CHESAPEAKE ENERGY CORP
Form 10-Q
August 10, 2009
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

[X] Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended June 30, 2009

[ ] Transition Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from to

Commission File No. 1-13726

Chesapeake Energy Corporation

(Exact name of registrant as specified in its charter)

Oklahoma (State or other jurisdiction of incorporation or organization)	**73-1395733** (I.R.S. Employer Identification No.)
6100 North Western Avenue **Oklahoma City, Oklahoma** (Address of principal executive offices)	**73118** (Zip Code)

(405) 848-8000

Registrant s telephone number, including area code

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes [X] No [ ]

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes [X] No [ ]

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer , accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer [X]	Accelerated filer [ ]
Non-accelerated filer [ ] (Do not check if a smaller reporting company)	Smaller reporting company [ ]

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes [ ] No [X]

As of August 6, 2009, there were 641,652,116 shares of our $0.01 par value common stock outstanding.

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CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES

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CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

	June 30, 2009	December 31, 2008 (Adjusted)
	($ in millions)	
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 554	$ 1,749
Accounts receivable	1,122	1,324
Short-term derivative instruments	1,133	1,082
Other	139	137
Total Current Assets	2,948	4,292
PROPERTY AND EQUIPMENT:		
Natural gas and oil properties, at cost based on full-cost accounting:		
Evaluated natural gas and oil properties	33,886	28,965
Unevaluated properties	9,465	11,379
Less: accumulated depreciation, depletion and amortization of natural gas and oil properties	(22,199)	(11,866)
Total natural gas and oil properties, at cost based on full-cost accounting	21,152	28,478
Other property and equipment:		
Natural gas gathering systems and treating plants	3,256	2,717
Buildings and land	1,618	1,513
Drilling rigs and equipment	556	430
Natural gas compressors	248	184
Other	522	482
Less: accumulated depreciation and amortization of other property and equipment	(616)	(496)
Total Other Property and Equipment	5,584	4,830
Total Property and Equipment	26,736	33,308
OTHER ASSETS:		
Investments	394	444
Long-term derivative instruments	88	261
Other assets	303	288
Total Other Assets	785	993
TOTAL ASSETS	$ 30,469	$ 38,593

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CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS (Continued)

(Unaudited)

	June 30, 2009	December 31, 2008 (Adjusted)
	($ in millions)	
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$ 971	$ 1,611
Short-term derivative instruments	28	66
Accrued liabilities	983	880
Deferred income taxes	401	358
Income taxes payable		108
Revenues and royalties due others	371	431
Accrued interest	220	167
Total Current Liabilities	2,974	3,621
LONG-TERM LIABILITIES:		
Long-term debt, net	13,568	13,175
Deferred income tax liabilities	906	4,200
Asset retirement obligations	279	269
Long-term derivative instruments	322	111
Other liabilities	418	200
Total Long-Term Liabilities	15,493	17,955
CONTINGENCIES AND COMMITMENTS (Note 3)		
STOCKHOLDERS EQUITY:		
Preferred Stock, $0.01 par value, 20,000,000 shares authorized:		
4.50% cumulative convertible preferred stock, 2,558,900 shares issued and outstanding as of June 30, 2009 and December 31, 2008, entitled in liquidation to $256 million	256	256
5.00% cumulative convertible preferred stock (series 2005B), 2,095,615 shares issued and outstanding as of June 30, 2009 and December 31, 2008, entitled in liquidation to $209 million	209	209
5.00% cumulative convertible preferred stock (series 2005), 5,000 shares issued and outstanding as of June 30, 2009 and December 31, 2008, entitled in liquidation to $1 million	1	1
6.25% mandatory convertible preferred stock, 0 shares and 143,768 shares issued and outstanding as of June 30, 2009 and December 31, 2008, respectively, entitled in liquidation to $0 and $36 million		36
4.125% cumulative convertible preferred stock, 0 and 3,033 shares issued and outstanding as of June 30, 2009 and December 31, 2008, respectively, entitled in liquidation to $0 and $3 million		3
Common Stock, $0.01 par value, 1,000,000,000 shares and 750,000,000 shares authorized, 630,251,782 and 607,953,437 shares issued at June 30, 2009 and December 31, 2008, respectively	6	6
Paid-in capital	12,032	11,680
Retained earnings (deficit)	(929)	4,569
Accumulated other comprehensive income (loss), net of tax of ($267) million and ($163) million, respectively	438	267
Less: treasury stock, at cost; 718,800 and 657,276 common shares as of June 30, 2009 and December 31, 2008, respectively	(11)	(10)
Total Stockholders Equity	12,002	17,017

TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 30,469	$ 38,593

The accompanying notes are an integral part of these condensed consolidated financial statements.

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CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008 (Adjusted)	2009	2008 (Adjusted)
	($ in millions except per share data)			
REVENUES:				
Natural gas and oil sales	$ 1,097	$ (1,594)	$ 2,494	$ (821)
Natural gas and oil marketing sales	532	1,099	1,084	1,895
Service operations revenue	44	40	90	82
Total Revenues	1,673	(455)	3,668	1,156
OPERATING COSTS:				
Production expenses	213	219	451	419
Production taxes	24	88	46	163
General and administrative expenses	74	101	164	180
Natural gas and oil marketing expenses	500	1,075	1,023	1,849
Service operations expense	46	32	87	67
Natural gas and oil depreciation, depletion and amortization	295	523	742	1,038
Depreciation and amortization of other assets	58	40	115	76
Impairment of natural gas and oil properties and other assets	5		9,635	
Restructuring costs	34		34	
Total Operating Costs	1,249	2,078	12,297	3,792
INCOME (LOSS) FROM OPERATIONS	424	(2,533)	(8,629)	(2,636)
OTHER INCOME (EXPENSE):				
Other income (expense)	(2)	(1)	5	(11)
Interest expense	(22)	(54)	(8)	(153)
Impairment of investments	(10)		(162)	
Loss on exchanges of Chesapeake debt	(2)		(2)	
Total Other Income (Expense)	(36)	(55)	(167)	(164)
INCOME (LOSS) BEFORE INCOME TAXES	388	(2,588)	(8,796)	(2,800)
INCOME TAX EXPENSE (BENEFIT):				
Current income taxes	1	3	1	3
Deferred income taxes	144	(999)	(3,299)	(1,081)
Total Income Tax Expense (Benefit)	145	(996)	(3,298)	(1,078)
NET INCOME (LOSS)	243	(1,592)	(5,498)	(1,722)
PREFERRED STOCK DIVIDENDS	(6)	(9)	(12)	(21)
LOSS ON CONVERSION/EXCHANGE OF PREFERRED STOCK		(42)		(42)

NET INCOME (LOSS) AVAILABLE TO COMMON SHAREHOLDERS	$ 237	$ (1,643)	$ (5,510)	$ (1,785)
EARNINGS (LOSS) PER COMMON SHARE:				
Basic	$ 0.39	$ (3.16)	$ (9.18)	$ (3.52)
Assuming dilution	$ 0.39	$ (3.16)	$ (9.18)	$ (3.52)
CASH DIVIDEND DECLARED PER COMMON SHARE	$ 0.075	$ 0.075	$ 0.15	$ 0.1425
WEIGHTED AVERAGE COMMON AND COMMON EQUIVALENT SHARES OUTSTANDING (in millions):				
Basic	603	521	600	507
Assuming dilution	610	521	600	507

The accompanying notes are an integral part of these condensed consolidated financial statements.

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CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Six Months Ended June 30, 2009	Six Months Ended June 30, 2008 (Adjusted)
	($ in millions)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
NET INCOME (LOSS)	$ (5,498)	$ (1,722)
ADJUSTMENTS TO RECONCILE NET INCOME (LOSS) TO CASH PROVIDED BY OPERATING ACTIVITIES:		
Depreciation, depletion and amortization	857	1,119
Deferred income taxes	(3,299)	(1,081)
Impairments	9,792	
Unrealized (gains) losses on derivatives	29	4,538
Realized (gains) losses on financing derivatives	(35)	32
Stock-based compensation	68	61
Interest expense on contingent convertible notes	40	33
Restructuring costs	29	
Loss from equity investments	8	
Loss on exchanges of Chesapeake debt	2	
Other	12	20
Change in assets and liabilities	(7)	(202)
Cash provided by operating activities	1,998	2,798
CASH FLOWS FROM INVESTING ACTIVITIES:		
Exploration and development of natural gas and oil properties	(2,092)	(2,935)
Acquisitions of natural gas and oil companies, proved and unproved properties and leasehold, net of cash acquired	(412)	(2,815)
Interest capitalized on unproved properties	(314)	(244)
Proceeds from sale of volumetric production payments	41	616
Divestitures of proved and unproved properties and leasehold	187	247
Additions to other property and equipment	(980)	(1,229)
Proceeds from (additions to) investments	2	(81)
Proceeds from sale of drilling rigs and equipment		34
Proceeds from sale of compressors	68	51
Deposits made for acquisitions	(9)	(19)
Deposits received for divestitures	8	
Proceeds from sale of other assets	36	2
Cash used in investing activities	(3,465)	(6,373)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from credit facility borrowings	3,363	6,758
Payments on credit facility borrowings	(4,166)	(6,195)
Proceeds from issuance of senior notes, net of offering costs	1,346	2,136
Proceeds from issuance of common stock, net of offering costs		1,011
Cash paid for common stock dividends	(89)	(66)

Cash paid for preferred stock dividends		(12)		(22)
Derivative settlements		9		(93)
Net increase (decrease) in outstanding payments in excess of cash balance		(350)		47
Proceeds from mortgage of building		54		
Proceeds from sale/leaseback of surface land		145		
Excess tax benefit from stock-based compensation				21
Other		(28)		(23)
Cash provided by financing activities		272		3,574
Net decrease in cash and cash equivalents		(1,195)		(1)
Cash and cash equivalents, beginning of period		1,749		1
Cash and cash equivalents, end of period	$	554	$	

The accompanying notes are an integral part of these condensed consolidated financial statements.

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CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)

(Unaudited)

	Six Months Ended June 30, 2009	Six Months Ended June 30, 2008 (Adjusted)
	($ in millions)	
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION OF CASH PAYMENTS FOR:		
Interest, net of $314 million and $244 million of capitalized interest, respectively	$ 2	$ 96
Income taxes, net of refunds received	$ 176	$ 5
SUPPLEMENTAL SCHEDULE OF NON-CASH INVESTING AND FINANCING ACTIVITIES:		

As of June 30, 2009 and 2008, dividends payable on our common and preferred stock were $51 million and $48 million, respectively.

For the six months ended June 30, 2009 and 2008, natural gas and oil properties were adjusted by a nominal amount and $12 million, respectively, for net income tax liabilities related to acquisitions.

For the six months ended June 30, 2009 and 2008, natural gas and oil properties were adjusted by ($65) million and $33 million, respectively, as a result of an increase (decrease) in accrued exploration and development costs.

For the six months ended June 30, 2009 and 2008, other property and equipment were adjusted by ($12) million and $17 million, respectively, as a result of an increase (decrease) in accrued costs.

We recorded non-cash asset additions (reductions) to natural gas and oil properties of ($2) million and $6 million for the six months ended June 30, 2009 and 2008, respectively, for asset retirement obligations.

On March 31, 2009, we converted all of our outstanding 4.125% Cumulative Convertible Preferred Stock (3,033 shares) into 182,887 shares of common stock.

On June 15, 2009, we converted all of our outstanding 6.25% Mandatory Convertible Preferred Stock (143,768 shares) into 1,239,538 shares of common stock.

In June 2009, we privately exchanged approximately $85 million in aggregate principal amount of our 2.25% Contingent Convertible Senior Notes due 2038 for an aggregate of 2,530,650 shares of our common stock.

For the six months ended June 30, 2009, we issued 15,823,838 shares of common stock, valued at $269 million, for the purchase of proved and unproved properties and leasehold pursuant to an acquisition shelf registration statement.

For the six months ended June 30, 2008, holders of our 5.0% (Series 2005B) Cumulative Convertible Preferred Stock exchanged 2,718,500 shares for 7,780,703 shares of common stock in privately negotiated exchanges.

The accompanying notes are an integral part of these condensed consolidated financial statements.

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CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

(Unaudited)

	Six Months Ended June 30, 2009	Six Months Ended June 30, 2008 (Adjusted)
	($ in millions)	
PREFERRED STOCK:		
Balance, beginning of period	$ 505	$ 960
Exchange of common stock for 143,768 and 0 shares of 6.25% preferred stock	(36)	
Exchange of common stock for 3,033 and 0 shares of 4.125% preferred stock	(3)	
Exchange of common stock for 0 and 2,718,500 shares of 5.00% preferred stock (series 2005B)		(272)
Balance, end of period	466	688
COMMON STOCK:		
Balance, beginning of period	6	5
Issuance of 15,823,838 and 0 shares of common stock for the purchase of proved and unproved properties and leasehold		
Issuance of 0 and 23,000,000 shares of common stock		
Exchange of 2,530,650 and 0 shares of common stock for convertible notes		
Exchange of 1,422,425 and 7,780,883 shares of common stock for preferred stock		
Balance, end of period	6	5
PAID-IN CAPITAL:		
Balance, beginning of period	11,680	7,532
Issuance of 15,823,838 shares and 0 shares of common stock for the purchase of proved and unproved properties and leasehold	254	
Issuance of 0 and 23,000,000 shares of common stock		1,052
Issuance of 2.25% contingent convertible senior notes due 2038		345
Exchange of 2,530,650 and 0 shares of common stock for convertible notes	54	
Exchange of 1,422,425 and 7,780,883 shares of common stock for preferred stock	39	272
Stock-based compensation	119	82
Exercise of stock options	1	7
Offering expenses		(53)
Dividends on common stock	(91)	
Dividends on preferred stock	(12)	
Tax benefit (reduction in tax benefit) from exercise of stock options and restricted stock	(12)	21
Balance, end of period	12,032	9,258
RETAINED EARNINGS (DEFICIT):		
Balance, beginning of period	4,569	4,145
Net income (loss)	(5,498)	(1,722)
Dividends on common stock		(73)
Dividends on preferred stock		(10)

Balance, end of period	(929)	2,340
ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS):		
Balance, beginning of period	267	(11)
Hedging activity	110	(1,191)
Investment activity	61	28
Balance, end of period	438	(1,174)
TREASURY STOCK COMMON:		
Balance, beginning of period	(10)	(6)
Purchase of 64,242 and 0 shares for company benefit plans	(1)	
Release of 2,718 and 1,098 shares for company benefit plans		
Balance, end of period	(11)	(6)
TOTAL STOCKHOLDERS EQUITY	$ 12,002	$ 11,111

The accompanying notes are an integral part of these condensed consolidated financial statements.

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CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(Unaudited)

	Three Months Ended June 30, 2009	Three Months Ended June 30, 2008 (Adjusted)	Six Months Ended June 30, 2009	Six Months Ended June 30, 2008 (Adjusted)
	($ in millions)			
Net income (loss)	$ 243	$ (1,592)	$ (5,498)	$ (1,722)
Other comprehensive income (loss), net of income tax:				
Change in fair value of derivative instruments, net of income taxes of $37 million, ($530) million, $333 million and ($833) million	63	(865)	547	(1,357)
Reclassification of (gain) loss on settled contracts, net of income taxes of ($120) million, $103 million, ($232) million, and $52 million	(197)	167	(381)	85
Ineffective portion of derivatives qualifying for cash flow hedge accounting, net of income taxes of ($13) million, $24 million, ($34) million and $49 million	(22)	39	(56)	80
Unrealized (gain) loss on investments, net of income taxes of $7 million, $16 million, $11 million and $17 million	12	27	18	28
Reclassification of loss on investments, net of income taxes of $0, $0, $26 million and $0			43	
Comprehensive income (loss)	$ 99	$ (2,224)	$ (5,327)	$ (2,886)

The accompanying notes are an integral part of these condensed consolidated financial statements.

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CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Basis of Presentation and Summary of Significant Accounting Policies

Principles of Consolidation

The accompanying unaudited condensed consolidated financial statements of Chesapeake Energy Corporation and its subsidiaries have been prepared in accordance with the instructions to Form 10-Q as prescribed by the Securities and Exchange Commission (SEC). Chesapeake s annual report on Form 10-K for the year ended December 31, 2008 (2008 Form 10-K) includes certain definitions and a summary of significant accounting policies and should be read in conjunction with this Form 10-Q. The accompanying consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto for the year ended December 31, 2008 contained in our Current Report on Form 8-K dated June 25, 2009. All material adjustments (consisting solely of normal recurring adjustments) which, in the opinion of management, are necessary for a fair statement of the results for the interim periods have been reflected. The results for the three and six months ended June 30, 2009 are not necessarily indicative of the results to be expected for the full year. This Form 10-Q relates to the three and six months ended June 30, 2009 (the Current Quarter and the Current Period , respectively) and the three and six months ended June 30, 2008 (the Prior Quarter and the Prior Period , respectively). Any material subsequent events have been considered for disclosure through August 10, 2009, the filing date of this Form 10-Q.

Change in Accounting Principle

On January 1, 2009, we adopted and applied retrospectively Financial Accounting Standards Board (FASB) Staff Position No. APB 14-1, *Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion*. As a result, our prior year condensed consolidated financial statements have been retrospectively adjusted. See Note 6 for additional information on the application of this accounting principle.

Oil and Natural Gas Properties Ceiling Test

We review the carrying value of our natural gas and oil properties under the full-cost accounting rules of the SEC on a quarterly basis. This quarterly review is referred to as a ceiling test. Under the ceiling test, capitalized costs, less accumulated amortization and related deferred income taxes, may not exceed an amount equal to the sum of the present value of estimated future net revenues (including the impact of cash flow hedges) less estimated future expenditures to be incurred in developing and producing the proved reserves, less any related income tax effects. Any excess of the net book value, less deferred income taxes, is written off as an expense. As of June 30, 2009, the present value of our proved reserves was $11.076 billion which exceeded our net capitalized cost and no impairment was necessary.

In calculating future net revenues, prices and costs used are those as of the end of the appropriate quarterly period except where different prices are fixed and determinable from applicable contracts for the remaining term of those contracts, including the effects of derivatives qualifying as cash flow hedges. Our qualifying cash flow hedges as of June 30, 2009, which consisted of swaps and collars, covered 253 bcfe, 74 bcfe and 11 bcfe in 2009, 2010 and 2011, respectively. Our natural gas and oil hedging activities are discussed in Note 2 of these condensed consolidated financial statements. Based on spot prices for natural gas and oil of $3.89 per mcf and $70.00 per barrel, respectively, as of June 30, 2009, these cash flow hedges increased the full-cost ceiling by $1.219 billion, thereby reducing any potential ceiling test write-down by the same amount. Had the effects of our cash flow hedges not been considered in calculating the ceiling limitation, the impairment as of June 30, 2009 would have been approximately $115 million, net of tax.

Critical Accounting Policies

We consider accounting policies related to hedging, natural gas and oil properties, income taxes and business combinations to be critical policies. These policies are summarized in Management s Discussion and Analysis of Financial Condition and Results of Operations in our 2008 Form 10-K.

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CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

2. Financial Instruments and Hedging Activities

Natural Gas and Oil Derivatives

Our results of operations and operating cash flows are impacted by changes in market prices for natural gas and oil. To mitigate a portion of the exposure to adverse market changes, we have entered into various derivative instruments. These instruments allow us to predict with greater certainty the effective natural gas and oil prices to be received for our hedged production. Although derivatives often fail to achieve 100% effectiveness for accounting purposes, we believe our derivative instruments continue to be highly effective in achieving the risk management objectives for which they were intended. As of June 30, 2009, our natural gas and oil derivative instruments were comprised of the following:

For swap instruments, Chesapeake receives a fixed price for the hedged commodity and pays a floating market price to the counterparty.

Collars contain a fixed floor price (put) and ceiling price (call). If the market price exceeds the call strike price or falls below the put strike price, Chesapeake receives the fixed price and pays the market price. If the market price is between the call and the put strike price, no payments are due from either party. On occasion, we sell an additional put option with the collar and receive a premium to make a three-way collar. This eliminates the counterparty s downside exposure below the second put option.

For knockout swaps, Chesapeake receives a fixed price and pays a floating market price. The fixed price received by Chesapeake includes a premium in exchange for the possibility to reduce the counterparty s exposure to zero, in any given month, if the floating market price is lower than certain pre-determined knockout prices.

For cap-swaps, Chesapeake receives a fixed price and pays a floating market price. The fixed price received by Chesapeake includes a premium in exchange for a cap limiting the counterparty s exposure. In other words, there is no limit to Chesapeake s exposure but there is a limit to the downside exposure of the counterparty.

For call options, Chesapeake receives a premium from the counterparty in exchange for the sale of a call option. If the market price exceeds the fixed price of the call option, Chesapeake pays the counterparty such excess. If the market price settles below the fixed price of the call option, no payment is due from Chesapeake.

For put options, Chesapeake receives a premium from the counterparty in exchange for the sale of a put option. If the market price falls below the fixed price of the put option, Chesapeake pays the counterparty such shortfall. If the market price settles above the fixed price of the put option, no payment is due from Chesapeake.

Basis protection swaps are arrangements that guarantee a price differential to NYMEX for natural gas or oil from a specified delivery point. For non-Appalachian Basin basis protection swaps, which typically have negative differentials to NYMEX, Chesapeake receives a payment from the counterparty if the price differential is greater than the stated terms of the contract and pays the counterparty if the price differential is less than the stated terms of the contract. For Appalachian Basin basis protection swaps, which typically have positive differentials to NYMEX, Chesapeake receives a payment from the counterparty if the price differential is less than the stated terms of the contract and pays the counterparty if the price differential is greater than the stated terms of the contract. All of our derivative instruments are net settled based on the difference between the fixed-price payment and the floating-price payment, resulting in a net amount due to or from the counterparty.

Chesapeake enters into counter-swaps from time to time for the purpose of locking-in the value of a swap. Under the counter-swap, Chesapeake receives a floating price for the hedged commodity and pays a fixed price to the counterparty. The counter-swap is 100% effective in locking-in the value of a swap since subsequent changes in the market value of the swap are entirely offset by subsequent changes in the market value of the counter-swap. We refer to this locked-in value as a locked swap. Generally, at the time Chesapeake enters into a counter-swap, Chesapeake removes the original swap s designation as a cash flow hedge and classifies the original swap as a non-qualifying hedge under SFAS 133. The reason for this new designation is that collectively the swap and the counter-swap no longer hedge the exposure to variability in expected future cash flows. Instead, the swap and counter-swap effectively lock-in a specific gain or loss that will be unaffected by subsequent variability in natural

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CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

gas and oil prices. Any locked-in gain or loss is recorded in accumulated other comprehensive income and reclassified to natural gas and oil sales in the month of related production.

Gains or losses from certain derivative transactions are reflected as adjustments to natural gas and oil sales on the condensed consolidated statements of operations. Realized gains (losses) are included in natural gas and oil sales in the month of related production. Pursuant to SFAS 133, certain derivatives do not qualify for designation as cash flow hedges. Changes in the fair value of these non-qualifying derivatives that occur prior to their maturity (i.e., temporary fluctuations in value) are reported currently in the condensed consolidated statements of operations as unrealized gains (losses) within natural gas and oil sales. Following provisions of SFAS 133, changes in the fair value of derivative instruments designated as cash flow hedges, to the extent they are effective in offsetting cash flows attributable to the hedged risk, are recorded in accumulated other comprehensive income until the hedged item is recognized in earnings. Any change in fair value resulting from ineffectiveness is currently recognized in natural gas and oil sales as unrealized gains (losses). The components of natural gas and oil sales for the Current Quarter, the Prior Quarter, the Current Period and the Prior Period are presented below.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
	($ in millions)			
Natural gas and oil sales	$ 717	$ 2,233	$ 1,495	$ 3,925
Realized gains (losses) on natural gas and oil derivatives	597	(423)	1,115	(208)
Unrealized gains (losses) on non-qualifying natural gas and oil derivatives	(253)	(3,340)	(206)	(4,409)
Unrealized gains (losses) on ineffectiveness of cash flow hedges	36	(64)	90	(129)
Total natural gas and oil sales	$ 1,097	$ (1,594)	$ 2,494	$ (821)

The estimated fair values of our natural gas and oil derivative instruments as of June 30, 2009 and December 31, 2008 are provided below. The associated carrying values of these instruments are equal to the estimated fair values.

	June 30, 2009	December 31, 2008
	($ in millions)	
Derivative assets (liabilities)[(a)]:		
Fixed-price natural gas swaps	$ 733	$ 863
Fixed-price natural gas collars	492	402
Fixed-price natural gas knockout swaps	47	141
Natural gas call options	(157)	(178)
Natural gas put options	(59)	(39)
Natural gas basis protection swaps	(54)	93
Fixed-price oil swaps	1	31
Fixed-price oil knockout swaps	66	19
Fixed-price oil cap-swaps		3
Oil call options	(71)	(35)

Fixed-price oil collars				5
Estimated fair value	$	998	$	1,305

(a) After adjusting for $488 million and $736 million of unrealized premiums, the value to be realized for these derivatives as of June 30, 2009 and December 31, 2008 was $1.486 billion and $2.041 billion, respectively.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The volume hedged under natural gas and oil derivative instruments as of June 30, 2009 and December 31, 2008 is summarized below.

	June 30, 2009	December 31, 2008
Natural Gas and Oil Volume Hedged:		
Natural Gas (bbtu)		
Fixed-price natural gas swaps	354,291	466,800
Fixed-price natural gas collars	260,110	457,715
Fixed-price natural gas knockout swaps	98,670	532,660
Natural gas call options	595,525	551,555
Natural gas put options	91,400	73,000
Natural gas basis protection swaps	210,822	219,487
Total natural gas volume	1,610,818	2,301,217
Oil (mbbls)		
Fixed-price oil swaps	(460)	(310)
Fixed-price oil knockout swaps	9,148	12,248
Fixed-price oil cap-swaps		362
Oil call options	14,996	19,355
Fixed-price oil collars		730
Total oil volume	23,684	32,385

To mitigate our exposure to the fluctuation in prices of diesel fuel, we have entered into diesel swaps from July 2009 to March 2010 for a total of 29,025,000 gallons with an average fixed price of $1.58 per gallon. The fair value of these swaps as of June 30, 2009 was an asset of $10 million.

We have six secured hedging facilities, each of which permits us to enter into cash-settled natural gas and oil commodity transactions, valued by the counterparty, for up to a stated maximum value. Outstanding transactions under each facility are collateralized by certain of our natural gas and oil properties that do not secure any of our other obligations. The value of reserve collateral pledged to each facility is required to be at least 1.3 or 1.5 times the fair value of transactions outstanding under each facility. In addition, we may pledge collateral from our revolving bank credit facility, from time to time, to these facilities to meet any additional collateral coverage requirements. The hedging facilities are subject to a per annum exposure fee, which is assessed quarterly based on the average of the daily negative fair value amounts of the hedges, if any, during the quarter. The hedging facilities contain the standard representations and default provisions that are typical of such agreements. The agreements also contain various restrictive provisions which govern the aggregate natural gas and oil production volumes that we are permitted to hedge under all of our agreements at any one time. The fair value of outstanding transactions, per annum exposure fees and the scheduled maturity dates are shown below.

	Secured Hedging Facilities[a]					
	#1	#2	#3	#4	#5	#6

			($ in millions)			
Fair value of outstanding transactions, as of June 30, 2009	$ 130	$ 370	$ 22	$ (1)	$ 77	$ 84
Per annum exposure fee	1%	1%	0.8%	0.8%	0.8%	0.8%
Scheduled maturity date	2010	2013	2020	2012	2012	2012

(a) Chesapeake Exploration, L.L.C. is the named party to the facilities numbered 1 3 and Chesapeake Energy Corporation is the named party to the facilities numbered 4 6.

On June 11, 2009, we entered into a multi-counterparty secured hedging facility with 13 hedge counterparties, one of which is a new counterparty to the company. These 13 hedge counterparties have committed to provide approximately 3.9 tcfe of trading capacity under the terms of the facility. Each of the six counterparties to our existing secured hedging facilities is a party to this new facility. The facility allows us to enter into cash-settled natural gas and oil price and basis hedges with the hedge counterparties. Our obligations under the new facility will be secured by natural gas and oil proved reserves, the value of which must cover the fair value of the transactions outstanding under the facility by at least 1.65 times, and guarantees by our subsidiaries that also guarantee our revolving bank credit facility and indentures. The hedge counterparties obligations under the facility will be secured by cash or short-term U.S. Treasury instruments to the extent that any mark-to-market amounts they owe to Chesapeake exceed defined thresholds. The maximum volume-based trading capacity under the facility is governed by the expected production of the pledged reserve collateral and volume-based trading limits are applied separately to price and basis hedges. In addition, there are volume-based sub-limits for natural gas and oil hedges. Chesapeake has significant flexibility with regard to releases and/or substitutions of pledged reserves, provided that

CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

certain collateral coverage and other requirements are met. The facility does not have a maturity date. Counterparties to the agreement have the right to cease trading with the company on a prospective basis as long as obligations associated with any existing trades in the facility continue to be satisfied in accordance with the terms of the agreement.

All existing trades with the hedge counterparties are expected to be novated into the multi-counterparty facility along with any collateral currently pledged under the existing secured hedge facilities. Trades novated into the multi-counterparty facility from the existing secured hedge facilities will continue to be subject to pre-existing exposure fees, if any, but we are not required to pay an exposure fee for any new trades in the multi-counterparty facility. The new multi-counterparty facility will consolidate and replace our six secured hedging facilities described above. As of July 31, 2009, no trades had been transacted or novated or collateral pledged under the multi-counterparty facility.

Interest Rate Derivatives

We use interest rate derivatives to mitigate our exposure to volatility in interest rates related to our senior notes and credit facility. For interest rate derivative instruments designated as fair value hedges (in accordance with SFAS 133), changes in fair value are recorded on the condensed consolidated balance sheets as assets (liabilities), and the debt s carrying value amount is adjusted by the change in the fair value of the debt subsequent to the initiation of the derivative. Changes in the fair value of non-qualifying derivatives that occur prior to their maturity (i.e., temporary fluctuations in value) are reported currently in the condensed consolidated statements of operations as unrealized gains (losses) within interest expense.

Gains or losses from certain derivative transactions are reflected as adjustments to interest expense on the condensed consolidated statements of operations. Realized gains (losses) included in interest expense were $5 million, $4 million, $12 million and $4 million in the Current Quarter, the Prior Quarter, the Current Period and the Prior Period, respectively. Unrealized gains (losses) included in interest expense were $42 million, $14 million, $87 million and $1 million in the Current Quarter, the Prior Quarter, the Current Period and the Prior Period, respectively.

As of June 30, 2009, the following interest rate derivatives were outstanding:

		Notional Amount ($ in millions)	Weighted Average Fixed Rate	Weighted Average Floating Rate[b]	Fair Value Hedge	Net Premiums ($ in millions)	Fair Value ($ in millions)
Fixed to Floating Interest Rate:							
Swaps							
April 2009	December 2018	$ 1,750	7.78%	1 6 mL plus 492 bp	Yes	$	$ (62)
April 2008	November 2020	$ 1,000	8.09%	1 6 mL plus 485 bp	No	$ (1)	$ (16)
Call Options							
August 2009	November 2009	$ 500	6.69%	1 6 mL plus 263 bp	No	$	$ (14)
Floating to Fixed Interest Rate:							
Swaps							

August 2007	July 2012	$	1,375	4.20%	1 - 6 mL	No	$		$	(32)
Collars[(a)]										
August 2007	August 2010	$	250	4.52%	6 mL	No	$		$	(9)
Swaption										
August 2009		$	500	2.56%	1 mL	No	$	4	$	(11)
							$	3	$	(144)

(a) The collars have ceiling and floor fixed interest rates of 5.37% and 4.52%, respectively.

(b) Month LIBOR has been abbreviated mL and basis points has been abbreviated bp .

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In the Current Period, we closed interest rate derivatives for gains totaling $30 million, of which $18 million was recognized in interest expense. The remaining $12 million was from interest rate derivatives designated as fair value hedges and the settlement amounts received will be amortized as a reduction to interest expense over the remaining term of the related senior notes ranging from four to eleven years.

Foreign Currency Derivatives

On December 6, 2006, we issued 600 million of 6.25% Euro-denominated Senior Notes due 2017. Concurrent with the issuance of the euro-denominated senior notes, we entered into a cross currency swap to mitigate our exposure to fluctuations in the euro relative to the dollar over the term of the notes. Under the terms of the cross currency swap, on each semi-annual interest payment date, the counterparties pay Chesapeake 19 million and Chesapeake pays the counterparties $30 million, which yields an annual dollar-equivalent interest rate of 7.491%. Upon maturity of the notes, the counterparties will pay Chesapeake 600 million and Chesapeake will pay the counterparties $800 million. The terms of the cross currency swap were based on the dollar/euro exchange rate on the issuance date of $1.3325 to 1.00. Through the cross currency swap, we have eliminated any potential variability in Chesapeake s expected cash flows related to changes in foreign exchange rates and therefore the swap qualifies as a cash flow hedge under SFAS 133. The fair value of the cross currency swap is recorded on the condensed consolidated balance sheet as an asset of $7 million at June 30, 2009. The euro-denominated debt in notes payable has been adjusted to $841 million at June 30, 2009 using an exchange rate of $1.4020 to 1.00 with an offsetting entry to other comprehensive income of $34 million related to future interest expense.

Disclosures About Derivative Instruments and Hedging Activities

In accordance with FASB Interpretation No. 39, to the extent that a legal right of set-off exists, Chesapeake nets the value of its derivative arrangements with the same counterparty in the accompanying condensed consolidated balance sheets. Pursuant to SFAS 161, the following table sets forth the fair value of each classification of derivative instrument as of June 30, 2009 on a gross basis:

	June 30, 2009		
	Balance Sheet Location		**Fair Value ($ in millions)**
ASSET DERIVATIVES:			
Derivatives designated as hedging instruments under SFAS 133:			
Foreign exchange contracts	Long-term derivative instruments	$	7
Commodity contracts	Short-term derivative instruments		797
Commodity contracts	Long-term derivative instruments		84
Total			888
Derivatives not designated as hedging instruments under SFAS 133:			
Interest rate contracts	Long-term derivative instruments		5
Commodity contracts	Short-term derivative instruments		454
Commodity contracts	Long-term derivative instruments		82
Total			541

LIABILITY DERIVATIVES:

Derivatives designated as hedging instruments under SFAS 133:			
Interest rate contracts	Long-term derivative instruments		62
Commodity contracts	Short-term derivative instruments		3
Total			65
Derivatives not designated as hedging instruments under SFAS 133:			
Interest rate contracts	Short-term derivative instruments		26
Interest rate contracts	Long-term derivative instruments		61
Commodity contracts	Short-term derivative instruments		117
Commodity contracts	Long-term derivative instruments		289
Total			493
Total derivative instruments		$	871

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

A consolidated summary of the effect of derivative instruments on the condensed consolidated statement of operations for the three and six months ended June 30, 2009 is provided below, separating fair value, cash flow and non-qualifying hedges (as defined by SFAS 133).

The following table presents the gain (loss) recognized in net income (loss) for instruments designated as fair value hedges:

Fair Value Derivatives	Location of Gain (Loss)	Three Months Ended June 30, 2009	Six Months Ended June 30, 2009
		($ in millions)	
Interest rate contracts	Interest expense[(a)]	$ 10	$ 18

(a) Interest expense on the hedged items for the Current Quarter and the Current Period was $20 million and $33 million, respectively, which is included in interest expense on the condensed consolidated statement of operations.

The following table presents the pre-tax gain (loss) recognized in, and reclassified from, accumulated other comprehensive income (AOCI) and recognized in net income (loss), including any hedge ineffectiveness, for derivative instruments classified as cash flow hedges ($ in millions):

Cash Flow Derivatives	Gain (Loss) Recognized in AOCI (Effective Portion)	Location of Gain (Loss) Reclassified from AOCI (Effective Portion)	Gain (Loss) Reclassified from AOCI (Effective Portion)	Location of Gain (Loss) Recognized (Ineffective Portion)	Gain (Loss) Recognized (Ineffective Portion) [(a)]
Three Months Ended June 30, 2009					
Commodity contracts	$ 30	Natural gas and oil sales	$ 317	Natural gas and oil sales	$ 36
Foreign exchange contracts	35	Other income		Other income	
Total	$ 65		$ 317		$ 36
Six Months Ended June 30, 2009					
Commodity contracts	$ 712	Natural gas and oil sales	$ 613	Natural gas and oil sales	$ 90
Foreign exchange contracts	78	Other income		Other income	
Total	$ 790		$ 613		$ 90

(a) The amount of gain (loss) recognized in net income (loss) represents the ineffective portion of all our cash flow derivatives.

Based upon the market prices at June 30, 2009, we expect to transfer approximately $461 million (net of income taxes) of the gain included in the balance in accumulated other comprehensive income to net income (loss) during the next 12 months in the related month of production. All transactions hedged as of June 30, 2009 are expected to mature by December 31, 2022.

The following table presents the gain (loss) recognized in net income (loss) for derivatives not designated under SFAS 133: