Chesapeake

Letter to Shareholders - 2004 Annual Report

FOCUSED. We believe this word best describes Chesapeake. Despite the rapid growth of our company during the past seven years from a struggling small-cap, with a $1 billion enterprise value, to a successful industry leader with an $11 billion enterprise value, we have remained focused on creating shareholder value through the successful execution of a clear and concise business strategy.

This strategy focuses on achieving the following results:

* BUILDING one of the nation's largest natural gas resource bases;
* GENERATING double-digit annual organic growth through the drillbit;
* CREATING double-digit annual acquisition growth through regional consolidation of assets;
* DISCOVERING deep conventional natural gas reserves and shallower unconventional natural gas reserves;
* ATTRACTING and motivating many of the best employees in the industry; and
* PROVIDING responsible stewardship of our environment and active leadership in the communities where we operate.

2004 IN REVIEW

As evidence of the success of Chesapeake's business strategy, we would like to highlight the company's operational and financial achievements of 2004. In doing so, we also extend our appreciation to the company's 1,900 employees for helping deliver Chesapeake's terrific performance during the past year. Highlights of 2004 include:

* Oil and natural gas production increased 35% from 268 bcfe to 363 bcfe;
* Proved oil and natural gas reserves increased 55% from 3,169 bcfe to 4,902 bcfe;
* Revenues rose 58% from $1.72 billion to $2.71 billion;
* Ebitda* increased 52% from $1.04 billion to $1.58 billion;
* Operating cash flow** grew 57% from $904 million to$1.42 billion;
* Net income to common shareholders increased 51%from $291 million to $439 million;
* Reserve replacement for the year reached 578% at a drilling and acquisition cost of only $1.21 per mcfe; and
* Total return to common shareholders reached 23%, improving our total return to common shareholders to almost 1,600% for the 12 years since our IPO in 1993.

As a result of the company's 2004 achievements, Chesapeake has become the fourth largest independent producer of U.S. natural gas, producing 2% of the nation's natural gas from our interests in 20,000 wells. In 2005, we again expect to lead the industry in drilling activity, utilizing about 6% of the nation's active drilling rig fleet to drill more than 1,000 new wells. Moreover, we expect to increase our production by at least 20% in 2005 and, in doing so, expect to become the third largest independent producer of U.S. natural gas.

This industry-leading drilling campaign requires the great people and great geological prospects that Chesapeake has in abundance. We are constantly energized by the role Chesapeake plays in meeting our country's increasing need for clean-burning, domestically produced natural gas. We firmly believe the building blocks of future success are in place and should help make 2005 another very rewarding year for Chesapeake's shareholders.

BENEFITS OF A FOCUSED STRATEGY

Achieving and maintaining focus in any business is difficult, especially when the business has grown as rapidly as ours. Greater size often brings reduced focus as many exploration and production (E&P) companies discover their existing strategies require ongoing modification to accommodate increasing scale. This seemingly natural response too often results in operational mediocrity rather than in the operational excellence that we strive to achieve.

At Chesapeake, we are discovering the company's rapidly increasing scale is actually enhancing our operational and financial returns rather than inhibiting them. While somewhat counter-intuitive, we have achieved these enhanced returns by remaining focused on the following six key drivers of the company's strategy.

FOCUSED ON NATURAL GAS

The easiest way to understand Chesapeake is to recognize our single-minded focus over the past seven years on finding and producing the cleanest-burning hydrocarbon in the world – natural gas. Back in 1998 and early 1999, when gas was exceptionally cheap (frequently selling for less than $1.25 per mcf), most industry and government observers predicted that the U.S. gas market would increase from 22 tcf to 30 tcf per year by 2010 and that gas prices would remain low.

After examining the fundamentals of North American natural gas, we concluded these predictions were unlikely to come true and began repositioning the company to pursue a contrarian strategy based on the following beliefs:

* gas production depletion rates would accelerate;
* finding, development and operating costs would increase;
* natural gas demand would gradually move away from more cost-sensitive industrial demand to less cost-sensitive power generation demand; and
* U.S. natural gas production would soon reach a peak from which there could be no recovery, regardless of higher prices or improved technology.

To recognize these trends, we first studied U.S. oil production history and became convinced that U.S. natural gas production would likely follow a similar bell-shaped curve of ramping up to a historic peak (1970 for oil, 2000 for natural gas) and then beginning a slow but steady decline thereafter. We also reasoned the major oil companies would begin withdrawing from the search for increasingly scarce natural gas reserves in the U.S. and refocus their natural gas strategies on building global natural gas franchises around more abundant worldwide gas reserves that could be transformed into liquefied natural gas (LNG).

As the majors began de-emphasizing their search for new gas reserves in the U.S., we felt certain the

35% of U.S. gas production the majors represented would decline at a rate that would surprise many industry observers. It also seemed clear to us the smaller independent E&P companies would not be able to increase their own natural gas production enough to overcome the majors' production declines.

Accordingly, we decided that Chesapeake should adopt four objectives that would provide first-mover advantages if our theories proved correct:

* acquire all of the existing natural gas production and reserves that we could afford;
* lease all the potentially gas productive acreage that we could identify;
* hire all of the talented landmen, geoscientists and engineers that we could find; and
* regionally consolidate onshore in the southwestern U.S., the source of 50% of the nation's natural gas production.

Over the past seven years, we have accomplished all these objectives. Meanwhile, gas prices have risen to levels nearly 500% greater than they were in 1998 and early 1999. More importantly, natural gas demand still exceeds supply and continued natural gas price strength is likely for years to come. As a result of anticipating these trends and developing a first-mover strategy to take advantage of them, Chesapeake is very well-prepared to prosper in the years ahead.

FOCUSED ON ORGANIC GROWTH

We believe the best way to create value in the natural gas industry is to grow production organically, often referred to as "growing through the drillbit." Given the nation's ongoing natural gas production declines, growing through the drillbit has obviously proven challenging in the increasingly mature U.S. gas producing regions. However, because growing through the drillbit is potentially much more rewarding than growing through acquisitions, Chesapeake maintains a primary focus on organic growth and has built a drilling machine that is unequalled in the industry.

Chesapeake manages its growth strategies by attempting to balance growth through the drillbit with growth through strategic acquisitions. In 2004, for example, our organic growth was an industry-leading 20% and our growth through acquisitions was an excellent 15%. Most impressively, we generated this strong growth in an industry marking its fourth consecutive year of U.S. natural gas production declines.

How did Chesapeake lead the industry in organic growth in 2004? It was a combination of anticipation, preparation and execution. We correctly determined in 1998 and early 1999 the future would reward companies that anticipated the unfolding U.S. gas production shortfall. We then prepared for the opportunity by making acquisitions of producing properties and companies, by building a portfolio of more than 7,000 drillsites (that provide an approximate seven-year inventory of future growth opportunities) and by hiring more than 300 of the most talented landmen, geoscientists and engineers we could find (thereby quadrupling our human capital in the three major technical disciplines of the E&P industry).

We successfully executed this focused strategy and the proof is in our results – during the past four years, Chesapeake's annual organic growth has averaged an industry-leading 14% and our stock price has increased by approximately 150%. For those companies only now realizing the opportunities our industry offers today, it would be impossible to duplicate what Chesapeake has built over the past seven years. This is particularly true in Oklahoma, the third largest gas producing state in the U.S. In just seven years, we have moved from fifth to first in natural gas production in Oklahoma and we are proud to say our gas production market share of 19% is the largest of any company in any major gas producing state.

FOCUSED ON ACQUISITIONS

Our focused acquisition strategy fits hand-in-glove with our focused organic growth strategy. Over time, we have learned that successful drilling creates significant acquisition opportunities and in turn, successful acquisitions create attractive drilling opportunities.

Chesapeake's integrated approach to acquisitions is enhanced by our very tight focus on the geography and size of the assets we acquire. With regard to geography, we only acquire properties that are located onshore in the southwestern U.S., comprised of Oklahoma, Texas, New Mexico, Louisiana, Kansas and Arkansas. These contiguous states collectively produce about 50% of the nation's natural gas. They also generally promote a PIMBY (Please In My Backyard) business environment, rather than the NIMBY (Not In My Backyard) attitude often found in other regions of the U.S. Furthermore, they offer reserve life profiles, operating costs and drilling upside that we know and understand as well as anyone in the industry.

In addition, even though the company has grown ten-fold in the past seven years, we have remained focused on acquisitions of less than $600 million. Acquisitions of this size are easier to assimilate, have less execution risk and have traditionally offered more attractive value than bigger transactions. While we may someday find an attractive acquisition of greater scale, we intend to stay primarily focused on the small-to-medium sized deals that have worked so well for us to date. Having completed more than $5.4 billion of acquisitions over the past seven years, mainly in 48 transactions between $10 million and $600 million, we have confidence that more acquisitions in that range will remain an attractive aspect of our business strategy.

FOCUSED ON EXPLORATION

For much of the past 20 years, the E&P industry has been a tough place to make a living. The industry has been handicapped by low prices, accelerating depletion rates, increasing finding costs, a shrinking labor pool, rising environmental opposition and more costly governmental regulations. It is a wonder the industry survived at all. Not surprisingly, investors ignored the E&P industry, choosing instead to focus their investments on energy-consuming industries that were the beneficiaries of our industry's tough times.

Today's E&P industry is comprised of a relatively small number of resilient companies that survived through a long period of low oil and natural gas prices by being financially and operationally conservative. We believe this conservatism has caused many of our peers to be overly cautious in increasing drilling activity in response to prices that have risen steadily during the past seven years. For example, even though oil and natural gas prices have increased six-fold from their 1998 and early 1999 lows, drilling activity has increased by less than three-fold.

As a consequence, U.S. natural gas production in 2004 decreased for the fourth consecutive year. Perhaps more worrisome, the industry has been trending away from searching for new gas reserves through exploratory drilling in favor of drilling infill wells that are designed to drain known gas reserves more quickly. This trend reflects a natural reaction to an extended period of low oil and natural gas prices and a common skepticism about the longevity of today's higher prices. "Harvest it while you can before prices decline again" is still a view widely held by industry management, analysts and investors.

On the other hand, Chesapeake has adopted a different approach. We have invested more than $1.3 billion in acquiring leasehold and 3-D seismic information during the past four years, enabling our employees to develop large numbers of developmental and exploratory drilling prospects from the largest onshore inventories of 3-D seismic and leasehold in the industry.

Some of our exploration opportunities target deep natural gas reservoirs at depths of 15,000-23,000 feet, while others test various unconventional gas resource ideas. Successful exploration has been a key reason for our ability to generate industry-leading organic growth rates of 18% in 2003 and 20% in 2004. We are optimistic the projects targeted for exploratory drilling in 2005 will be successful and will enable us to exceed our projected organic growth rate of 10%.

FOCUSED ON EMPLOYEES

Another key ingredient of Chesapeake's success has been the investment we have made in strengthening our employee talent pool. Seven years ago, when we overhauled the company's business strategy, we identified the elements coming together for stronger oil and natural gas prices and began to build the foundation of natural gas assets and drilling upside that characterize the company today.

To accomplish these goals, we recognized we would need a deeper and broader pool of employee talent and over the past seven years, we have increased the number of our employees from 500 to 1,900. Approximately 1,600 work in our E&P operations while another 300 work in our midstream gas and drilling rig subsidiaries. We have primarily focused on strengthening our land, geoscience and engineering departments, areas where we anticipated shortages of skilled labor would become increasingly acute as the industry began ramping up drilling activity in reaction to higher prices.

A particular focus of Chesapeake's hiring during the past few years has been the identification of young talent and our success in attracting them to join our rapidly growing company. Since the industry's last hiring boom of the late 1970's and early 1980's, there have been very few reasons for young people to join this industry. In most E&P companies today, the average age of senior landmen, geoscientists and engineers is over 50, making our industry one of the oldest in the country.

During the next 10-15 years, when we believe the U.S. and the world will increasingly struggle to meet rising energy needs, 75% of the industry's technical talent will reach retirement age, potentially creating a serious vacuum of talent. Further exacerbating this disturbing demographic trend, very few young people across the country are aware of the abundant opportunities available in the E&P industry today and of the favorable future supply/demand trends for oil and natural gas that should make their jobs rewarding for many years to come.

Therefore, in addition to continuing to hire experienced industry professionals, we have also focused on attracting younger workers. We believe the combination of the two age groups adds to the high energy level on our headquarters' campus in Oklahoma City. To help attract and retain our new employees, we have built facilities that encourage them to first join our company and then increase their productivity while here.

The first of these facilities is The Wildcat, the on-campus restaurant for Chesapeake employees and their guests (and we might add, for shareholders if you visit us). The Wildcat offers a great variety of nutritionally-balanced, affordable meals for our Oklahoma City-based employees.

We have also opened The Health Club, a 40,000 square foot state-of-the-art employee health facility in Oklahoma City. This very popular building won a national design award last year and is the centerpiece of our efforts to help enable employees to work more productively by improving their fitness. We are proud of The Wildcat and The Health Club and believe they have helped build and retain a workforce that is among the most talented and productive in the industry.

FOCUSED ON STEWARDSHIP

As part of our business strategy, we have also become an important source of good stewardship in the communities where we conduct business. In these communities, we are active philanthropically and operate in an environmentally responsible manner, producing the most environmentally attractive fuel in the nation's energy mix.

Most importantly, we have been good stewards of your financial investments with us, as evidenced by the company's second place ranking in creating shareholder value among mid- and large-cap E&P companies in the 12 years since our IPO. Beyond our primary stewardship obligations to you, we are also stewards of many other assets and responsibilities. This stewardship includes the land on which we drill and produce natural gas, and the states, cities, towns and neighborhoods in which we conduct our business.

We supplement this good stewardship with our corporate checkbook, having contributed almost $4 million in civic, educational and charitable giving during the past three years. In addition, we are personally involved in a large number of philanthropic initiatives locally and nationally. We believe Chesapeake's philanthropy is simply the right thing to do from both a moral and corporate self-interest perspective. Not only are our employees, vendors and investors proud of the way we make a difference in the lives of those around us, we are also welcomed in the many communities where we drill for and produce natural gas.

Finally, as scientists, policy-makers and businessmen debate the possible effects of potential global warming, which some argue could be partially caused by the increasing use of fossil fuels, we are proud to remind investors that Chesapeake is a "good guy" in this debate. We produce a valuable fuel that is in increasingly short supply, is domestically produced and therefore requires no military commitment to defend it and produces very few pollutants when burned. We look forward to natural gas increasing in value over time as policy-makers and consumers increasingly appreciate the many positive attributes of this versatile and valuable "wonderfuel" – clean-burning, domestically-produced natural gas.

LOOKING FORWARD WITH OPTIMISM

As we conclude this letter and reflect on having delivered a 1,600% stock price increase to our shareholders during Chesapeake's 12 years as a public company, we remain optimistic about the continued success of the company and our ability to continue delivering value to shareholders. We have built a strong foundation based on the commitment of 1,900 top-notch employees, a successful time-tested and focused business strategy, a value-added risk management program, a steadily improving balance sheet and increasingly valuable oil and natural gas assets. We also offer an entrepreneurial and experienced management team that has proven itself through a full range of commodity cycle challenges.

We are off to a great start in delivering another successful year of performance to our shareholders in 2005. In the first three months of the year, we have already closed or negotiated $1.0 billion of acquisitions, commenced drilling operations on approximately 375 new wells, established daily production records and reached a record level of proved reserves. U.S. natural gas prices continue to strengthen because of tightening supply/demand fundamentals in both U.S. gas and world oil markets. These supply/demand imbalances cannot be easily or cheaply fixed, and as a result, we believe the stage is set for an extended period of strong oil and natural gas prices.

In the 1990's, low oil and natural gas prices greatly benefited energy consumers at the expense of energy producers and their shareholders. In contrast, this decade should result in the opposite outcome. In this environment, we believe Chesapeake will stay focused on leading the way in delivering exceptional shareholder value in 2005 and beyond.

Best regards,

Aubrey K. McClendon
Chairman and Chief Executive Officer

Tom L. Ward
President and Chief Operating Officer

April 15, 2005

***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.**
