



## **Letter to shareholders:**

Chesapeake continues to lead the independent oil and natural gas industry in creating shareholder value.

Our company has led the sector in total shareholder return for the past two years - 544% in fiscal 1995 and 431% in fiscal 1996. We believe this success is attributable to our focused and clearly articulated strategy and to our experienced and highly motivated management team, supported by technical teams second to none.

Since Chesapeake's inception in 1989, our business strategy has been "growth through the drillbit." Using this strategy, the company has rapidly expanded its reserves and production through the acquisition and development of large blocks of undeveloped acreage overlying deep, under developed geological reservoirs such as fractured carbonates. We are attracted to these reservoirs because they offer low geological risk, large reserve potential, and the opportunity to earn attractive economic returns through the application of advanced drilling and completion techniques.

Our successful implementation of this strategy has enabled Chesapeake to become one of the premier independent energy producers. As the company has matured, we have developed the following five competitive advantages that we believe are the keys to continued growth:

- Growth through the drillbit business strategy;
- Five-year inventory of future drilling opportunities created by establishing dominant leasehold positions;
- Technological leadership resulting in new oil and gas discoveries and a lower cost structure;
- Superior profit margins that generate high levels of cash flow per unit of production to reinvest in growing our company; and
- Close alignment of shareholder and management interests resulting from management's 40% ownership stake.

Before explaining why we believe these competitive advantages can continue to generate attractive returns to our shareholders, we will highlight our results for fiscal 1996.

During the year, Chesapeake:

- Increased oil and natural gas production 88% to 60 Bcfe;
- Increased total revenues 122% to \$149.4 million;
- Increased earnings 100% to \$23.4 million and earnings per share 91% to \$0.80;
- Increased operating cash flow 100% to \$90.3 million;
- Increased proved reserves 76% to 425 Bcfe and increased SEC-PV10 value 193% to \$547 million.

## **COMPETITIVE ADVANTAGE No. 1**

### **Growth through the drillbit**

The rewards for Chesapeake and its shareholders are generated by the company's expertise in producing large amounts of oil and gas from unconventional reservoirs. These reservoirs have traditionally been uneconomic to develop because of their geological complexity. Using new technologies, however, we can now profitably exploit these reservoirs and generate a rapid return on our investments.

We have elected to build our company through our expertise with the drillbit rather than by acquiring other companies' producing properties. This strategy makes Chesapeake fundamentally different and more profitable than most independent energy companies for three reasons.

First, this strategy enables our company to capture more upside by drilling new wells that have much higher productive capabilities than older wells. In Chesapeake's project areas, new wells can develop reserves with a value of up to five times the cost of drilling such wells. They provide a much higher return on investment than can be generated by purchasing partially depleted wells from other companies and then attempting to stimulate marginal production increases.

Secondly, there is less competition for good exploration ideas in Chesapeake's areas of operation because most major oil and natural gas companies have significantly reduced domestic onshore exploration efforts, and many independent producers have focused on producing property acquisitions. With less competition, our company has a greater opportunity to leverage its exploration expertise into new areas that could significantly increase shareholder value.

The third reason for Chesapeake's growth through the drillbit strategy is the efficiency created from owning new wells. Just as in operating any new equipment, operating a newly drilled well is less expensive than operating an older well which requires ongoing maintenance.

Consequently, the company's administrative and production costs per unit of oil and natural gas produced have been the lowest in the industry. This cost structure provides Chesapeake with more cash flow to reinvest in its drilling program, thereby providing a key component of the funding required to continue the company's growth.

The success of this growth through the drillbit strategy is most evident in Chesapeake's oil and natural gas production growth. In the fourth quarter of fiscal 1993, our first full quarter as a public company, Chesapeake produced 1.1 Bcfe. By the fourth quarter of fiscal 1996, just three years later, Chesapeake's production had increased sixteenfold to 17.6 Bcfe.

During fiscal 1996, Chesapeake continued its high level of drilling activity, finishing as the fourth most active driller of new wells and ranking first in average depth drilled per well (more than 16,000 feet). By drilling deeper and utilizing today's most sophisticated technologies in developing well-known, but underexploited reservoirs, our company can reduce exploration risk and increase the potential for discovering large amounts of new oil and natural gas reserves.

## **COMPETITIVE ADVANTAGE No. 2**

### **Five-year inventory of drillsites**

The leading indicator of any oil and natural gas producer's potential for future success is the size and quality of its inventory of future drilling projects. Chesapeake's five-year inventory of undrilled locations is our second competitive advantage and provides the springboard for our continued reserve and production growth.

For all energy producers, the greatest challenge is replacing the reserves that deplete naturally through daily oil and gas production. Similarly, the greatest challenge facing energy investors is to identify companies that can continue to grow their reserves and production while generating superior rates of return.

Through Chesapeake's strategy of building a long-term inventory of future drillsites, a prospective investor is not required to speculate on how Chesapeake will replace its produced reserves. Instead, an investor only has to examine our inventory of over 900 undrilled locations to evaluate whether Chesapeake has the ability to maintain its superior growth rates.

This inventory consists of prospective drillsites in the Louisiana Austin Chalk Trend, the downdip Giddings Field in Texas, the Knox and Sholem Alechem Fields in southern Oklahoma, and our new project areas in the Arkoma Basin in eastern Oklahoma, the Lovington area in eastern New Mexico and the Williston Basin in North Dakota and Montana. Successful drilling of Chesapeake's inventory has the potential to more than double the company's proved reserves of oil and natural gas.

The common theme linking these projects is Chesapeake's exploration focus on geologically complex reservoirs, especially deep fractured carbonates. When subjected to intense geological pressure, these formations have a tendency to fracture vertically. Because of past technological limitations, fractured carbonate reservoirs have been underexploited. With the continuing evolution of horizontal drilling, 3-D seismic, and new completion techniques, Chesapeake has been able to exploit these hydrocarbon-rich formations over the past three years. We hope to make further discoveries in the future while maintaining a large backlog of drillsites.

### **COMPETITIVE ADVANTAGE No. 3**

#### **Technological leadership**

Scientific progress in such areas as horizontal drilling, 3-D seismic, and deep fracture stimulation have enabled Chesapeake to identify and develop new oil and natural gas reserves more profitably than at any time during the past 20 years. While distinguishing itself in each of these new technologies, Chesapeake's leadership in horizontal drilling is particularly distinctive. Our company is now the second leading driller of horizontal wells in the world, drilling 90 such wells in fiscal 1996 and 275 since 1990.

The company's expertise in horizontal drilling provides the potential for greater reserve recovery per dollar invested at an unusually low level of risk. This results in a much higher rate of return on invested capital than is typically enjoyed by the industry.

The talent of Chesapeake's exploration teams, the company's strong alliances with the vendors who design and manufacture horizontal drilling equipment, and our willingness to experiment with new ideas have allowed Chesapeake to drill increasingly deeper horizontal wells and thereby expand the boundaries of our fields. For example, in just the past two years, technical improvements in measurement-while-drilling and logging-while-drilling tools, downhole motors, and drillbit technology have enabled Chesapeake to extend the industry's depth barrier from 13,000 feet to almost 17,000 feet. This provides a much larger fairway of potentially productive acreage for the company to develop.

The extension of this depth limit is important because as horizontal drilling technology improves, the number of prospective drillsites on Chesapeake's leasehold inventory can continue to increase. In the past year alone, the company added over 400 drillsites to its inventory as a result of deeper drilling successes and an aggressive leasehold acquisition program in the Louisiana Austin Chalk Trend. This area, considered uneconomical just two years ago, is today one of the most active exploration areas in the U.S.

Chesapeake also has increased its expertise by applying another significant industry advancement, 3-D seismic imaging. Advancements in computer processing capability have

enabled exploration companies to enhance their understanding of deep geological structures. When applied in the appropriate geological environment, this technology results in higher success rates and more prolific wells.

During fiscal 1996, Chesapeake acquired or participated in eight 3-D seismic projects in four states. As a result of early drilling success on our 3-D seismic projects in the Knox, Lovington, and Williston Basin areas, we have planned an additional twelve 3-D projects in six states in fiscal 1997. We believe 3-D seismic surveys will play an increasingly important role in our future exploration projects.

#### **COMPETITIVE ADVANTAGE No. 4**

##### **Superior profit margin**

Chesapeake's fourth competitive advantage is our high profit margin per-unit-of-production. During fiscal 1996, this margin was \$0.77 per Mcfe, the highest in our peer group. This margin is defined as oil and natural gas revenues minus lease operating costs (which include lease operating expenses and production taxes), general and administrative expenses, and oil and gas depreciation, depletion, and amortization expenses. We believe the key to creating shareholder value is generating large amounts of cash flow from Chesapeake's superior profit margin and then reinvesting this cash flow into the profitable search for new reserves.

We have developed our company's low cost structure by:

- Utilizing advanced drilling and completion technologies to reduce the cost of finding and producing the company's oil and natural gas reserves;
- Concentrating the company's drilling in areas which provide the critical mass necessary to spread operating and overhead costs over a large number of wells;
- Operating 87% of the company's production, thereby allowing our employees to implement the most cost effective and technologically sophisticated drilling, completing, and operating procedures; and
- Maintaining a flat organizational structure with performance-based pay and stock option incentives to motivate Chesapeake's employees so they can quickly respond to attractive opportunities.

Although we believe continuing worldwide economic growth may cause oil and gas prices to increase, Chesapeake budgets for inflation-adjusted prices to remain flat in the coming years. Therefore, management believes the most profitable Mcf of gas or barrel of oil that can be produced is the one produced today.

Long-lived reserves, which are burdened by future operating, financing, and administrative costs and are adversely effected by the time value of money and the risk of future mechanical problems, are less valuable than reserves that can be monetized more quickly. Consequently, reserves produced in a shorter time frame have higher profit margins and therefore are more likely to create shareholder value than longer-lived reserves.

Chesapeake attempts to develop large per-well oil and natural gas reserves with an average life of five to seven years, intentionally shorter than the industry average of eight to ten years. The combination of accelerating the production of reserves, generating high cash flows from the production, and then successfully reinvesting the cash flows into a technologically advanced exploration program is the formula that we believe can provide Chesapeake's shareholders with increasing value.

## **COMPETITIVE ADVANTAGE No. 5**

### **Management's large equity stake**

Chesapeake's fifth competitive advantage is management and directors' ownership of approximately 42% of Chesapeake's equity, among the highest in the industry and of all NYSE-listed companies. This large ownership stake has fostered a culture of entrepreneurship in our company that we believe results in more creative and productive employees. Furthermore, it more closely aligns the interests of management and shareholders.

The daily decisions involved in managing Chesapeake's active and technically sophisticated drilling program are made decisively and are implemented by employees who have direct lines of communication to management and a significant stake in the outcome of those decisions. This flat organizational structure combined with our motivated work teams enables Chesapeake to seize competitive opportunities more quickly and to establish leasehold dominance in its areas of operations.

### **Looking Forward**

Chesapeake's growth strategy has always been based on three fundamental beliefs:

- Greater financial returns and more shareholder value can be created by drilling new wells;
- Large amounts of oil and natural gas reserves remain in fractured carbonate reservoirs; and
- Continuing advances in technology will enable Chesapeake to more profitably extract its existing reserves and to more easily develop significant new reserves.

During the past seven years, we have grown from five employees and \$50,000 in assets to an industry leader with 275 employees and an enterprise value of almost \$2 billion. We believe Chesapeake is evolving into one of the premier large capitalization independent energy producers.

To accelerate this evolution, we are committed to increasing the financial strength of our company so that we can more reliably replicate our results over the long term. Our success in fiscal 1996 provides the foundation for our optimism that Chesapeake will continue to remain an industry leader in creating shareholder value.

Aubrey K. McClendon  
*Chairman and CEO*

Tom L. Ward  
*President and COO*

October 1, 1996