



## Dear Fellow Shareholders:

### Welcome to the Age of Natural Gas!

Just as the 17th century and before was the Age of Wood, the 18th and 19th centuries the Age of Coal and the 20th century the Age of Oil, the 21st century will be the Age of Natural Gas. No other company is better positioned than Chesapeake to prosper in this new age.

The cover of this year's annual report features an image representing the very simple and elegant molecular structure of natural gas –  $\text{CH}_4$ , one atom of carbon and four atoms of hydrogen. This molecular structure provides the key to understanding why the 21st century will be the Age of Natural Gas – it's clean, abundant, affordable and American. We are proud to highlight these key advantages of our superior product in this year's report.

Natural gas is 80% hydrogen, the most abundant form of matter on earth and listed first in the periodic table of elements because it's the lightest of all elements. When burned, hydrogen creates only light, heat and water and it represents the ultimate prize in meeting the world's energy needs. A world powered by an abundant fuel that is 80% hydrogen is a world fueled by a clean energy source that is superior to the more complex carbon-filled molecules of coal (commonly  $\text{C}^{135}\text{H}^{96}\text{O}^9\text{NS}$ ) or oil (ranging  $\text{C}^5\text{H}^{12}$  to  $\text{C}^{36}\text{H}^{74}$ ).

As the Age of Natural Gas unfolds, my goal for Chesapeake is to be at the forefront of developing and producing the new supplies of "carbon-light" natural gas that our nation and our world will increasingly require in order to meet the dual challenges of more energy and less pollution.

## 2007 In Review

The past year stands out as a year of outstanding achievement for Chesapeake. In 2007, we became the largest independent producer of U.S. natural gas and ended the year with our largest-ever backlog of future drilling opportunities – more than 36,000, representing approximately 100 trillion cubic feet of natural gas equivalent (tcfe) of potential future reserves. Despite volatile oil and natural gas prices, modestly lower realized hedging gains and slightly higher operating costs than in 2006, our company generated the strong financial and operating results highlighted below:

- Average daily oil and natural gas production increased 23% from 1.59 billion cubic feet of natural gas equivalent (bcfe) to 1.96 bcfe;
- Proved oil and natural gas reserves increased 21% from 9.0 tcfe to 10.9 tcfe;
- Reserve replacement for the year reached 369% at a drilling and acquisition cost of \$2.08 per thousand cubic feet of natural gas equivalent (mcfe)<sup>(1)</sup>;

- Revenues rose 6% from \$7.3 billion to \$7.8 billion;
- Adjusted ebitda<sup>(2)</sup> increased 13% from \$4.4 billion to \$5.0 billion;
- Operating cash flow<sup>(3)</sup> grew 14% from \$4.0 billion to \$4.6 billion; and
- Chesapeake's stock price increased by 35%, from \$29.05 per share to \$39.20 per share.

We are pleased with the market's recognition of our accomplishments over the years and the value delivered to shareholders through our stock price increase from \$1.33 per share at our IPO in February 1993 to more than \$46 today. This accomplishment is the second-best stock price performance in our industry during the past 15 years.

What were the keys to delivering this strong operational and financial performance in 2007? As we have discussed in the past, Chesapeake's major advantage is our singular focus on delivering a great product, natural gas, and the consistent execution of a business strategy that is underpinned by our industry's three key building blocks of success – people, land and science. Each of these building blocks is vital for significant achievement in our industry and Chesapeake has abundant inventories of all three.

## Creating Shareholder Value

**People** – We always begin discussions about creating shareholder value with a focus on our employees, 6,200 strong at year-end 2007. Last year, we added more than 1,300 employees as the company continued to grow its exploration and production (E&P) activities and its service operations. Approximately 60% of our employees work in our E&P business while 40% work for the service companies that manage our drilling rigs and provide other field services that support our primary mission of finding and producing natural gas as efficiently as possible.

We are especially proud that Chesapeake was named one of the FORTUNE 100 Best Companies to Work For<sup>®</sup> in 2008.<sup>(4)</sup> Two other Oklahoma City-based companies received this honor, giving our hometown the distinction of having more of the FORTUNE 100 Best Companies to Work For<sup>®</sup> per capita than any other major city in the U.S. In addition, Forbes magazine honored us during the past year as “The Best Managed Oil and Gas Company”<sup>(5)</sup> and we were also named the “Hydrocarbon Producer of the Year” at the 9<sup>th</sup> Annual Platts Global Energy Awards in New York. We appreciate receiving these accolades and look forward to maintaining our high rankings in these surveys.

Chesapeake continues to place a particularly strong focus on expanding our capabilities in the geoscience, engineering, operations and land departments. During 2007, we added more than 400 new employees in these technically focused departments, an increase of approximately 20%. We also are hiring many new young people throughout the company because our industry faces a wave of retirements during the next 10-15 years. Today, 40% of our Oklahoma City headquarters work force of 2,400 is comprised of employees younger than 30 years old. We have created an attractive corporate campus and a distinctive corporate culture, enabling us to attract the dozens of talented and dedicated new employees needed every month to meet the increasing size and scope of our operations. Our early recognition of the challenges of expanding the industry's work force has been a key advantage for the company in executing its growth plans during the past few years and will serve us especially well in years to come.

**Land** – To deliver great results, great people need great assets and I believe Chesapeake has the best assets in the U.S. E&P industry. We now own interests in approximately 38,500 producing wells and we are adding more than

3,600 wells every year. Our assets are located entirely onshore in the U.S. and they are characterized by low operating costs, predictable decline curves and substantial upside potential. In an industry that until very recently was incapable of growing its natural gas production, Chesapeake has led the way in building a backlog of future drilling opportunities, operating the nation's most active drilling program and leading the industry in natural gas production growth.

This drilling activity enabled the company to increase its average daily natural gas production in 2007 by more than 23% compared to 2006, or approximately 350 million cubic feet (mmcf) per day. Including our partners' working and royalty interests, our drilling efforts directly and indirectly accounted for approximately one-third of the industry's increase in U.S. natural gas production during 2007. Remarkably, we accomplished this performance using only one-twelfth of the nation's drilling rigs.

Chesapeake now owns more than 13 million net acres of leasehold and we believe this is the independent E&P industry's largest inventory of leasehold. Why is lease ownership so important? It's easy – without the lease, any good geological or engineering idea is just that, an idea. Our job is to turn ideas into leases and leases into production and production into shareholder value. We have assembled a large and efficient lease-buying machine to do just that. We now employ 700 professionals in our land and lease records departments, plus we support more than 3,000 independent leasing agents in the field who are researching land ownership records and buying new leases for Chesapeake.

As the industry has discovered that unconventional formations, especially many shales, can now be made productive through advanced horizontal drilling and completion technologies, a great land run has occurred during the past five years to stake claims to newly prospective areas. In the exciting and historic tradition of the great Oklahoma land runs of the late 1800s, we believe Chesapeake has won the great land run of the early 2000s. We now own some of the largest stakes in the best shale plays in the U.S., including the Barnett, Fayetteville, Woodford, Marcellus, Lower Huron and, most recently, and perhaps most importantly, the Haynesville. These shale plays complement our ownership in other great plays, such as the East Texas tight sands, the massive Sahara play in northwest Oklahoma and the Granite Wash plays of the Anadarko Basin in Oklahoma and the Texas Panhandle. Wherever there is a big new onshore play in the U.S., east of the Rockies, unconventional or conventional, you will very likely find Chesapeake right in the middle of it.

**Science** – There has never been a more exciting time to be a scientist in the E&P industry. In addition to the marvels of horizontal drilling, advances in 3-D seismic technology have made understanding the complexities of the earth easier and locating hidden deposits of natural gas reserves more successful than ever before. Chesapeake leads the industry in onshore 3-D seismic information with more than 19 million acres of data now in inventory and under evaluation. In 2008, we have budgeted \$250 million to acquire even more 3-D, likely the largest budget for 3-D in the U.S. Our view on 3-D is simple – we have yet to shoot a 3-D seismic survey that has failed to significantly improve our odds of finding natural gas reserves. In 2008 and beyond, we plan to extend our leadership in this area and will continue generating and delivering the significant benefits of this very important scientific asset.

Perhaps the most distinctive 3-D seismic survey we have ever acquired was the one we shot across the 18,000-acre Dallas/Fort Worth International Airport (DFW) in late 2006 and early 2007. This survey is the only 3-D seismic survey ever conducted at a major U.S. airport. Restricted to shooting only at night and acquired under the strictest of safety, homeland security and regulatory oversight rules, Chesapeake's 3-D survey has been critical to our success in drilling Barnett Shale wells at DFW. Using this 3-D information to avoid intersecting major faults in the Barnett Shale, we have been able to drill more than 50 successful wells to date and will drill another 250 or so during the next three years. We are producing approximately 60 mmcfe per day from the DFW lease and project that peak gross production may reach 250 mmcfe per day by 2010, which should rank it as a Top-30 U.S. natural gas producer if it were a stand-alone company!

Another notable scientific achievement in 2007 was the completion of our Reservoir Technology Center (RTC). Opened last April, the RTC is where we "crack the code" in evaluating new shale plays through our proprietary analysis of shale core samples. Not all shales are created equally. It is essential for us to determine whether shale formations are likely to be productive prior to investing hundreds of millions of dollars leasing and drilling in a new play. There were several shale plays that Chesapeake avoided this past year because the RTC was able to predict they would not be commercially productive. The RTC also allows us to more quickly evaluate new ideas and accelerate commercialization of unconventional shale plays, thereby giving Chesapeake a tremendous head start on our competition. We believe it's the only such proprietary shale core research lab in the industry and it provides a critical scientific advantage for the company.

**Results** – Putting land, people and science together working on great assets with the right business strategy can create impressive operational results and significant increases in shareholder value. Although we have 17 operating districts and dozens of individual fields and plays generating impressive results, I thought highlighting our three most important plays could help provide a better understanding of how value is created at Chesapeake.

The most productive of these three areas is the *Barnett Shale*. Centered around Fort Worth in North Texas, the Barnett Shale has quickly become the largest producing natural gas field in the U.S. Chesapeake made its first investment in the Barnett in late 2004 with an 18,000-acre acquisition that included just 25 mmcfe per day of production. At the time, that made us barely a Top-10 player in the field. However, in less than four years we have become the second-largest producer of natural gas from the Barnett with gross production exceeding 650 mmcfe per day. We believe we can continue growing our Barnett production by 300-500 mmcfe per day during each of at least the next three years as we work through the company's backlog of more than 3,500 undrilled locations on our 260,000 net acres of Barnett leasehold. This play could ultimately provide nearly 10 tcf of potential natural gas reserves for Chesapeake. To accelerate production and value creation from the Barnett, we recently announced a planned increase in our Barnett rig count from 40 rigs currently to 45 rigs by year-end 2008.

Our second-biggest shale play is the *Fayetteville Shale* located in north-central Arkansas. We entered this play in early 2005 and drilled our first wells in 2006. Today we own almost 600,000 net acres of prospective leasehold in the core area and are producing 150 mmcfe per day, making Chesapeake the second-largest producer in the Fayetteville. The company's future looks very bright in the Fayetteville – we have only drilled 150 wells to date, yet have a drilling backlog that exceeds 5,700 future wells. This play could ultimately provide nearly 12 tcf of potential

natural gas reserves for Chesapeake. To accelerate production and value creation from the Fayetteville, we recently announced a planned increase in our Fayetteville rig count from 12 rigs currently to 25 rigs by year-end 2008.

Finally, I would like to highlight our newest shale success story – the *Haynesville Shale* in Louisiana. This is a project developed in-house two years ago and through great geoscience and engineering skill, combined with early and aggressive leasing work, we have made a major new discovery. Although for competitive reasons we have not yet disclosed any detailed technical information about the play, we believe we have potentially discovered at least 7.5 tcf underlying our more than 200,000 net acres in the play. We believe the Haynesville will be among the three biggest projects in Chesapeake's inventory for years to come and that it could potentially have a larger impact on the company than any other play in which Chesapeake has participated to date. To accelerate development and value creation from the Haynesville, we recently announced a planned increase in our rig count from four rigs currently to 10 rigs by year-end 2008.

## **Creating a Better World**

Certainly this is an ambitious title for the next section of this letter, but I believe our shareholders should understand that while Chesapeake's primary focus is on creating shareholder value, we are also focused on creating a better world around us. Fortunately, we believe that is much easier to do when you produce a product as environmentally friendly as natural gas. But in addition to selling a great product, Chesapeake goes above and beyond the normal requirements of good corporate citizenship in a number of areas worth highlighting.

**Environmental Stewardship** – How a great product is produced is sometimes just as important as the value of the product itself. That is why Chesapeake has been a driver and adopter of the best environmental practices in our industry. For example, we have been a leader in developing the ability to use one surface pad site from which to drill many wells. The fewer the pad sites, the smaller the footprint we make on the earth's surface and the happier our surface owners are. We have also been a leader for the past 15 years in the development of horizontal drilling, which allows us to recover from one well what could take as many as 10 vertical wells to recover. Again, less drilling means a smaller footprint, more environmental benefits and greater capital efficiency.

We are also pleased to report that in 2007, the American Clean Skies Foundation (ACSF) was formed through grants from Chesapeake and others. It is a Washington, D.C.-based foundation dedicated to promoting energy conservation and the greater use of cleaner fuels, including natural gas, to meet our country's need for more electricity and less pollution. More information on ACSF can be found at [www.cleanskies.org](http://www.cleanskies.org) and its online television affiliate can be viewed at [www.cleanskies.tv](http://www.cleanskies.tv).

Finally, we made some new friends this year. We reached out to two leading environmental organizations, the Sierra Club and the Natural Resources Defense Council (NRDC), to discuss areas where our interests might be aligned. In discussions during 2007 and thus far in 2008, we have determined that there are many areas where Chesapeake, Sierra and NRDC can work together. We believe this collaboration is unique in the industry and will benefit both Chesapeake and these environmental organizations for years to come.

**Community Stewardship** – Chesapeake owns assets in 17 states and we currently have drilling operations that stretch from the Finger Lakes region of central New York through the mountains of West Virginia to the hills of central Alabama, and then west through the piney woods of northern Louisiana and East Texas to the plains of North Texas and Oklahoma out to the deserts of West Texas and New Mexico. In dozens of areas, ranging from wide-open farm and ranch country to rural, suburban and urban communities, Chesapeake is deeply engaged in the lives of the communities in which we operate.

Our employees donate their time and Chesapeake donates its resources to ensure that we are always focused on improving the quality of life in the areas in which we operate. During 2007, more than 1,200 Chesapeake employees volunteered for dozens of projects and the company donated more than \$20 million to various philanthropic and charitable endeavors.

One of our most satisfying and important areas of stewardship is education. From our various mentoring programs at local grade schools to our Chesapeake Scholars Program in colleges and universities, we are investing in the lives of young people across our areas of operation. The Chesapeake Scholars Program has become especially effective. We now have awarded scholarships to more than 225 students at 32 universities and colleges in 12 states. This program gives us the opportunity to invest in the lives of many deserving young people and also helps increase the number of qualified job candidates for Chesapeake employment.

## **Looking Forward**

As much as I always enjoy writing this letter and looking back at the year just ended to reflect on the accomplishments of the company and the value created for our shareholders, I enjoy looking into the future even more. Not that I have any special insight into what the future holds – it's just that I strongly believe this management team is comfortable anticipating and responding to opportunities and challenges in our industry. In fact, I would hope that observers see Chesapeake as the most dynamic and adaptable company in our industry.

Ever since entering this industry 27 years ago, I have been energized by studying and anticipating trends in the industry. We were early to recognize the value of horizontal drilling and to recognize the value of natural gas. More recently we have been among the earliest to understand the impact that unconventional plays would have on our industry and our country.

Today we are entering a fascinating period when both the U.S. and the world will be grappling with one of the great challenges of our time – how to supply more energy, but with less pollution. It is increasingly clear that natural gas is the only clean fuel the U.S. has in sufficient quantities to meet this daunting challenge. The problem is that most policymakers and consumers believe we are running out of natural gas and that it can not be depended upon to meet the growing need for more energy, especially more clean-burning energy.

That is where Chesapeake has a rewarding opportunity and an important responsibility – first, to convince policymakers and consumers that our country and our world has a rich endowment of natural gas, and second to remain an industry leader in increasing natural gas production year after year so that our nation can continue counting on the promise of natural gas – it's clean, abundant, affordable and American.

The Age of Natural Gas is now upon us and I believe there is no other company in our industry better positioned in this new age than Chesapeake to create and deliver shareholder value. I appreciate the investments our shareholders have made in Chesapeake over the years as we have grown 740-fold from a \$50 million enterprise value company at the time of our IPO in 1993 to a \$37 billion enterprise value industry leader today.

I also recognize and appreciate the efforts of our Board of Directors, our management team and our 6,200 employees on Chesapeake's very successful 2007. I look forward with great optimism to 2008 and beyond.

Best regards,

Aubrey K. McClendon

Chairman and Chief Executive Officer

March 31, 2008

1. **Reserve replacement is calculated by dividing the sum of reserve additions from all sources by actual production for the corresponding period. We calculate drilling and acquisition cost per mcf by dividing total costs incurred during the year, less certain costs primarily related to unproved property acquisitions, geological and geophysical cost and deferred taxes related to corporate acquisitions by total proved reserve additions excluding price-related revisions.**
2. **Adjusted ebitda is net income before interest expense, income tax expense, and depreciation, depletion and amortization expense, excluding certain items that management believes affect the comparability of operating results.**
3. **Operating cash flow is net cash provided by operating activities before changes in assets and liabilities.**
4. **FORTUNE 100 Best Companies to Work For<sup>®</sup> listed in the magazine's February 4, 2008 issue.**
5. **Forbes' Platinum 400 list of America's Best Big Companies and recognized as the best managed company in the Oil & Gas Operations category in the magazine's January 8, 2007 issue.**

Note: Reconciliations and other information on the measures referenced in notes 1, 2 and 3 are presented on the Reconciliation of Non-GAAP Financial Measures page on our web site at [www.chk.com](http://www.chk.com).