

# Chesapeake



## Letter to Shareholders - Third Quarter 2006

### Dear Fellow Investors:

Chesapeake's 2006 third quarter results provide further evidence of the growth, opportunity and value creation that we believe Chesapeake can consistently deliver to investors through the continued successful execution of our business strategy.

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

- \* Average daily oil and natural gas production increased 22% from 1.308 billion cubic feet of natural gas equivalent (bcfe) to 1.597 bcfe;
- \* Proved oil and natural gas reserves increased 36% from 6.2 trillion cubic feet of natural gas equivalent (tcf) to 8.4 tcf while unproved reserves increased 193% from 5.6 tcf to 16.4 tcf;
- \* Revenues rose 78% from \$1.1 billion to \$1.9 billion;
- \* Adjusted ebitda(1) increased 59% from \$686 million to \$1.1 billion;
- \* Operating cash flow(2) grew 56% from \$635 million to \$989 million; and
- \* Adjusted earnings per diluted common share(3) increased 28% from \$0.65 to \$0.83.

### **PRODUCTION SETS QUARTERLY RECORD**

The 2006 third quarter was Chesapeake's 21st consecutive quarter of sequential U.S. production growth. Over these 21 quarters, Chesapeake's U.S. production has increased 308%, for an average compound quarterly growth rate of 6.9% and an average compound annual growth rate of 30.5%. This is a record of performance that clearly distinguishes the company among its peers in the industry.

Daily production during the 2006 third quarter averaged 1.597 bcfe, an increase of 289 million cubic feet of natural gas equivalent (mmcf), or 22%, over the 1.308 bcfe of daily production in the 2005 third quarter and an increase of 29 mmcf, or 2%, over the 1.568 bcfe of daily production in the 2006 second quarter. Based on the company's projected drilling levels and anticipated drilling results, we are forecasting production growth of 23% to 24% in 2006 and are raising Chesapeake's production growth forecasts to ranges of 14% to 18% in 2007 and 10% to 14% in 2008 from previous forecasts of 10% to 12% and 5% to 7%, respectively.

### **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 first three quarters of 2006, Chesapeake continued the nation's most active drilling program, drilling 1,024 gross (845 net) operated wells and participating in another 1,154 gross (141 net) wells operated by other companies. The company's drilling success rate was 98% for company-operated wells and non-operated wells.

During the first three quarters of 2006, Chesapeake invested \$1.769 billion in operated wells (using an average of 89 operated rigs), \$363 million in non-operated wells (using an average of 74 non-operated rigs), \$456 million to acquire new leasehold (exclusive of \$2.1 billion in unproved leasehold acquired through acquisitions) and \$102 million to acquire new 3-D seismic data.

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

In addition to generating solid production growth, Chesapeake has also successfully continued to grow its proved reserve base. The company began 2006 with estimated proved reserves of 7.521 tcf and ended the third quarter with 8.433 tcf, an increase of 912 bcfe, or 12%. During the first three quarters of 2006, the company replaced its 426 bcfe of production with an estimated 1.339 tcf of new proved reserves, for a reserve replacement rate of 314%.

Reserve replacement through the drillbit was 825 bcfe, or 194% of production (including 541 bcfe of positive performance revisions and 387 bcfe of downward revisions resulting from natural gas price declines between December 31, 2005 and September 30, 2006), and 62% of the total increase. Reserve replacement through the acquisition of proved reserves was 514 bcfe, or 120% of production, and 38% of the total increase.

### **HEDGING ACTIVITIES CONTINUE TO CREATE VALUE AND MITIGATE RISK**

During the third quarter, Chesapeake realized hedging gains of \$301 million, bringing the company's total hedging gains for the year to \$807 million. Recently, Chesapeake lifted a portion of its fourth-quarter 2006 and full-year 2007, 2008 and 2009 hedges and, as a result, has secured additional gains of \$540 million which will be recognized in earnings in future periods.

Together with the approximate \$700 million mark-to-market value of our open hedges, more than \$2.0 billion of value has been created for shareholders through Chesapeake's recent hedging activities. We believe this further demonstrates the company's ability to secure premium price realizations and achieve substantial risk mitigation through our hedging programs.

To further hedge our exposure to potentially higher oilfield service costs and to achieve greater operational efficiencies, Chesapeake recently invested approximately \$250 million to acquire a 19.9% interest in a rapidly growing, privately-held provider of well stimulation and high pressure pumping services, with operations currently focused in Texas and the Rocky Mountains. This service company also has expansion efforts underway in other key regions in which Chesapeake operates.

This investment complements Chesapeake's direct and indirect drilling rig investments that have served as effective hedges against higher service costs and have also provided competitive advantages in making acquisitions and in developing the company's own leasehold on a more timely and efficient basis. To date, Chesapeake has built or acquired 42 drilling rigs and is building 22 additional rigs. In total, the company's drilling rig fleet should reach 82 rigs by mid-year 2007, which should then rank Chesapeake as the sixth largest drilling rig contractor in the U.S.

## **CHESAPEAKE SIGNIFICANTLY EXPANDS BARNETT SHALE HOLDINGS**

During the third quarter, Chesapeake significantly expanded its holdings in the Fort Worth Barnett Shale play through acquisitions totaling approximately 55,400 net acres primarily in Johnson, Tarrant and western Dallas counties. These transactions included 26,500 net acres acquired from Four Sevens Oil Co. Ltd. and Sinclair Oil Corporation, 16,600 net acres acquired from the Dallas/Fort Worth International Airport Board and the cities of Dallas and Fort Worth and 12,300 net acres acquired from a private company. In addition, Chesapeake has continued its ongoing "on-the-ground" leasing efforts in the play through numerous transactions with various municipalities, school districts and industrial and commercial property owners.

Chesapeake's Tier 1 leasehold position now totals approximately 150,000 net acres and is concentrated in the "sweet spot" of Johnson, Tarrant and western Dallas counties. On this acreage, the company believes it has the ability to drill approximately 2,100 additional net horizontal wells with lateral lengths of approximately 3,000 feet on 500 foot average well spacing. The company's expected results for wells drilled on its Tier 1 acreage are \$2.7 million to develop 2.45 gross bcfe per well (1.8 net bcfe after royalties and other burdens). From its Fort Worth Barnett Shale acreage position, Chesapeake is now producing approximately 240 gross mmcfe per day (168 net mmcfe) from 347 gross operated wells, of which Chesapeake has drilled 213 and has acquired 134.

Chesapeake is currently utilizing 17 operated drilling rigs to develop its Fort Worth Barnett Shale acreage and by the end of 2006 should have approximately 24 operated rigs drilling in the play. For 2007 and 2008, the company is budgeting an average operated drilling rig count of 30 to 35 rigs in the play. From a drilling program of this scale, the company believes that it should be able to drill 450 to 500 wells per year and should be able to replace 120% to 140% of the company's total production from its Fort Worth Barnett Shale drilling program alone. This would leave approximately 100 additional operated rigs to deliver further growth in production and proved reserves elsewhere.

## **CHESAPEAKE EXPANDS ACREAGE POSITION IN OTHER SHALE PLAYS**

Chesapeake has previously stated a goal of establishing a top three presence in every major shale play east of the Rockies. The company believes it has largely accomplished this goal through a series of focused and innovative transactions. For example, in the Fayetteville Shale play in Arkansas, Chesapeake now owns approximately 1,040,000 net acres, of which approximately 340,000 net acres are in the highly prospective core area in the central and western portions of the play. The company has drilled 12 horizontal wells to date, is in the process of acquiring several large 3-D seismic surveys and is increasing its operated rig count from two to seven rigs by year-end 2006.

In the Barnett and Woodford Shale plays of the Delaware Basin in far West Texas, the company has entered into four joint venture agreements with one public independent company and three private companies to pursue the development of these shales and other conventional and unconventional plays. In Culberson, Reeves, Pecos and Brewster counties, Chesapeake now owns the right to develop approximately 700,000 net acres (1.3 million gross acres), the largest leasehold position in the Delaware Shale play. The company currently has two operated rigs drilling on this acreage and plans to further explore the area in 2007 and 2008 with active 3-D seismic and exploratory drilling programs.

Since 2000, Chesapeake has invested \$5.7 billion in new leasehold and 3-D seismic acquisitions and now owns the largest inventories of onshore leasehold (10.5 million net acres) and 3-D seismic (14.7 million acres) in the U.S. On this leasehold, the company has an estimated 25,000 net drilling locations, representing an approximate 10-year inventory of drilling projects. From this inventory, Chesapeake

believes it can develop approximately 3.2 tcf of proved undeveloped reserves and approximately 16.4 tcf of risked unproved reserves (68 tcf of unrisked unproved reserves). Adding the company's total proved reserves of 8.4 tcf to its estimated 16.4 tcf of risked unproved reserves increases the company's estimated total reserves to approximately 24.8 tcf.

### **MANAGEMENT OUTLOOK**

In light of continued strong returns available through the drillbit on our extensive prospect inventory, Chesapeake continues to increase its industry-leading U.S. drilling activity to accelerate development of the company's substantial proved undeveloped and unproved reserve base. We currently have 120 operated rigs drilling, up from an average of 73 operated rigs in 2005, and an average of 89 operated rigs to date in 2006. We anticipate increasing the company's drilling activity to approximately 133 operated rigs by year-end 2006 and up to 150 operated rigs in 2007.

Chesapeake is clearly transitioning from the past six years of resource inventory land capture into a longer term phase of resource inventory value conversion. We believe the result of this transition will be significant increases in proved reserves and production levels in 2007 and beyond. This shift in focus is best evidenced by our recently announced increases in future production growth rate ranges of 14% to 18% for 2007 and 10% to 14% for 2008.

Our business strategy continues to emphasize 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 can continue to successfully execute the company's distinctive business strategy and deliver significant value to our investors for years to come.

Best regards,

Aubrey K. McClendon

Chairman and Chief Executive Officer

October 27, 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 and losses on repurchases or exchanges of senior notes.

(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 and losses on repurchases or exchanges of senior notes.