



## Letter to Shareholders

During 1998, a very difficult and challenging year for the oil and gas industry, Chesapeake completed the strategic repositioning effort it began in late 1997. Our goal was to reduce the company's risk profile, generate more attractive drilling results and build an inventory of long-lived natural gas reserves – the fuel of choice for the 21st century. Completely transformed, Chesapeake now owns 1.1 trillion cubic feet equivalent (tcf) of proved oil and gas reserves, one of the 20 largest inventories of onshore U.S. natural gas, and is well positioned to benefit when natural gas prices recover.

### **Building long-term natural gas reserves**

Prior to our transformation, Chesapeake was known primarily as an innovative exploration company that grew rapidly during 1994-96 through the application of advanced-technology horizontal drilling on its large leasehold inventory in the Texas Austin Chalk area. Despite high expectations in the industry and on Wall Street for the vast potential of extending the Austin Chalk Trend into Louisiana, falling oil prices and significant geological and engineering challenges generated disappointing returns for all operators involved.

To recover from this major setback and to better position the company for the coming growth in the natural gas industry, Chesapeake successfully transformed itself during the second half of 1997 and the first half of 1998. Unfortunately, during the process, we incurred substantial debt at the same time that oil and natural gas prices began to fall precipitously. To date, these factors have resulted in a market valuation that does not reflect the true value of Chesapeake's long-lived natural gas assets.

Chesapeake is confident that natural gas is the long-term, environmentally sensitive answer to the nation's energy needs. Based on this belief and on our expertise in increasing value from natural gas assets, Chesapeake completed eight major property acquisitions in 1998. The 750 billion cubic feet of natural gas equivalent (bcfe) of acquired properties significantly strengthened the company, preparing it for a brighter future with higher natural gas prices. Acquired for a \$700 million combination of cash and Chesapeake common stock, these properties:

- nearly tripled Chesapeake's oil and gas reserves to 1,091 bcfe;
- doubled the company's reserves-to-production index from five years to 10 years;

- increased the percentage of natural gas reserves from 70% to 87%;
- raised the percentage of proved developed reserves by value from 66% to 78%;
- increased 1998's oil and gas production by 62%.

We are confident that our acquisitions will add substantial value in the long-term. However, full-cost accounting standards have resulted in a series of asset writedowns reflecting exceptionally low oil and gas prices (\$10.48 per barrel and \$1.68 per mcf as of December 31, 1998. These prices are the lowest inflation adjusted prices in the past 50 years and yield unrealistic values for Chesapeake's reserves. Factoring in the two-year decline in oil and gas prices, the present value (discounted at 10%) of Chesapeake's reserves has decreased from approximately \$2.1 billion (pro forma for acquisitions) as of January 1, 1997 to \$661 million as of December 31, 1998, leading to significant asset writedowns in 1998 and 1997.

An important feature of how we built our long-life gas reserve base is that we used long-term capital. We have no net bank debt and our earliest senior debt maturity is in 2004. Even at today's unusually low oil and gas prices, we have sufficient cash flow to pay interest on our debt and fund a capital program sufficient to maintain our reserve base. We are confident Chesapeake has enough staying power to wait for the eventual turnaround in prices, which should lead to a dramatic increase in the value of our oil and gas assets.

### **First-class assets in three gas-rich areas**

Despite the large non-cash impairment charges, we are pleased with the strength of our asset base and the value we have added in just the first year of owning our acquired properties. Chesapeake's portfolio of assets is concentrated in three major areas: the Mid-Continent region, the onshore Gulf of Mexico, and in far northeastern British Columbia, Canada. All of these project areas are characterized by a high concentration of valuable natural gas reserves. They are also areas where Chesapeake has a substantial asset base, significant technological expertise, and a large inventory of undeveloped leasehold with low-risk development drilling opportunities and high-impact exploratory projects. In the years ahead, the company's strategy is to continue building on its economies of scale in these core asset areas through value-enhancing drillbit activity and by further consolidating our ownership in these areas.

We are particularly interested in building Chesapeake's asset base in the Mid-Continent area of the U.S., which includes Oklahoma, Kansas and the Texas Panhandle. The Mid-Continent is the third largest gas supply area in the U.S., exceeded only by the offshore and onshore Gulf of Mexico regions. Characterized by long reserve lives, attractive lifting costs, excellent gas markets and abundant consolidation opportunities, the Mid-Continent is Chesapeake's operating backyard and the location of 57% of its reserves. The wisdom of increasing our assets in the Mid-Continent is particularly apparent during this time of historically low prices. Many of Chesapeake's Mid-Continent properties will continue producing for decades, and we believe these long-lived assets will enable the company to outlast what we anticipate will be a relatively

brief period of low natural gas prices. Afterwards, we expect to prosper as natural gas prices increase substantially as a result of declining supply and rising demand.

### **Lessons from past cycles**

Over the past 20 years, Chesapeake's management team has witnessed a number of down cycles in the energy industry: 1982-83, 1985-86, 1991-92 and 1994-95 come to mind. Although the current cycle has been unusually severe, history reinforces the wisdom of contrarians who understand that powerful self-correcting market forces generate strong price recoveries following cyclical downturns like the current one. While some investors may be reluctant to invest in this sector during tough times, Chesapeake's management knows that price collapses provide the foundation for improved valuations in the future. Simply put, low prices cure low prices as consumers are motivated to consume more and producers are compelled to produce less. Furthermore, history tells us that the depth of this cycle assures a coming recovery in natural gas prices that is likely to be faster and more powerful than most observers realize.

Based upon an expected 50% reduction in drilling levels for new reserves in 1999 and the depletion of existing wells accelerating to annual rates of 15-20%, we anticipate that U.S. gas production may fall 5-10% in the next 18-24 months. With overall demand projected to increase by as much as 10% during the same period, Chesapeake believes a substantial increase in natural gas prices may be just ahead, possibly as soon as in the second half of 1999. With our 1.1 tcf of natural gas reserves, low operating cost structure, \$3.00 substantial inventory of low-risk drilling projects, operational expertise to rejuvenate acquired properties and a high-potential 3-D seismic exploration program, Chesapeake is poised to benefit from the strong market forces shaping the future of the natural gas industry.

### **The long-term case for natural gas**

Every day more residential, commercial and industrial consumers select natural gas as their fuel of choice. Natural gas is America's best energy value at an average cost of 25% less than electricity and 15% less than fuel oil. It is also the most environmentally sensitive fuel - the same level of energy derived from burning natural gas generates 50% less carbon emissions than coal and 30% less than fuel oil.

The electricity generation sector is a major component of the projected strong demand growth for natural gas. This past summer's extremely volatile electric utility markets demonstrated that electrical generating capacity has not kept up with rising demand for electricity. As a result, an estimated 45,000 megawatts of new gas-fired electrical generating units are scheduled to come on line by 2001. This alone could increase natural gas demand by an additional 2-4% per year, just as production declines should begin accelerating from the severe contraction in drilling activity.

In addition, increasingly stringent environmental standards will create an even greater reliance on gas-fired generation. The Environmental Protection Agency has recently issued a rule that requires 22 states east of the Mississippi River to lower their emissions by 28% before the year 2007. This rule strongly favors gas-fired generation over coal-fired facilities. Though nuclear power plants still provide 20% of the nation's electricity, during the next 20 years up to 75% of these facilities will likely be decommissioned and replaced by natural gas-fired power plants. Rising electricity usage, decreasing nuclear power capability and the significant environmental benefits of natural gas should make natural gas America's fuel of choice in the 21st century.

### **Favorable supply and demand trends**

In the face of these impressive demand trends, the oil and gas industry will have to generate significant supply increases. If present growth trends continue, natural gas demand increases of 2-4% per year will require a supply increase from approximately 22 tcf in 1998 to 30 tcf in 2010. To satisfy this demand, the U.S. natural gas industry will be required to discover over 200 tcf of new natural gas reserves in the next 10 years, a task we believe the industry cannot accomplish without significantly higher natural gas prices. Our conclusion that gas demand will greatly outstrip supply in the next decade was the motivating factor behind Chesapeake's natural gas-focused acquisitions in 1997 and 1998, and our willingness to increase Chesapeake's debt in funding the acquisitions.

During the past two years, energy companies invested an estimated \$50 billion in drilling new U.S. wells, increasing the active rig count by over 40% to more than 1,000 rigs in February 1998. Despite these record expenditures, the nation's gas production level increased by only 1% per year. Today's rig count of around 500, barely half of last year's, is the lowest level since industry record keeping began in 1944. By way of comparison, an all-time high of 4,530 rigs were drilling in December 1981, which represents an 88% reduction in drilling activity during the past 18 years.

Several factors have contributed to the lack of production growth. In the Gulf of Mexico, the most important gas supply basin in the U.S., a huge increase in drilling activity in 1995-98 resulted in no net supply increase. Finding costs were much higher than projected, and annual depletion rates approaching 30-40% in the high-deliverability, short-reserve life, shallow-water region overwhelmed the increased drilling activity, leaving the area with an average reserve life of less than five years. Further deepening the expected supply declines in the years ahead is the large reduction in rigs working the Gulf, from 140 in February 1998 to 100 today. The heavy concentration of drilling during the past few years in other high-deliverability, short-reserve life areas such as the Austin Chalk and Cotton Valley Pinnacle Reef trends has compounded the Gulf supply problem.

Many investors believe that the gas production required to meet increasing U.S. demand and overcome U.S. supply problems will come from Canada. While this has been true during the

past 10 years, we believe gas supply problems are as challenging for the Canadian industry as they are for the U.S. producers. We do not believe Canadian natural gas productivity can expand in the near term to fill the new Canadian pipeline projects. The required level of Canadian gas well drilling to fill the pipelines when they come into service in 2001 is projected to be in excess of 4,500 wells projected to be drilled in 1999. Further compounding the Canadian supply challenge is a well depletion problem similar to that in the U.S., with annual reservoir decline rates now approaching 20%.

### **Acting decisively to enhance asset value**

To ensure adequate liquidity, Chesapeake has significantly reduced its capital expenditures for 1999, matching the company's drilling budget with its expected cash flows from production and miscellaneous asset sales. Because service costs are down, our dollars are going further and achieving much lower finding and development costs. The 1999 budget is mostly allocated to low-risk, development drilling opportunities in the Helmet area of northeastern British Columbia and in the Mid-Continent, including Sahara in northwest Oklahoma, West Panhandle in the Texas Panhandle, and the Knox/Bradley/Cement and Watonga-Chickasha areas in west central Oklahoma.

In these core areas, Chesapeake will concentrate on improving operational efficiencies, increasing production through the installation of additional compression facilities and completing various production stimulation programs and mechanical reworks. The remaining budget is dedicated to higher-potential, higher-risk areas such as the Tuscaloosa Trend in Louisiana and the Austin Chalk Trend in Texas.

We are also continuing to reduce Chesapeake's already low operating costs through our program of selling approximately 1,000 low margin oil properties. To date, we have generated proceeds of \$40 million with an additional \$45 million of sales projected for later this year.

In addition, the company has reduced its general and administrative expenses. After completing eight acquisitions in early 1998, we have reduced Chesapeake's pro forma overhead expense by 40%. Recently, we further reduced staff by consolidating our Texas and Louisiana district offices into our Oklahoma City headquarters.

### **Looking Forward**

To continue enhancing the value of Chesapeake's assets, we are building our inventory of drilling opportunities and retaining our best employees. We have a strong technical team that rigorously reviews all of our assets to identify the best opportunities to increase production and reserves. It is important for you to know that Chesapeake's management, directors and employees own 30% of the company's outstanding common shares. This level of ownership, among the highest levels in our industry, keeps all Chesapeake employees focused on our goal of continuing to build a first-class inventory of natural gas projects. We believe the fundamental

value of Chesapeake's natural gas reserves will move up dramatically in the near future. All of our efforts are designed to reach this point with the best set of assets and the highest quality people possible. We believe the wisdom of our transformation to a long-lived natural gas producer will be strongly vindicated and that better days are ahead for Chesapeake and our shareholders in 1999 and beyond.

Aubrey K. McClendon

Tom L. Ward

March 15, 1999