Chesapeake

Letter to Shareholders - 2003 Annual Report

Performance - it's what the cover of our 2003 Annual Report is all about, it's what Chesapeake is all about and it's what all business should be about. The expectation of exceptional performance is why you (and we) own Chesapeake stock, and the delivery of exceptional performance is management's #1 responsibility. However, because the natural gas exploration and production (E&P) business is highly competitive and the prices received for the products we sell are extremely volatile, consistent performance in delivering shareholder value in our industry is not easy to achieve.

Accordingly, in this year's letter, we focus not only on Chesapeake's performance during 2003, but also on the company's track record of performance during the 11 years since our IPO in February 1993. We will also discuss how we have positioned Chesapeake to continue delivering exceptional performance to our shareholders in the years ahead.

Performance Through Operational and Financial Achievement

First, let's review our operational and financial performance in 2003, which by almost all measures, was our best year ever. We began the year with a full head of steam from our ONEOK and El Paso acquisitions ($800 million of first class properties in the Mid-Continent), made a number of important gas discoveries through the drillbit, dramatically improved our balance sheet and then ended the year with our Laredo and Concho acquisitions ($620 million of excellent properties in the Mid-Continent, Permian Basin and South Texas areas). These acquisitions and several others announced earlier this month have provided us with an especially strong start to 2004.

Here are some selected operational and financial performance highlights for the year 2003:

* Production increased 48% from181 bcfe to 268 bcfe;
* Proved reserves increased 44% from 2,205 bcfe to 3,169 bcfe;
* Revenues grew by 132% from $739 million to $1.717 billion;
* Ebitda* increased by 151% from $414 million to $1.042 billion;
* Operating cash flow** grew by 119% from $413 million to $904 million;
* Net income to common shareholders grew by 863% from $30 million to $291 million, and;
* Shareholders' equity increased by 91% from $908 million to $1.733 billion.

Performance Through Stock Price Appreciation

At the end of the day, the only performance that matters for a public company is stock price performance. We are therefore pleased to report that Chesapeake's 75% stock price increase during 2003 was the best performance among our mid- and large-cap competitors. In fact, during the past six years (1998-2003), Chesapeake's stock price performance leads our entire industry with an increase of 1,345%, or a compound average annual increase of 71%.

We are also happy to note that earlier this month, the Wall Street Journal reported that Chesapeake recorded the 13th best stock price performance among all U.S. public companies during the past ten years. During that period, Chesapeake's stock price increased by 2,476%, a compound average annual increase of 39%. A little known fact is that during the past ten years, Chesapeake's stock price performance has exceeded that of each of the 30 largest companies in the world, including such stock market leaders as Microsoft, Cisco, ExxonMobil, Pfizer, Intel, General Electric, IBM and Citigroup.

Performance Through a Successful Business Strategy

We have not forgotten, however, that Chesapeake's stock price did decline in three of the past ten years. It was the disappointments of two of those years,1997 and 1998, a period of declining oil and gas prices and uneconomic Louisiana drilling results from a much smaller Chesapeake, that persuaded us to alter our strategy and concentrate on natural gas while pursuing greater scale, longer lived reserves, and a balance between drillbit growth and acquisition growth. This strategy, implemented in 1998 and executed consistently during the past six years, has served our shareholders well and we believe still provides the best game plan for continuing to deliver strong shareholder value performance in the years ahead.

Through consistent execution of our focused and clearly articulated business strategy, we have built a regionally dominant U.S. E&P company by successfully integrating an aggressive and technologically advanced drilling effort with an active acquisition program. This program has been focused on small- to medium-sized corporate and producing property acquisitions that we believe are under-valued, under-exploited or under-explored.

In addition to constantly strengthening Chesapeake's Mid-Continent position (where approximately 80% of our reserves and production are located), we are continuing to build secondary footholds in other areas of opportunity, particularly focusing on the Permian Basin, South Texas and Texas Gulf Coast regions. All of these areas share similar characteristics with the Mid-Continent region. We believe the company's successful regional consolidation strategy and advanced technology drilling expertise can be readily applied to these new areas as well.

Performance Through High Quality Acquisitions

The successful execution of our regional consolidation program has been one of the primary drivers of the company's strong performance during the past six years. Our acquisition program is focused on acquiring high-quality producing properties, primarily natural gas and primarily in the Mid-Continent, that have long lives, exhibit predictable decline curves and offer significant development and high-potential deep drilling opportunities. Since January 1, 1998, we have acquired $3.6 billion of proved reserves at an attractive average cost of $1.20per mcfe. The vast majority of these acquisitions either increased our ownership in existing wells and fields, or added additional drilling locations to our primary or secondary operating areas. In addition, because both our primary and secondary operating areas are home to many small companies seeking liquidity opportunities and large companies divesting non-core assets, we expect to continue creating value-enhancing performance through successfully harvesting future acquisition opportunities in these areas in the years ahead.

Performance Through Organic Drillbit Growth

One of Chesapeake's most distinctive characteristics has been the company's ability to create shareholder value through consistent drillbit performance. In an industry that has been unable to deliver increases in natural gas production for three consecutive years, Chesapeake's ability to increase its production through the drillbit is an increasingly rare attribute. Founded on a "growth through the drillbit" philosophy, our strength in this area highlights the company's performance as a pacesetter in the industry. Based on our review of 2003 results from other mid- and large-cap E&P companies, Chesapeake's 20% organic production growth was the best performance with the drillbit in our industry.

With an inventory of more than 2,500 prospective drillsites (many of which have been identified using advanced 3-D seismic information) on the company's three million net acre leasehold inventory, we have built a solid foundation to deliver further drillbit performance in 2004 and beyond. From this prospect-rich platform, Chesapeake is conducting the second most active U.S. drilling program. During 2004, we expect to employ an average of 45-50 rigs that will drill approximately 500 company-operated wells and 40-50 rigs that will drill approximately 500 outside-operated wells.

These onshore natural gas wells provide a safe and reliable source of the clean energy our country increasingly demands. Across our entire base of operations, Chesapeake balances risk and return opportunities, with one-third of our drilling focused on low-risk developmental targets at depths shallower than 10,000 feet, one-third on medium depth drilling consisting of developmental and higher-potential targets between 10-15,000 feet and one-third targeting deeper exploratory targets with significant upside potential below 15,000 feet. This balanced range of prospects provides the company with one of the largest and most attractive drilling inventories of all E&P companies and will play an important role in enabling Chesapeake to continue delivering industry-leading performance in the years ahead.

Performance Through Building Regional Scale

One of the keys to consistently delivering great performance in the E&P industry is building scale in a limited number of core operating areas. Achieving economies of scale provides many important benefits, including higher per unit revenues, lower per unit costs, greater drilling success, better acquisition results, and higher returns on invested capital. Chesapeake first began pursuing regional scale in the Mid-Continent in 1998 and the success of our strategy has enabled the company to become the region's largest natural gas producer, its most active driller and its most active acquirer of producing and non-producing properties.

We favor the Mid-Continent because it offers many attractive characteristics. These characteristics include long-lived natural gas properties with predictable decline curves, multiple-pay geological targets, strong oil and natural gas prices, lower service costs, and a favorable regulatory environment with virtually no federal land ownership. Chesapeake's secondary operating areas possess many of these same characteristics. The company's regional scale and focus should provide significant performance opportunities for Chesapeake's shareholders in the years ahead.

Performance Through Maintaining a Low Cost Structure

By minimizing the operating cost of the company's wells and reducing general and administrative expenses through strict cost controls and regional operating scale, we have been able to deliver attractive financial performance through almost all phases of the commodity price cycle. Chesapeake' slow cost structure is the result of management's effective cost-control programs, a high-quality asset base and the extensive and competitive service, processing and transportation infrastructures that exist in our core operating areas. By maintaining a low cost structure, we are able to achieve high returns on Chesapeake's capital and deliver strong operational and financial performance to our shareholders, including a gross profit margin of 39% and a return on equity of 32% in 2003.

Performance Through Successful Risk Management

During the past six years, Chesapeake has developed a distinctive identity in the industry by being one of the earliest to predict that the U.S. would begin experiencing the increasingly volatile natural gas prices that are with us today. For years, our view that U.S. natural gas production would peak and then start an inexorable decline (just as oil production has been declining in the U.S. for more than 30 years) was not widely shared. Our view that natural gas prices would increase significantly as a result was also not widely shared and, in fact, was just the opposite of what our federal government had been forecasting.

The company's anticipation of accelerating U.S. production declines and the resulting natural gas price volatility led to the development of our commodity price risk management policies that have generated industry-leading hedging results. In fact, during the past three years alone, we have generated realized hedging gains of over $180 million. By investing this extra revenue in the company's drilling program, we have been able to create over $300 million of additional reserve value through risk management. Although we do not expect to generate increased revenues from our hedging program every year, overtime we believe this program can generate significant value while substantially reducing commodity price risk for our shareholders.

Performance Through Improving Our Balance Sheet

A key driver of Chesapeake's exceptional stock price performance in 2003 and during the past six years has been the significant improvement made to our balance sheet. When our stock price declined in 1997 and 1998 because of the operational setbacks and declining oil and gas prices mentioned earlier, the company was forced to significantly write down the value of its assets. This reduction in asset value caused our debt to total capitalization to reach a peak of 137% at year-end 1998.

However, through strong earnings growth and several equity offerings built around some of our larger acquisitions, we have reduced Chesapeake's debt to total capitalization to below 50%. We have also reduced the average interest rate of our out-standing senior notes to 7.7% and have extended our average senior note maturity to 9.6 years. After paying off $46 million of senior notes in March 2004, we now have only $210 million of senior note maturities in the next seven years.

The benefits to our shareholders from these steady improvements in Chesapeake's balance sheet include a lower cost of capital, increased shareholder confidence in the company's ability to create value even when commodity prices are unfavorable and a higher trading multiple for our common stock. One of our key financial goals continues to be reducing the company's debt to total capitalization and to achieve an investment grade rating for our unsecured debt in the years ahead.

During 2003, Chesapeake's secured debt facility earned an investment grade rating and we are confident the strength of our assets and business strategy will provide further significant balance sheet improvement and strong shareholder value performance in the years ahead.

Eleven Years of Industry-Leading Performance

We hope the foregoing review of our business strategy helps explain how Chesapeake has been able to create industry-leading performance for our shareholders during our first 11years as a public company. Please find below various operational and financial achievements that we believe highlight just how much progress we have made as a company during the past 11 years:

* Production has increased from 4 bcfe to 268 bcfe, a compound annual growth rate (CAGR) of 48%;

* Proved reserves have increased from 137 bcfe to 3,169 bcfe, a CAGR of 35%;
* Revenues have grown from $17 million to $1.717 billion, a CAGR of 55%;
* Ebitda* has increased from $7 million to $1.042 billion, a CAGR of 62%;
* Operating cash flow** has grown from $4 million to $904 million, a CAGR of 6%;
* Net income available to common shareholders has grown from a first year loss to $291 million;
* Shareholders' equity has increased from $31 million to $1.733 billion, a CAGR of 46% and;
* Chesapeake's stock price has grown from a split-adjusted IPO price of $1.33 per share to a year-end 2003 price of $13.58 per share, a CAGR of 24%.

We are proud of the company's track record of performance during the past 11 years and believe we can continue building on it during 2004.

Looking Forward

As we conclude this letter and reflect on our performance during Chesapeake's first 11 years, were main optimistic about the continued success of the company and our ability to deliver value to our shareholders. We have built a strong foundation based on the commitment of 1,300 top-notch employees, a time-tested and successful business strategy, a value-added risk-management program, a steadily improving balance sheet and increasingly valuable natural gas assets. We also offer an entrepreneurial and experienced management team that has proven itself through a full range of commodity cycle challenges in building a $6.4 billion enterprise from an initial $50,000 investment in just 15 years.

We are off to a great start in delivering another successful year of performance to our shareholders in 2004. In the first three months of the year, we have already negotiated $600 million of acquisitions, drilled 120 new operated wells, established new daily production records and increased our production and earnings forecasts for the year.

In addition, natural gas prices continue to strengthen because of increasing U.S. gas demand and decreasing U.S. gas sup-ply. As a result, we believe the stage is set for an extended period of strong natural gas prices. Just as the 1990's with its low gas prices was a decade that mostly benefited natural gas consumers, this decade with its high gas prices will primarily benefit natural gas producers and their shareholders. In this environment, we believe Chesapeake can continue leading the way in delivering exceptional shareholder value performance in 2004 and beyond.

Best regards,

Aubrey K. McClendon
Chairman and Chief Executive Officer

Tom L. Ward
President and Chief Operating Officer

March 31, 2004

***Ebitda is a non-GAAP measure that represents net income before the cumulative effect of accounting changes, income tax expense, interest expense and depreciation, depletion and amortization expense.**

**** Operating cash flow is a non-GAAP measure that represents net cash provided by operating activities before changes in assets and liabilities.**