercises in Last Fiscal Year and Fiscal Year End Option/SAR Values

| Name (a) | Shares acquired on exercise (#) (b) | Value realized (c) | Number of unexercised options/SARs at FY-end (#) exercisable/ unexercisable (d) | Value of unexercisable in-the-money options/SARs at FY-end (\$) exercisable/ unexercisable (e) |
|-----------------|---|-----------------------|---|---|
| Mark W. Harding | 135,833 | \$727,000 | 764,167 / 0 | \$4,241,000 / 0 |

Long-Term Incentive Plans – Awards in the Last Fiscal Year – With the exception of stock option plans described above, the Company does not have any long-term incentive plans.

Section 16 (a) beneficial ownership reporting compliance – The Company’s directors and executive officers and persons who are beneficial owners of more than 10% of common stock are required to file reports of their holdings and transactions in common stock with the Securities and Exchange Commission and furnish the Company with such reports. Based solely upon the review of the copies received by the Company, or upon written representations from these persons, the Company believes that, during the fiscal year ended August 31, 2005 all the directors, executive officers, and 10% beneficial owners had complied with the applicable Section 16 (a) filing requirements, except that Mr. Howell and TPC Ventures LLC each filed a late Form 3.

Code of Ethics – The Company has a code of ethics for its directors, officers and employees, which can be viewed on our website at www.purecyclewater.com.

Certain relationships and related transactions

Borrowings from Thomas P. Clark

From time to time since December 6, 1987, Thomas P. Clark, a former director and former Chief Executive Officer of the Company, loaned funds to the Company to cover operating expenses. These funds have been treated by the Company as unsecured debt, and promissory notes have been issued to Mr. Clark. The notes bear interest at rates ranging from 8.36% to 9.01% per annum, and mature on October 1, 2007. To date, Mr. Clark has loaned the Company \$310,720, of which \$43,350 has been repaid, leaving a principal balance of \$267,370. As of December 1, 2005, the outstanding balance, including principal and accrued interest, on the Notes totaled \$583,543. All loans were made on terms determined by the board members (Mr. Clark abstaining) to be at market rates. In June 2005, Mr. Clark passed away and therefore these promissory notes are currently payable to Mr. Clark’s estate.

Borrowings from LCH, Inc.

LCH, Inc., a Delaware corporation which owns 20% of LC Holdings, Inc., which is 80% owned by Mr. Clark’s estate, loaned the Company a total of \$950,000 between November, 1988 and February, 1989. The Notes were secured by a pledge of Company common stock owned by Mr. Clark. During the fiscal year ended August 31, 1998, the Company reached an agreement with LCH, Inc. to defer payment of principal and interest on the Notes until October 1, 2007.

Effective August 31, 2004, LCH, Inc. retired \$2,506,514 in debt (consisting of principal and interest) and terminated its right to receive \$4,000,000 from the sale of Export Water in exchange for payment from the Company of \$950,000 in cash and the surrender by Mr. Clark of 306,279 shares of the Company’s common stock that he had pledged to LCH to secure payment of the Company’s obligations. In response to a claim by Mr. Clark, on January 13, 2005, the Company paid Mr. Clark \$50,555 in cash and issued Mr. Clark 300,000 shares of restricted common stock.

Office Lease – The Company leases office space from the estate of Mr. Clark. Prior to September 1, 2004, the Company was not required to pay rent. Effective September 1, 2004 the Company executed a lease agreement

whereby the Company leases the office space on a month-to-month basis for \$1,000 per month, a rate that approximates market value.

Comprehensive Amendment Agreement – Mr. Augur and Mr. Middlemas (by reason of his status as ultimate general partner of Apex) are a party to the Comprehensive Amendment Agreement (the “CAA”) with the Company. Under the CAA the Company is required to distribute to numerous external parties, at varying levels of priority, \$23,415,389 of future proceeds received from the sale of Export Water (as defined therein). Mr. Augur is a partner, with his wife, in a partnership that is entitled to receive a total of \$150,000 thereunder. Apex and therefore by reason of his status as ultimate general partner of Apex, Mr. Middlemas, is entitled to receive a total of \$7,163,264 thereunder.

REPORT OF THE AUDIT COMMITTEE¹

The Audit Committee of the board of directors is comprised of three directors and operates under a written charter adopted by the board of directors. The charter is reassessed and updated at least annually, or as needed, in accordance with applicable rules of the Securities and Exchange Commission and the NASDAQ Stock Market. Each of the members of the Audit Committee is a non-employee director and is independent as defined by the NASDAQ standards for independence.

Management is responsible for the Company’s internal controls and financial reporting process. The independent auditors are responsible for performing an independent audit of the Company’s financial statements in accordance with the standards of the Public Company Accounting Oversight Board (United States) and issuing a report thereon. The Audit Committee’s primary responsibility is to monitor and oversee these processes and recommend to the board of directors the selection of the Company’s independent auditors. In fulfilling its oversight responsibilities, the Audit Committee reviewed with management, the Company’s audited financial statements and discussed not only the acceptability but also the quality of the accounting principles, the reasonableness of the significant judgments and estimates, critical accounting policies and the clarity of disclosures in the audited financial statements prior to issuance.

The Audit Committee reviewed and discussed the audited financial statements as of and for the year ended August 31, 2005 with Anton Collins Mitchell LLP (“ACM”) and discussed not only the acceptability but also the quality of the accounting principles, the reasonableness of the significant judgments and estimates, critical accounting policies and the clarity of disclosures in the audited financial statements prior to issuance. The Audit Committee discussed with ACM matters required to be discussed by the Statement on Auditing Standards No. 61 (Communication with Audit Committees) to the extent applicable. ACM provided the Audit Committee the written disclosures required by Independence Standards Board Standard No. 1 (Independence Discussions with Audit Committees), and the Audit Committee discussed ACM’s independence with ACM.

Based on the foregoing, the Audit Committee recommended to the board of directors that the Company’s audited financial statements be included in the Company’s Annual Report on Form 10-KSB for the fiscal year ended August 31, 2005.

/s/ Peter C. Howell
/s/ Harrison H. Augur
/s/ Richard L. Guido

¹ This section is not “soliciting material,” is not deemed “filed” with the Commission and is not to be incorporated by reference in any filing of the Company under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, whether made before or after the date hereof and irrespective of any general incorporation language in any such filing.

ELECTION OF DIRECTORS

(Proposal No. 1)

The current number of members of the board of directors is fixed at five. The board of directors nominates the following five persons currently serving on the board for reelection to the board: Mark W. Harding, Harrison H. Augur, Richard L. Guido, Peter C. Howell and George M. Middlemas. Biographical information regarding the directors follows:

Mark W. Harding. Mr. Harding joined Pure Cycle in April 1990 as the Corporate Secretary and Chief Financial Officer. He was appointed President in April 2001, and joined the board of directors in 2004. He brings a background in public finance and management consulting. From 1988 to 1990, Mr. Harding worked for Price Waterhouse, where he provided public finance and other investment banking related services. Mr. Harding is the President and serves on the board of directors of the Rangeview Metropolitan District. Mr. Harding has a B.S. Degree in Computer Science and a Masters in Business Administration in Finance from the University of Denver.

Harrison H. Augur. Mr. Augur joined the board and was elected Chairman in April 2001. For more than 20 years, Mr. Augur has been involved with investment management and venture capital investment groups. Mr. Augur has been a general partner of CA Partners since 1987, and general partner of Patience Partners LLC since 1999. Mr. Augur received a Bachelor of Arts degree from Yale University, an LLB degree from Columbia University School of Law, and an LLM degree from New York University School of Law.

Richard L. Guido. Mr. Guido previously served as a member of the board from July 1996 through August 31, 2003, when he was an employee of Inco Limited (he was employed at Inco Limited from 1980 through February 2004) pursuant to a voting agreement between Inco and the Company. That agreement is no longer in effect. Mr. Guido then rejoined the board in 2004. Mr. Guido was Associate General Counsel of Inco Limited and President, Chief Legal Officer and Secretary of Inco United States, Inc. Mr. Guido received a Bachelor of Science degree from the United States Air Force Academy, a Master of Arts degree from Georgetown University, and a Juris Doctor degree from the Catholic University of America.

Peter C. Howell. Mr. Howell was appointed to fill a vacancy on the board on February 3, 2005. From 1997 to present, Mr. Howell has served as an advisor to various business enterprises in the area of acquisitions, marketing and financial reporting. From August 1994 to August 1997, Mr. Howell served as the Chairman and Chief Executive Officer of Signature Brands USA, Inc. (formerly known as Health-O-Meter) and from 1989 to 1994 Mr. Howell served as Chief Executive Officer and a director of Mr. Coffee, Inc. Mr. Howell is a member of the board of directors of Libbey, Inc. and a number of private companies. Mr. Howell received a Master of Arts degree in Economics from Cambridge University.

George M. Middlemas. Mr. Middlemas has been a director since April 1993. Mr. Middlemas has been a general partner with Apex Investment Partners, a diversified venture capital management group, since 1991. From 1985 to 1991, Mr. Middlemas was Senior Vice President of Inco Venture Capital Management, primarily involved in venture capital investments for Inco Securities Corporation. From 1979 to 1985, Mr. Middlemas was Vice President and a member of the Investment Committee of Citicorp Venture Capital Ltd., where he sourced, evaluated and completed investments for Citicorp. Mr. Middlemas is a director of Tut Systems and Pennsylvania State University-Library Development Board. Mr. Middlemas received a Bachelors degree in History and Political Science from Pennsylvania State University, a Masters degree in Political Science from the University of Pittsburgh and a Master of Business Administration from Harvard Business School.

The Proxy cannot be voted for more than the five nominees named. Directors are elected for one-year terms or until the next Annual Meeting of the Stockholders and until their successors are elected and qualified. All of the nominees have expressed their willingness to serve, but if because of circumstances not contemplated, one or more nominees is not available for election, the proxy-holders named in the enclosed proxy card intend to vote for such other person or persons as the Nominating Committee may nominate.

Mr. Middlemas was designated as a nominee to the board of directors pursuant to the Environmental Private Equity Fund II, L.P. ("EPEF") Voting Agreement, which agreement obligates; (by reason of the transfer of Mr. Clark's shares in the Company for estate planning purposes), TPC Ventures, LLC; Ms. Hansson, a former director of the Company; the Apex Partnerships; and Fletcher Byrom, a former director of the Company, to vote for the designee of the EPEF. This agreement will terminate at such time as EPEF no longer owns shares of common stock of the Company, or warrants to acquire shares of common stock, which aggregate 130,100 shares of common stock. As of December 1, 2005, EPEF owned 416,584 shares of common stock.

THE BOARD OF DIRECTORS RECOMMENDS THAT THE STOCKHOLDERS VOTE “FOR” THE ELECTION AS DIRECTORS OF THE SIX PERSONS NOMINATED.

RATIFICATION OF APPOINTMENT OF INDEPENDENT AUDITORS

(Proposal No. 2)

Action is to be taken by the stockholders at the Meeting with respect to the ratification and approval of the selection by the Audit Committee of the Company’s board of directors of Anton Collins Mitchell LLP (“ACM”) to be the independent auditors of the Company for the fiscal year ending August 31, 2006. In the event of a negative vote on such ratification, the Audit Committee of the board of directors will reconsider its selection. A representative of ACM is expected to be present at the Meeting, will have the opportunity to make a statement if he or she desires to do, and is expected to be available to respond to appropriate questions.

Change in Auditors – On December 15, 2004, Pure Cycle replaced KPMG, LLP as its independent registered public accountant. The reports of KPMG, LLP for the years ended August 31, 2004 and 2003 did not contain an adverse opinion or a disclaimer of opinion and were not qualified or modified as to uncertainty, audit scope or accounting principles. The decision to replace KPMG, LLP was approved by the Audit Committee of the board of directors.

KPMG’s reports on the financial statements of the Company for the fiscal years ended August 31, 2004 and 2003, did not contain an adverse opinion or a disclaimer of opinion, nor was either qualified or modified as to uncertainty, audit scope or accounting principles.

During the fiscal years ended August 31, 2004 and 2003, and the subsequent interim period through December 15, 2004 (the date of the change in auditors), there were (i) no disagreements with KPMG on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedures which, if not resolved to KPMG’s satisfaction, would have caused KPMG to make reference to the subject matter of such disagreement in connection with its reports on the financial statements of the Company, and (ii) no reportable events as listed in Item 304(a)(1)(v) of Regulation S-K.

On December 15, 2005, the Company engaged its new independent registered public accountant, ACM. Since its appointment, the Company has not consulted with ACM on matters of the type contemplated by Item 304(a)(2) of Regulation S-K.

ACM has no direct or indirect financial interest in the Company and does not have any connection with the Company in the capacity of promoter, underwriter, voting trustee, director, officer or employee. Neither the Company, nor any officer, director or associate of the Company has any interest in ACM.

Audit Fees – For the fiscal year ended August 31, 2005, ACM’s fees for annual audit services and the review of interim financial statements was \$31,500. For the fiscal year ended August 31, 2004, KPMG’s fees for annual audit services and the review of interim financial statements was \$45,000. The Audit Committee approved 100% of these fees in accordance with the Audit Committee Charter.

Audit-Related Fees – During the fiscal year ended August 31, 2004, KPMG’s fees for audit-related services was \$69,200. This related to the review of the Registration Statement used in the equity offering completed in June 2004. There were no audit-related fees incurred during fiscal 2005.

Tax and Other Fees – The Company did not pay ACM or KPMG any fees related to tax consultations, tax return preparation or other professional services.

Pre-Approval Policy – The Audit Committee has established a pre-approval policy in its Charter. In accordance with the policy, the Audit Committee pre-approves all audit, non-audit and internal control related services provided by the independent auditors prior to the engagement of the independent auditors with respect to such services.

THE BOARD OF DIRECTORS RECOMMENDS A VOTE “FOR” THE RATIFICATION OF ANTON COLLINS MITCHELL LLP AS INDEPENDENT AUDITORS.

ACTION TO BE TAKEN UNDER THE PROXY

The accompanying Proxy will be voted “FOR” approval of proposal 2 and “FOR” the directors nominated by the board, unless the Proxy is marked in such a manner as to withhold authority to so vote. The accompanying Proxy will also be voted in connection with the transaction of such other business as may properly come before the Meeting or any adjournment or adjournments thereof. Management knows of no other matters, other than the matters set forth above, to be considered at the Meeting. If, however, any other matters properly come before the Meeting or any adjournment thereof, the persons named in the accompanying Proxy will vote such Proxy in accordance with their best judgment on any such matter. The persons named in the accompanying Proxy will also, if in their judgment it is deemed to be advisable, vote to adjourn the Meeting from time to time.

STOCKHOLDER PROPOSALS

Stockholder proposals for inclusion in the Proxy Statement for the 2007 Annual Meeting of Stockholders must be received at the principal executive offices of the Company by August 14, 2006 but not before June 15, 2006. For more information refer to the Company’s Bylaws which were filed as Exhibit 3.2 to the Registration Statement on Form SB-2/A filed on June 10, 2004. The Company is not required to include proposals received outside of these dates in the proxy materials for the 2007 Annual Meeting of Stockholders.

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corporate data

Corporate Offices

Pure Cycle Corporation
8451 Delaware Street
Thornton, CO 80260
303.292.3456

Executive Officers and Directors

Mark W. Harding
President, CFO and Director

Harrison H. Augur
Chairman of the Board

Richard L. Guido
Director

Peter C. Howell
Director
Chairman of the Audit Committee

George M. Middlemas
Director

Pure Cycle's stock is traded on the NASDAQ SmallCap market under the symbol "PCYO".

For more information please visit our website at www.purecyclegwater.com

Legal Counsel

Davis, Graham & Stubbs LLP
1550 17th Street, Suite 500
Denver, CO 80202
303.892.9400

Stock Transfer Agent & Register

Computershare Investor Services
350 Indiana Street, Suite 800
Golden, Colorado 80201
303.262.0600

Corporate Auditor

Anton Collins Mitchell LLP
303 East 17th Ave. Suite 600
Denver, CO 80203
303.830.1120

This Annual Report to Stockholders, including the letter to the stockholders from President Mark W. Harding, contains forward-looking statements within the meaning of Section 27A of the Securities Exchange Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. The words "will", "expect", "should", "scheduled", "plan", "believe", "promise", "anticipate", "could" and similar expressions are intended to identify forward-looking statements. Pure Cycle expectations regarding these matters are only its forecasts. These forecasts may be substantially different from actual results, which are affected by many factors. The use of "PureCycle", "our", "we", and similar terms are not intended to describe or imply particular corporate organizations or relationships.



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