Chesapeake

Current Annual Report Letter | Current Quarterly Letter | Archived Letters

Letter to Shareholders - Third Quarter 2007

Dear Fellow Investors:

Chesapeake's third quarter 2007 operational and financial results continue to confirm our attractive business strategy and our excellent execution of that strategy. Chesapeake's oil and natural gas production and proved reserves surged to record levels during the quarter and we unveiled our 2008 and 2009 financial and operational plan to enthusiastic response from investors. With oil prices seemingly headed over $100 per barrel in the coming months, we see significant opportunities ahead for natural gas to increase its market share in a nation and world that are increasingly in need of cleaner and more abundant supplies of energy.

Strong Financial Performance
For the 2007 third quarter, Chesapeake generated net income available to common shareholders of $346 million ($0.72 per fully diluted common share), operating cash flow(1) of $1.085 billion and ebitda of $1.240 billion(2) on revenue of $2.027 billion and production of 186 billion cubic feet of natural gas equivalent (bcfe). The company's net income available to common shareholders and ebitda for the quarter include an unrealized after-tax mark-to-market gain of $16 million resulting from the company's oil and natural gas and interest rate hedging programs. This type of item is typically not included in published estimates of the company's financial results by certain securities analysts. Excluding this item, Chesapeake
generated adjusted net income to common shareholders(3) in the 2007 third quarter of $330 million ($0.69 per fully diluted common share) and adjusted ebitda(4) of $1.195 billion.

Production Sets New Quarterly Record
The 2007 third quarter marked Chesapeake's 25th consecutive quarter of sequential production growth. Over these 25 quarters, Chesapeake's production has increased 417%, for an average compound quarterly growth rate of 7% and an average compound annual growth rate of 30%. Chesapeake's daily production during the 2007 third quarter averaged 2.026 bcfe, an increase of 429 million cubic feet of natural gas equivalent (mmcfe), or 27%, over the 1.597 bcfe of daily production in the 2006 third quarter, and an increase of 158 mmcfe, or 8%, over the 1.868 bcfe produced per day in the 2007 second quarter. As a result of better-than-expected results from the company's drilling program, we are raising our previous forecasts for total production growth for 2007 to 21-23% and 18-22% for 2008, while reaffirming our 12-16% production growth forecast for 2009.

Proved Reserves Also Set New Record

In addition to generating strong production growth, the company increased its proved reserves to a record level. Chesapeake began 2007 with estimated proved reserves of 8.956 trillion cubic feet of natural gas equivalent (tcfe) and ended the third quarter with 10.562 tcfe, an increase of 1.606 tcfe, or 18%. During the first three quarters of 2007, Chesapeake replaced its 510 bcfe of production with an estimated 2.116 tcfe of new proved reserves for a reserve replacement rate of 415%. Reserve replacement through the drillbit was 1.761 tcfe, or 345% of production (including 859 bcfe of positive performance revisions and 79 bcfe of positive revisions resulting from oil and natural gas price increases between December 31, 2006, and September 30, 2007) and 83% of the total increase. Reserve replacement through the acquisition of proved reserves completed during the first three quarters of 2007 was 355 bcfe, or 70% of production and 17% of the total increase.

Drilling Program Continues at Industry-Leading Pace

Chesapeake continued the industry's most active drilling program during the first three quarters of 2007, drilling 1,523 gross (1,307 net) operated wells and participating in another 1,262 gross (173 net) wells operated by other companies. The company's drilling success rate was 99% for company-operated wells and 97% for non-operated wells. During the first three quarters of 2007, Chesapeake invested $3.1 billion in operated wells (using an average of 138 operated rigs), $547 million in non-operated wells (using an average of 104 non-operated rigs). Total costs incurred in oil and natural gas acquisition, exploration and development activities including seismic, unproved properties, leasehold, capitalized interest and internal costs, non-cash tax basis step-up and asset retirement obligations, were $6.5 billion during the first three quarters of 2007.

Hedging Activities Continue to Create Value and Mitigate Risk

During the 2007 third quarter, Chesapeake generated a realized hedging gain of $286 million, or $1.53 per thousand cubic feet of natural gas equivalent (mcfe). Realized gains from oil and natural gas hedging activities during the quarter generated a $1.70 gain per thousand cubic feet (mcf) and a $1.51 loss per barrel (bbl). For the first three quarters of 2007, our realized gains from oil and natural gas hedging activities generated a $3.65 gain per bbl and a $1.91 gain per mcf for a total realized hedging gain of $916 million.

Oil prices seem to have separated themselves from natural gas prices as the forward visibility of world oil supply growth is substantially less clear than the forward visibility for increased natural gas supply, both in the U.S. and around the world. In the years ahead, our country and the world will need to increasingly rely on abundant reserves of clean-burning natural gas to provide more of our electricity and transportation needs. We believe it is an excellent time to be a natural gas producer and Chesapeake will remain dedicated to substantially boosting the amount of natural gas that we supply to U.S. energy markets.

Drilling Inventory Further Expands

Since 2000, Chesapeake has invested $8.8 billion in new leasehold and 3-D seismic acquisitions and now owns the largest combined inventories of onshore leasehold (12.5 million net acres) and 3-D seismic (18.5 million acres) in the U.S. On this leasehold, the company has approximately 28,000 net drilling locations, representing an approximate 10-year inventory of drilling projects, on which it believes it can develop an estimated 3.8 tcfe of proved undeveloped reserves and approximately 23 tcfe of risked unproved reserves (90 tcfe of unrisked unproved reserves). To aggressively develop these assets, Chesapeake has continued to significantly strengthen its technical capabilities by increasing its land, geoscience and engineering staff to over 1,300 employees. Today, the company has approximately 6,000 employees, of whom approximately 60% work in the company's E&P operations and approximately 40% work in the company's oilfield service operations.

Big Three Unconventional Plays Drive Growth

The Fort Worth Barnett Shale, the Fayetteville Shale in Arkansas and the Sahara play in northwest Oklahoma remain the key drivers of the company's growth in production and proved reserves. The Barnett Shale is the largest and most prolific unconventional gas resource play in the U.S. In this area, Chesapeake is the third-largest producer of natural gas, the most active driller and the largest leasehold owner in the Core and Tier 1 sweet spot of Tarrant, northern Johnson and western Dallas counties, from which we are producing approximately 330 mmcfe net per day. The company is currently using 38 operated rigs to drill approximately 600 gross wells per year to further develop its 235,000 net acres of Barnett Shale leasehold,
of which 200,000 net acres are located in the Core and Tier 1 areas.

The Fayetteville Shale play in Arkansas is increasingly important to the company as we continue to deliver better well results with lower costs while we also continue to consolidate our leasehold position, now up to 420,000 net acres, the second-largest leasehold position in the play. Chesapeake is currently utilizing 11 operated drilling rigs to drill wells at the rate of 110 gross operated wells per year. During the quarter, the company upgraded its expected returns from the play to 2.0 bcfe of estimated ultimate reserves per well at an average cost of $3.0 million. We now plan to increase our drilling activity to around 13 drilling rigs in 2008 and to approximately 15 rigs in 2009.

In northwest Oklahoma, Chesapeake continues to add to its industry-leading 800,000 net-acre leasehold position in the Sahara area and also continues to develop new play types inside the area. During the past 10 years in Sahara, we have drilled approximately 1,200 wells and to date have found an average of 0.6 bcfe per well at a cost of $850,000. During the quarter, new plays have been developed that feature very attractive new oil volumes as well as several significant new de-watering plays. Similar to the Fort Worth Barnett and the Fayetteville in Arkansas, the Sahara play will remain a foundational asset of the company for decades as we continue to drill through our estimated backlog of 13,000 undrilled wells in these areas.

Management Outlook

Our operational and financial results for the 2007 third quarter continue to clearly demonstrate the attractiveness of Chesapeake's business strategy, our assets and our people. In addition, we are increasingly involved in various public policy discussions involving how to meet the nation's need for more energy at affordable prices while also reducing greenhouse gas emissions. While Chesapeake clearly sees the need for more energy conservation and a greater role of solar and wind energy, the most reliable and affordable alternative energy available today is clean-burning American natural gas.

We are helping shape public policy through Chesapeake's direct involvement in those discussions as well as our ongoing support of the American Clean Skies Foundation (http://www.cleanskies.org) in its efforts to promote the greater use of natural gas in the U.S. We believe the evidence clearly demonstrates that natural gas is the most practical solution to our energy challenges ahead – it is abundant, affordable, reliable, clean-burning and domestically produced.

We intend to do good for our shareholders while doing good for our country and our world by producing ever greater amounts of natural gas. Chesapeake's focused business strategy, diversified growth platform, tremendous inventory of undrilled locations and attractive hedge positions continue to clearly differentiate Chesapeake as one of the very best value creators in the industry.

Best regards,

Aubrey K. McClendon

Chairman and Chief Executive Officer
November 6, 2007

(1) Operating cash flow is net cash provided by operating activities before changes in assets and liabilities.
(2) Ebitda is net income before income tax expense, interest expense, and depreciation, depletion and amortization expense.
(3) Adjusted earnings is net income available to common shareholders excluding, on an after-tax basis, unrealized gains on derivatives.
(4) Adjusted ebitda is net income before income tax expense, interest expense, and depreciation, depletion and amortization expense, adjusted to exclude unrealized gains on oil and natural gas derivatives.
