

# Chesapeake



## Letter to Shareholders - Third Quarter 2004

### Dear Fellow Shareholders:

For the thirteenth consecutive quarter, Chesapeake is proud to deliver another report of sequential production growth and strong operational and financial performance. As reflected in previous reports to you, we believe the consistency of our performance continues to be one of Chesapeake's most important distinguishing characteristics. With strong natural gas and oil prices reflecting ongoing strength in North American gas and in worldwide oil markets, we are excited about the opportunities to continue delivering significant increases in shareholder value as we continue executing our business strategy in the years ahead.

Starting in 1998, Chesapeake was one of the earliest believers that natural gas and oil prices were headed to sustainably higher levels. We invested accordingly and we are now distinctively positioned to continue delivering top-tier performance for years to come. In addition to the \$4.3 billion of acquisitions of proved reserves made during the past seven years, we have invested \$3.7 billion in our domestic drilling, leasehold acquisition and 3-D seismic programs during the same time. We believe we have invested wisely in building a strong foundation for future shareholder value creation.

We are now executing the nation's most active drilling program and have built an inventory of more than 5,000 drillsites, which represents an approximate seven-year backlog of drilling opportunities. We believe the upside associated with this inventory is at least 4.0 trillion cubic feet of natural gas equivalent (tcfe) of probable and possible reserves that can add significant value to our 4.45 tcfe of proved reserves.

### Operating and Financial Highlights

The following comparisons highlight the strength of our operational and financial performance during the 2004 third quarter as compared to the 2003 third quarter:

- \* Oil and gas production reached a record level of 94.2 billion cubic feet of natural gas equivalent (bcfe), up 33%;
- \* Proved oil and gas reserves increased to a record level of 4.45 tcfe, up 48%;
- \* Total revenue climbed to a record level of \$630 million, up 38%;
- \* Operating cash flow\* reached a record level of \$353 million, up 42%, and;
- \* Net income available to common shareholders increased to \$86 million, up 5%.

In addition, the company continued to tightly control its operating costs. The controllable operating costs of our business – G&A, production expense, and interest expense – totaled only \$1.11 per mcfe

this quarter vs. the same \$1.11 for the year-ago quarter, while our oil and natural gas sales revenue increased by \$0.27 per mcf.

In addition, during the quarter we replaced 94 bcfe of production with an internally estimated 744 bcfe of new proved reserves, resulting in an exceptionally strong reserve replacement rate of 789% at the very attractive drilling and acquisition cost of \$1.02 per mcf. While we can not promise a repeat of this impressive performance in quarters to come, we do believe our large operating scale and dominance of the Mid-Continent region gives us considerable negotiating power with service and equipment providers and therefore should allow our company to keep its costs lower than they otherwise might be. We believe this is an important competitive advantage for Chesapeake and should increase our chances of continuing to outperform the industry.

#### *Record Production Generated by Drilling Success and Acquisitions*

Chesapeake's production for the 2004 third quarter was 94.2 bcfe, an increase of 23.2 bcfe, or 33%, over the 71.0 bcfe produced in the 2003 third quarter and an increase of 7.7 bcfe, or 9%, over the 86.5 bcfe produced in the 2004 second quarter. The 23.2 bcfe increase in this year's third quarter production over 2003's third quarter production consisted of approximately 9.3 bcfe generated from organic drillbit growth and approximately 13.9 bcfe generated from acquisitions.

Chesapeake's annualized organic growth rate during the first three quarters of 2004 has been 13%, well above the company's previously forecasted organic growth rate of 5% and among the very best organic growth performances reported by public mid- and large-cap E&P companies this year. In addition, the balance between Chesapeake's growth through the drillbit and growth through acquisitions reflects the continued successful execution of the company's balanced growth strategy. Chesapeake is now projecting annual organic growth rates of 13% in 2004, 10% in 2005 and 8% in 2006. Total projected company production growth rates are 33% in 2004, 14% in 2005 and 8% in 2006.

The 2004 third quarter's production of 94.2 bcfe was comprised of 83.2 billion cubic feet of natural gas (88% on a natural gas equivalent basis) and 1.83 million barrels of oil and natural gas liquids (12% on a natural gas equivalent basis). Chesapeake's average daily production rate for the quarter was 1,024 million cubic feet of natural gas equivalent production (mmcf), consisting of 905 mmcf of gas and 19,935 barrels of oil and natural gas liquids. The 2004 third quarter was Chesapeake's 13th consecutive quarter of sequential production growth. During these 13 quarters, Chesapeake's production has increased 141%, for an average compounded quarterly growth rate of 7% and an average compounded annual growth rate of 31%.

#### *Chesapeake Updates 2004 Production Forecasts*

After delivering sequential production growth in each of the past 13 quarters and after raising the company's production forecasts for the 12th quarter in a row, we are now officially abandoning our previous long-term organic production growth estimate of 5% in favor of the specific out-year organic growth production forecasts provided above. At the end of 2006, we believe that our organic growth rate for the trailing 6 years will have averaged at least 10%. This will be an impressive, if not unique, performance in our industry and it will have been produced by a company that will have more than quadrupled in size during those six years. We believe this is solid evidence that our business model is scaleable and capable of continuing to deliver top-tier shareholder performance for years to come.

In addition, given the stability of our producing property base and the predictable nature of our drilling results, we now feel more comfortable than ever in estimating the company's year-end proved reserves. We estimate that Chesapeake's proved reserves will reach 4.6 tcf by year-end 2004, 5.0 tcf by year-

end 2005 and 5.4tcfe by year-end 2006, assuming we make no acquisitions during this time period.

### Management's Outlook

The 2004 third quarter was another in a series of impressive quarterly performances by Chesapeake for its shareholders. We believe the ingredients for continued success are reflected by the following:

- \* Chesapeake has delivered excellent financial returns to its investors, quarter-after-quarter and year-after-year;
- \* Chesapeake's production growth profile is among the very best in the industry, yet the company does not yet trade with a top of the market multiple, thereby creating an attractive investment opportunity, and;
- \* In anticipation of currently strong oil and gas prices, we have made large investments during the past seven years that should enable our company to continue delivering top-tier operational and financial results for years to come.

With the combination of our focused product and geographic strategies, value-added risk management strategy, balanced acquisition and drilling programs, and high quality assets and low operating costs, Chesapeake expects to consistently deliver one of the industry's best performances of value creation, year after year. We appreciate the confidence our shareholders have demonstrated in our company and we will remain focused on the delivery of value creation for our fellow shareholders.

Best regards,

Aubrey K. McClendon  
Chairman and Chief Executive Officer

Tom L. Ward  
President and Chief Operating Officer

November 1, 2004

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