

# Chesapeake



## Letter to Shareholders - Second Quarter 2006

### Dear Fellow Investors:

The 4,100 hard-working employees of Chesapeake delivered another exceptional quarter of growth, opportunity and value creation for Chesapeake and its investors during the 2006 second quarter. The company produced significant growth in oil and natural gas production and in proved and unproved reserves while also maintaining a high level of profitability.

The following summary highlights the company's achievements in the 2006 second quarter and compares them to the same quarter last year:

- \* Average daily oil and natural gas production increased 26% from 1.244 billion cubic feet of natural gas equivalent (bcfe) to 1.568 bcfe;
- \* Proved oil and natural gas reserves increased 38% from 5.9 trillion cubic feet of natural gas equivalent (tcfe) to 8.1 tcfe while unproved reserves increased 180% from 5 tcfe to 14 tcfe;
- \* Revenues rose 51% from \$1.0 billion to \$1.6 billion;
- \* Adjusted ebitda(1) increased 77% from \$565 million to \$1.0 billion;
- \* Operating cash flow(2) grew 101% from \$454 million to \$914 million; and
- \* Adjusted earnings per diluted common share(3) increased 64% from \$0.50 to \$0.82.

### PRODUCTION SETS QUARTERLY RECORD

The 2006 second quarter was Chesapeake's 20th consecutive quarter of sequential U.S. production growth. Over these 20 quarters, Chesapeake's U.S. production has increased 296%, for an average compound quarterly growth rate of 7.1% and an average compound annual growth rate of 31.7%. This is a record of performance that distinguishes the company from its peers in the industry.

Daily production for the 2006 second quarter averaged 1.568 bcfe, an increase of 324 million cubic feet of natural gas equivalent (mmcfe), or 26%, over the 1.244 bcfe of daily production in the 2005 second quarter and an increase of 49 mmcfe, or 3.2%, over the 1.519 bcfe of daily production in the 2006 first quarter. Of the 324 mmcfe increase in daily production from the year ago quarter, 45% was generated from organic drillbit growth and 55% was generated from acquisitions, with the company's trailing 12-month organic production growth rate calculated as 12.0%.

Of the 49 mmcfe daily increase in sequential quarterly production, 95% was generated from organic drillbit growth and 5% was generated from acquisitions, with the company's sequential quarterly organic production growth rate calculated as 3.1%. We are anticipating total production growth of at least 25% in 2006 and 11% in 2007, including organic growth rates of at least 10% each year.

### DRILLING PROGRAM DRIVES GROWTH

Chesapeake's exploratory and development drilling programs and production enhancement operations on our existing and acquired properties continue to produce outstanding operational results. During the 2006 first half, Chesapeake continued the industry's most active drilling program and drilled 613 gross (496 net) operated wells and participated in another 801 gross (88 net) wells operated by other companies. The company's drilling success rate was 97% for company-operated wells and 99% for non-operated wells.

During the 2006 first half, Chesapeake invested \$1.097 billion in operated wells (using an average of 82 operated rigs), \$241 million in non-operated wells (using an average of 75 non-operated rigs), \$324 million to acquire new leasehold (exclusive of leases acquired through acquisitions) and \$72 million to acquire new 3-D seismic data.

#### **PROVED RESERVES REACH RECORD LEVEL**

In addition to generating solid production growth, Chesapeake has also successfully grown its proved reserve base. The company began 2006 with estimated proved reserves of 7.521 tcf and ended the second quarter with 8.101 tcf, an increase of 580 bcfe, or 7.7%. During the 2006 first half, the company replaced its 279 bcfe of production with an estimated 860 bcfe of new proved reserves, for a reserve replacement rate of 308%.

Reserve replacement through the drillbit was 590 bcfe, or 211% of production (including 352 bcfe of positive performance revisions and 196 bcfe of downward revisions resulting from natural gas price declines between December 31, 2005 and June 30, 2006) and 69% of the total increase. Reserve replacement through the acquisition of proved reserves was 269 bcfe, or 97% of production and 31% of the total increase.

#### **OILFIELD SERVICE INVESTMENTS INCREASE**

Chesapeake recently purchased one of the leading drilling contractors in the Appalachian Basin. We are currently utilizing two of the contractor's 15 rigs and, through this acquisition, will gain enhanced operational flexibility in expanding activity levels in the basin. This acquisition bolsters the scale and operating capabilities of Chesapeake's 100% owned drilling rig subsidiary, Nomac Drilling Corporation.

To date, Chesapeake has invested approximately \$400 million to build or acquire 57 drilling rigs (including the recent acquisition of the Appalachian Basin drilling contractor) and is building 22 additional rigs. In total, Chesapeake's drilling rig fleet should reach 79 rigs by the end of the 2007 first quarter, which would rank Nomac as the sixth largest drilling rig contractor in the U.S.

#### **LEASEHOLD AND SEISMIC INVENTORIES PROVIDE FUTURE GROWTH OPPORTUNITIES**

Beginning in 1999, Chesapeake's management team was early to recognize that oil and natural gas prices were undergoing structural change. We subsequently began to invest aggressively in the building blocks of value creation in the exploration and production industry – people, land and science. During the past five years, Chesapeake has significantly strengthened its technical capabilities by increasing its land, geoscience and engineering staff by over 450% to nearly 800 employees. Today, the company has more than 4,100 employees, of which approximately 70% work in the company's E&P operations and approximately 30% work in the company's oilfield service operations.

In addition, since 2000 Chesapeake has invested \$4.7 billion in new leasehold and 3-D seismic acquisitions and now owns what we believe to be one of the largest inventories of onshore leasehold (9.7 million net acres) and 3-D seismic (12.9 million acres) in the U.S. On this leasehold, the company has an estimated 24,000 net drilling locations, representing an approximate 10-year inventory of drilling projects. From these, Chesapeake believes it can develop approximately 3.3 tcf of proved undeveloped reserves and approximately 14.0 tcf of unproved reserves. Adding the company's total proved reserves

of 8.1 tcf to its estimated 14.0 tcf of unproved reserves brings the company's estimated total reserves to 22.1 tcf.

#### **GAS RESOURCE PLAYS DRIVE FUTURE GROWTH**

Chesapeake characterizes its drilling activity by one of four play types: conventional gas resource, unconventional gas resource, emerging unconventional gas resource and Appalachian Basin gas resource. In these plays, Chesapeake uses a probability-weighted statistical approach to estimate the potential number of drillsites and unproved reserves associated with such drillsites. Chesapeake's ownership position and activity in each gas resource play type are summarized below.

**Conventional Gas Resource Plays** – In our traditional conventional areas (i.e., portions of the Mid-Continent, Permian, Gulf Coast, South Texas regions), where exploration targets are typically deep and defined using 3-D seismic data, we believe Chesapeake has a meaningful competitive advantage because of its operating scale, deep drilling expertise and over 10.0 million acres of 3-D seismic data. In these plays, Chesapeake owns 3.0 million net acres on which it has an estimated 1.0 tcf of proved undeveloped reserves, an estimated 2.4 tcf of risked unproved reserves and is currently utilizing 31 operated drilling rigs (up to 32 by year-end) to further develop its inventory of approximately 2,800 drillsites.

**Unconventional Gas Resource Plays** – In unconventional gas resource areas, Chesapeake owns 1.1 million net acres on which we have an estimated 1.7 tcf of proved undeveloped reserves, an estimated 6.0 tcf of risked unproved reserves and are currently utilizing 51 operated drilling rigs (up to 69 by year-end) to further develop our inventory of approximately 9,000 net drillsites. Examples of Chesapeake's most important unconventional gas resource plays are the Barnett Shale around Fort Worth in North Texas; the Mississippi, Chester and Hunton formations in the Sahara area in Northwest Oklahoma; the Travis Peak, Cotton Valley, Pettit and Bossier formations in the Ark-La-Tex region of East Texas and Northern Louisiana; and the Granite, Atoka and Cherokee Washes of Western Oklahoma and the Texas Panhandle.

**Emerging Unconventional Gas Resource Plays** – In emerging unconventional gas resource areas where commercial production has only recently been established but the future reserve potential could be substantial, Chesapeake owns 2.2 million net acres. On this land, we have an estimated 100 bcf of proved undeveloped reserves, an estimated 3.8 tcf of risked unproved reserves and we are currently utilizing 10 operated drilling rigs (up to 23 rigs by year-end) to further develop our inventory of approximately 2,600 net drillsites.

Chesapeake's most important emerging unconventional gas resource plays are the Fayetteville Shale in Arkansas; the Strawn, Atoka and Morrow formations in the Deep Haley play in West Texas; the Barnett and Woodford formations in the Delaware Basin of West Texas; the Caney and Woodford Shales in Oklahoma's Arkoma Basin; and the Deep Bossier formation in East Texas and Northern Louisiana.

**Appalachian Basin Gas Resource Plays** – In this newest core area of the company's operations, play types range from conventional to unconventional to emerging gas resource in various Devonian shales and in other formations. Chesapeake is the largest leasehold owner in Appalachia with 3.4 million net acres and on its leasehold has an estimated 468 bcf of proved undeveloped reserves and its risked unproved reserves are an estimated 1.8 tcf. The company is currently utilizing nine rigs (up to 11 rigs by year-end) to further develop its extensive leasehold position in Appalachia.

We also continue to actively develop various conventional, unconventional and emerging unconventional plays not mentioned above. These plays are located throughout the company's operations and we continue to actively generate new prospects and acquire additional leasehold in these areas.

### **MANAGEMENT OUTLOOK**

During the 2006 second quarter, the company delivered top-tier organic production growth and impressive profit margins as oil and natural gas price realizations far exceeded modest cost inflation. We also have opportunistically hedged service costs and a substantial portion of our anticipated production through 2008 at exceptional prices in order to help deliver sustainable profitability in the years ahead.

In light of continued attractive returns available through the drillbit on our extensive prospect inventory, we continue to increase our industry-leading U.S. drilling activity to accelerate development of our substantial unproved reserve base. We currently have 101 operated rigs working, up from an average of 73 operated rigs in 2005, and we anticipate increasing our drilling activity to approximately 135 operated rigs by year-end 2006. This increase in drilling activity creates the potential for increased proved reserves and production levels in the second half of this year and in 2007.

Our business strategy continues to feature delivering growth through a balance of acquisitions and organic drilling, focusing on clean-burning, domestically-produced natural gas to take advantage of attractive long-term natural gas supply and demand fundamentals, building dominant regional scale to achieve low operating costs and high returns on capital and mitigating financial and operational risks through hedging. I believe Chesapeake's management team will continue the successful execution of the company's distinctive business strategy and deliver significant value to the company's investors for years to come.

Best regards,

Aubrey K. McClendon  
Chairman and Chief Executive Officer

August 1, 2006

(1) Adjusted ebitda is net income before income tax expense, interest expense, and depreciation, depletion and amortization expense, adjusted to exclude unrealized (gains) losses on oil and natural gas derivatives, loss on repurchases/exchanges of debt and a reversal of a severance tax accrual.

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

(3) Adjusted earnings is net income available to common shareholders before loss on conversion/exchange of preferred stock excluding, on an after-tax basis, unrealized (gains) losses on derivatives, loss on repurchases/exchanges of debt, reversal of a severance tax accrual and cumulative impact of a new Texas margin tax.