

Chesapeake



Letter to Shareholders - 2005 Annual Report

Dear Fellow Shareholders:

GROWTH, VALUE AND OPPORTUNITY

The development of our annual report each year is guided by a theme that is unique for the year at hand and also articulates the consistent strategy we have successfully pursued during the past several years. This year, we have chosen to focus on three words – growth, value and opportunity. As this letter unfolds, I hope you will see why we believe these three words best describe Chesapeake in 2005 and should define our performance in 2006 and beyond.

2005 IN REVIEW

Let me first provide some context for this year's discussion. Certainly 2005 was an extraordinary year for Chesapeake, as it was for energy producers and consumers across the globe. Hot summers, mild winters, multiple hurricanes, geopolitical events and peak oil theories were just a few of the topics that dominated the news in 2005. Each of these topics dramatically impacted the worldwide energy business and all touched Chesapeake and its shareholders as well.

Following a mild winter, U.S. natural gas prices began 2005 just below \$6 per mmbtu and remained relatively stable through May. Natural gas prices then climbed steadily through the summer's heat and exceeded the \$10 per mmbtu level by late August. In the aftermath of Hurricanes Katrina and Rita, natural gas prices skyrocketed to over \$15 per mmbtu in December before slumping back to the \$7 per mmbtu range in March 2006 after yet another record-breaking mild winter.

Oil prices were volatile as well. Continued resilient demand driven by strong global economic growth, war in Iraq, tribal unrest in Nigeria, political uncertainty in Venezuela, terrorism risks in many parts of the world, multiple hurricanes and limited excess global production and refining capacity all impacted oil prices. Furthermore, mounting concerns regarding whether world oil production can stay ahead of world oil consumption in the longer term have contributed to additional price volatility. From a beginning price of about \$43 per bbl in January 2005, oil prices climbed to a high of nearly \$70 per bbl after Hurricane Katrina and have since eased back into a trading range of \$60 to \$68 per bbl during the past six months.

Against this backdrop of instability and uncertainty, Chesapeake delivered consistently superior operational and financial results throughout the year and our stock price increased by 92%. We accomplished this through our simple and focused business strategy, the safe location of our assets onshore in the U.S. and the predictable base of production we generate every day from our 30,000 wells.

These attributes enabled us to create substantial shareholder value from a business managed as an oasis of calm within the turmoil that defines today's global energy business.

A closer look at the company's achievements in 2005 reflects the following financial and operational highlights:

- Average daily oil and natural gas production increased 30% from 991 mmcfe to 1,284 mmcfe;
- Organic production growth reached 12%;
- Proved oil and natural gas reserves increased 53% from 4.9 tcf to 7.5 tcf;
- Reserve replacement for the year reached 659% at a drilling and acquisition cost of only \$1.74 per mcfe;
- Revenues rose 72% from \$2.7 billion to \$4.7 billion;
- Ebitda(1) increased 69% from \$1.6 billion to \$2.7 billion;
- Operating cash flow(2) grew 73% from \$1.4 billion to \$2.4 billion;
- Net income per fully diluted common share increased 64% from \$1.53 to \$2.51; and
- Total return to common shareholders reached 94%, improving our total return to common shareholders to almost 2,300% for the 13 years since our IPO in 1993.

As a result of our achievements in 2005, Chesapeake became the second largest independent producer of U.S. natural gas and the sixth largest producer overall. We produce roughly 2.5% of the nation's natural gas from our 30,000 wells. Moreover, we led the nation in drilling activity last year, using an average of 73 operated rigs and 66 non-operated rigs, or 10% of the nation's drilling rig fleet, to drill almost 2,000 wells. In 2006, we again expect to lead the industry in drilling and also expect to increase our total production by approximately 25% through the drillbit and through acquisitions. In addition, we anticipate increasing the company's net asset value per share by a similar amount.

Chesapeake's industry-leading drilling activity and consistent annual production growth (typically exceeding 25%) require great geological prospects and great people – assets that Chesapeake fortunately has in abundance. In addition to more than doubling our drilling backlog to 28,000 locations since the beginning of 2005, we have also doubled our employee count to over 3,500. Most industries (and often ours in the past) report with pride on being able to reduce their employee head count each year. However, after 15 difficult years from 1985 to 2000, our industry is increasingly short on human capital, especially for employees younger than 40. We were early to recognize the importance of being a first mover in attracting the human resources necessary to create long-term shareholder value and we anticipate that we will continue hiring aggressively in 2006.

CHESAPEAKE'S BUSINESS STRATEGY AND NATURAL GAS FOCUS

Chesapeake's business strategy is probably the easiest to understand among all large-cap public exploration and production (E&P) companies. We grow onshore in the U.S. through a balance of drilling and acquisitions, we regionally consolidate to achieve economies of scale, we focus almost exclusively on finding and producing natural gas and we work proactively to mitigate risk. By executing this strategy effectively, Chesapeake became America's top performing stock during the past seven years.(3)

In addition to the simplicity of our business strategy, our early recognition of evolving trends in natural gas markets and our willingness to seize opportunities have distinguished Chesapeake among its peers. Back in 1998 and early 1999, when natural gas was exceptionally cheap (frequently selling for less than \$1.25 per mmbtu), most industry and government observers predicted that the U.S. natural gas market would increase from 22 tcf to 30 tcf per year by 2010 and that natural gas prices would remain low indefinitely. After examining the fundamentals of the North American natural gas market, we arrived at

a very different conclusion and began repositioning the company to pursue a contrarian strategy based on the following beliefs about the U.S. natural gas industry beyond the year 2000:

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

These trends became evident when we studied U.S. oil production history and then predicted that U.S. natural gas production would likely follow a similar bell-shaped curve of ramping up to a historic peak (1970 for oil, 2001 for natural gas) and then slowly but steadily declining thereafter. We also reasoned that the major oil companies would begin withdrawing from the search for increasingly scarce natural gas reserves in North America and refocus their natural gas strategies on building global natural gas franchises around more abundant worldwide natural gas reserves that could be transformed into liquefied natural gas (LNG).

As the majors began de-emphasizing their search for new natural gas reserves in U.S., we felt certain the 35% of U.S. natural gas production the majors represented would decline at a rate that would surprise many industry observers. In fact, over the past five years, the majors' U.S. natural gas production has declined by a stunning one-third. It also seemed clear to us that 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 position itself to be a first mover to take advantage of this opportunity. To that end, we adopted four objectives:

- acquire all of the existing natural gas production and reserves we could afford;
- lease all the potentially natural gas productive acreage we could identify;
- hire all of the talented landmen, geoscientists and engineers we could find; and
- focus exclusively onshore in the U.S., safely away from hurricanes and geopolitical unrest.

Over the past eight years, we have accomplished all of these objectives. Meanwhile, with the help of higher oil prices, natural gas prices have risen to levels 600-800% greater than they were in 1998 and early 1999. More importantly, assuming normal weather patterns, natural gas demand is likely to exceed supply and continued natural gas price strength is probable for years to come. As a result of anticipating these trends and getting ahead of our competition, Chesapeake is very well-positioned for success in the years ahead.

GROWTH, VALUE AND OPPORTUNITY

With this context in mind, I now focus on the centerpiece of this letter – a discussion of why we believe Chesapeake offers the best combination of growth, value and opportunity in the industry.

GROWTH

First and foremost, Chesapeake is a growth company. At the time of our IPO in 1993 when we only produced 10 mmcfe per day, we were clearly a growth through the drillbit company in an industry focused primarily on acquisitions. Even though our production is now 150 times larger, we remain a

growth through the drillbit company. In 2005, our organic growth (that is, through the drillbit) was 12%, which is exactly what our five-year average organic growth rate has been and which we believe is the highest in the U.S. mid and large-cap E&P sector during that period.

Such an achievement is truly extraordinary considering the scale of our company today is five times larger than it was five years ago. Clearly the law of large numbers has not caught up with Chesapeake in the way many have predicted over the years. I would also note that Chesapeake's 2005 fourth quarter marked our 18th consecutive quarter of sequential U.S. production growth and our 16th consecutive year of production growth.

How did Chesapeake deliver top-tier organic growth in 2005? 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 impending U.S. natural gas production shortfall. We then prepared for the opportunity by hiring hundreds of the most talented landmen, geoscientists and engineers we could find and by making acquisitions of producing properties, companies and unproved leasehold.

Our consistent approach has enabled us to build a 7.8 tcf gas-focused reserve base (7.5 tcf as of December 31, 2005) and a diverse portfolio of more than 28,000 drillsites on 8.4 million net acres onshore in the U.S. This represents more than a ten-year inventory of future drilling and growth opportunities.

It is important to note that our growth has not come at the expense of returns. In 2005 for example, we increased our reserves by 53%, our operating cash flow by 73% and our earnings per fully diluted share by 64%. In addition, our return on average common equity during the year was 25%. The market applauded those achievements and during 2005 our stock price increased by 92%, bringing our total return to shareholders since our IPO in 1993 to nearly 2,300%, or a compound annual stock price increase of 28%. We believe that is the second best performance in the industry during the past 13 years.

Looking forward, Chesapeake's remarkable record of growth should continue into 2006 and beyond. We plan to organically grow our production and proved reserves by 10% this year, and if the past is any indication, acquisitions are likely to add at least another 15% to our production growth. Although acquisitions are difficult to forecast, our track record as a value-added regional consolidator and our ability to secure solid returns through hedging would suggest there will be ample opportunities to make further accretive acquisitions to complement the \$1 billion of acquisitions we have made to date in 2006.

VALUE

I would next like to discuss the tremendous value that we believe is embedded in Chesapeake's stock. Using year-end 2005 NYMEX prices of \$10.08 per mmbtu of gas and \$61.11 per bbl of oil, Chesapeake's proved reserves have a PV-10(4) value of \$23 billion. In addition, we have 8.4 million net acres of leasehold on which we have identified 28,000 locations that we believe contain unproved reserves of 8.8 tcf. We believe these are worth somewhere between \$5 and \$10 billion. Furthermore, we believe our non-E&P assets have a value of nearly \$2 billion.

Therefore using year-end oil and natural gas price assumptions, the asset value Chesapeake has built for investors equals \$30-35 billion. When debt and other liabilities of about \$7 billion are subtracted, the remaining shareholder value is \$23-28 billion, or \$50-60 per fully diluted share. Over the years, our stock price has generally moved in tandem with the net asset value (NAV) we create, so I have full confidence in the market's ability to keep up with the company's steadily increasing NAV per share.

No discussion about value would be complete without the topic of risk mitigation. My job, and the job of our senior management team, is to create and deliver the highest risk-adjusted returns possible to our investors. I often believe that many investors do not fully appreciate how much risk there is in this industry and how well we manage it at Chesapeake. For example, in 2006 when natural gas prices are widely expected to decline to below \$6 per mmbtu by late summer because of this past winter's record warmth, we have hedged 71% of our 2006 natural gas production at \$9.43 per mmbtu, 36% of our 2007 natural gas production at \$9.85 per mmbtu and 22% of our 2008 natural gas production at \$9.10 per mmbtu (excluding CNR hedges).

Additionally, we are the only E&P company that has significantly hedged its exposure to rising service costs by building drilling rigs and investing in related service industry providers. To date, these investments have appreciated in value by roughly \$250 million. We now own 32 rigs outright and have an additional 25 on order, which should account for approximately 60% of the rigs we plan to operate a year from now. Rig ownership is proving to be an extremely valuable competitive advantage in both acquisitions and in operations.

Moreover, in a time of increasing geopolitical unrest around the world, the prospect of asset loss in many areas of the world to arbitrary tax and royalty changes or even outright contract cancellation by foreign governments is a serious concern faced by all major integrated oil companies and many large independent E&P companies. Except for occasional chatter about a windfall profits tax in the U.S., Chesapeake's assets are safe from such political risks. I also emphasize that Chesapeake's assets are all high and dry onshore in the U.S. In a time of what appears to be a cycle of greater hurricane activity in the Gulf of Mexico, many investors may not fully appreciate the very high risks that Gulf of Mexico operators and investors may face in hurricane seasons to come.

Not having access to rigs to develop our assets or owning assets subject to confiscation by some foreign potentate or suffering damage from hurricanes are risks to which we have no exposure. That is why, dollar for dollar, we believe investors can achieve the very best risk-adjusted returns in the industry right here at CHK.

OPPORTUNITY

Now let's talk about opportunity. Much earlier than most companies, in fact as far back as 1998 and 1999, Chesapeake's management team anticipated changing industry conditions and quickly recognized the trends that have driven remarkable increases in oil and natural gas prices during the past eight years. We also recognized the need to develop the building blocks of future value creation in the E&P business – people, land and science.

During the past eight years we have aggressively captured opportunities in each of these critical areas. For example, before talented people became scarce in this industry, we were hiring them by the hundreds. Before prospects and leases became scarce, we built a system of prospect generation and leasehold acquisition that is second to none in the industry. And finally, when others were reluctant to invest in science and new ideas, we aggressively entered into virtually every major natural gas resource play in the U.S. east of the Rockies.

Chesapeake has significantly strengthened its technical capabilities during the past eight years by dramatically increasing its land, geoscience and engineering staff to more than 600 employees. In total, the company now has more than 3,500 employees, of which approximately 70% work in the company's E&P operations and 30% work in the company's oilfield service operations. These people are a highly valued (and much coveted) resource and we are proud they have chosen Chesapeake as their

professional home.

During the past eight years, we have invested more than \$3 billion in new leasehold and 3-D seismic data and now own the largest inventories in the U.S. of onshore leasehold (8.4 million net acres) and 3-D seismic data (11.6 million acres). As a result, we believe Chesapeake has unparalleled opportunities for future value creation.

As to future drilling opportunities, we organize Chesapeake's drilling inventory by one of four play types: conventional gas resource, unconventional gas resource, emerging gas resource and Appalachian Basin gas resource. The company's current leasehold and proved undeveloped and unproved reserve totals by play type are set forth below:

- 2.8 million net acres in our traditional conventional areas (i.e., much of the Mid-Continent, Permian, Gulf Coast, South Texas and other areas) on which we have identified approximately 2,700 drillsites, 1.0 tcf of proved undeveloped reserves and approximately 1.0 tcf of unproved reserves;
- 1.1 million net acres in our unconventional gas resource areas (i.e., Sahara, Granite/Cherokee/Atoka Washes, Hartshorne CBM, Barnett Shale and Ark-La-Tex tight sands) on which we have identified approximately 14,000 drillsites, 1.3 tcf of proved undeveloped reserves and approximately 4.2 tcf of unproved reserves;
- 1.2 million net acres in our emerging gas resource areas (i.e., Fayetteville Shale, Caney/Woodford Shales, Deep Haley, Deep Bossier and others) on which we have identified approximately 2,000 drillsites, 0.1 tcf of proved undeveloped reserves and approximately 1.9 tcf of unproved reserves; and
- 3.3 million net acres in the Appalachian Basin, where our play types range from conventional to unconventional to emerging gas resource. On the significant Appalachian Basin acreage base acquired from CNR in November 2005, we have identified approximately 9,200 drillsites, 0.4 tcf of proved undeveloped reserves and more than 1.7 tcf of unproved reserves.

The company continues to actively acquire more acreage throughout our operating areas with 1.4 million acres acquired in 2005, of which almost 500,000 acres were acquired in the 2005 fourth quarter alone through an aggressive land acquisition program that is currently utilizing more than 900 contract landmen in the field.

THE COLUMBIA NATURAL RESOURCES ACQUISITION

At the end of the 2005 third quarter, we announced the largest transaction in the company's history – the acquisition of Appalachian natural gas producer Columbia Natural Resources (CNR). Through this transaction, Chesapeake acquired daily net production of 125 mmcf, an extensive 6,500 mile network of natural gas gathering pipelines, and an internally estimated 3.0 tcf of proved, probable and possible reserves, comprised of 1.3 tcf of proved reserves and 1.7 tcf of probable and possible reserves. The purchase price was \$3 billion, which consisted of \$2.2 billion in cash and \$800 million in liabilities assumed at closing. The properties are principally located in West Virginia, Kentucky, Ohio, Pennsylvania and New York.

We first began evaluating the possible acquisition of CNR in 2002. When the opportunity finally became available last summer, we jumped on it for several reasons. First, we were enthusiastic about moving into the large and prolific Appalachian Basin. The basin covers over 185,000 square miles (almost three times the size of Oklahoma) and has produced more than 46 tcf of natural gas from over 400,000 wells.

Second, much of the basin remains under-explored. Less than 1% of the 400,000 wells drilled to date have penetrated below 7,500 feet, leaving substantial deeper exploration opportunities available for

Chesapeake to pursue. In addition, very few horizontal shale wells have been drilled and very few wells have been cored, leaving a great opportunity for Chesapeake to apply new scientific approaches to natural gas development in the region.

Third, we were attracted to the value proposition of producing natural gas for a premium price to NYMEX, rather than for the steep discount to NYMEX that natural gas sells for today in most other U.S. basins. Including an approximate 14% value upgrade for the rich BTU content of the natural gas, realized prices on Chesapeake's Appalachian natural gas production today are 20-30% per mcf higher than prices received in other U.S. basins.

Finally, we were eager to begin working in a large U.S. natural gas basin that shares many similarities to our stronghold in the Mid-Continent. As in the Mid-Continent area eight years ago, Appalachian Basin asset ownership today is very fragmented. In addition, we believe that Chesapeake's significant presence in the Barnett, Woodford, Caney and Fayetteville shale plays, our expertise in tight sand and horizontal coalbed methane drilling and our commitment to deep natural gas exploration make us uniquely positioned to transfer knowledge and achieve success in Appalachia.

TOM WARD

For the first time in 13 years as the CEO of Chesapeake, I am writing this letter without the benefit of my 23-year partnership with Chesapeake's co-founder and former President and Chief Operating Officer, Tom Ward. In early February 2006, Tom announced his retirement from the company so that he could redirect his efforts away from Chesapeake towards other business and personal interests he has developed over the years.

Tom and I first met in April 1983 as 23-year-old competing independent landmen. After quickly sizing up each other's work ethic, land skills and (thin) wallets, we shook hands on an informal partnership arrangement that lasted until May 1989, when we formally incorporated Chesapeake. At that time, we invested \$50,000 in our new company, hired our first employees and began drilling wells in southern Oklahoma.

Four years later, we had grown quickly enough to complete an initial public offering of Chesapeake's stock at a split-adjusted price of \$1.33 per share. Subsequently, we were the worst performing IPO in the U.S. in 1993 (down 65%), only to become the best performing stock on all U.S. markets from 1994 to 1996 (up 7,200%). We then saw our stock fall 98% in 1998 and 1999, and finally have seen our stock rise 3,900% from \$0.75 per share in 1999 to over \$30.00 today.

We are now both 46, have spent half of our lives working together to build Chesapeake and we plan to remain good friends and partners in various business ventures outside of Chesapeake for years to come. Although the company and I will miss Tom's drive, vision and character, the ultimate tribute to him may be that he helped build a company that is capable of surviving the loss of his services. We believe your company remains in the very capable hands of a deep and experienced senior management team.

LOOKING FORWARD

As I conclude this letter and reflect with a sense of accomplishment and gratitude on Chesapeake's performance during the past 13 years, I remain very optimistic about the continued success of the company and our ability to continue delivering value to our shareholders. We have the commitment and talents of over 3,500 top-notch employees, an engaged and insightful Board, a time-tested and successful business strategy, a value-added risk-management program, a steadily improving balance sheet and increasingly valuable onshore U.S. natural gas assets. Chesapeake also offers an

entrepreneurial and experienced management team that has proven itself capable of creating industry-leading value through a full range of commodity cycle challenges in building a \$20 billion enterprise from an initial \$50,000 investment in just 16 years.

We are off to a great start in delivering another successful year of performance to our shareholders in 2006. In the first three months of the year, we have already closed or negotiated \$1 billion of acquisitions, commenced drilling almost 500 operated and non-operated new wells, sold our stock in Pioneer Drilling Corporation for a \$115 million pretax gain, established new production records of over 1.5 bcfe per day and reached the record level of 7.8 tcf of proved reserves and 8.8 tcf of risked unproved reserves. In addition, we were recently added to the S&P 500 Index and were also included in the Fortune 500 list for the first time.

While presently weak relative to oil prices, we believe U.S. natural gas prices should strengthen later this year because of tight supply and demand fundamentals in both U.S. natural gas and world oil markets. These supply and demand imbalances cannot be quickly, easily or cheaply fixed, and as a result, we believe the stage is set for an extended period of strong (and volatile) oil and natural gas prices. In this environment, we believe Chesapeake can continue leading the way in delivering exceptional growth, value and opportunity to our shareholders in 2006 and beyond.

Best regards,

Aubrey K. McClendon
Chairman and Chief Executive Officer
March 31, 2006

1. Ebitda is net income (loss) before cumulative effect of accounting change, income tax expense (benefit), interest expense, and depreciation, depletion and amortization expense.

2. Operating cash flow is net cash provided by operating activities before changes in assets and liabilities.

3. Ranking is according to Zack's Investment Research (Zack's) based on stock price performance from 12/31/98 to 12/31/05 of nearly 3,000 companies tracked by Zack's with market capitalizations over \$50 million on 12/31/98.

4. PV-10 is the present value (10% discount rate) of estimated future gross revenue to be generated from the production of proved reserves, net of production and future development costs, using assumed prices and costs. Please see page 11 of our Form 10-K for information on the standardized measure of future net cash flow pursuant to SFAS 69.