CHESAPEAKE ENERGY CORP
Form 10-Q
November 09, 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 September 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** | **73-1395733** |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |

| | |
|---|---|
| **6100 North Western Avenue** | |
| **Oklahoma City, Oklahoma** | **73118** |
| (Address of principal executive offices) | (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 [ ] 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 November 4, 2009, there were 647,707,733 shares of our $0.01 par value common stock outstanding.

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**CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES**

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**PART I.**

**Financial Information**



**PART II.**

**Other Information**

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**CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES**

**CONDENSED CONSOLIDATED BALANCE SHEETS**

**(Unaudited)**

| | September 30, 2009 | December 31, 2008 (Adjusted) |
|---|---|---|
| | ($ in millions) | |
| **ASSETS** | | |
| **CURRENT ASSETS:** | | |
| Cash and cash equivalents | $ 520 | $ 1,749 |
| Accounts receivable, net | 1,298 | 1,324 |
| Short-term derivative instruments | 538 | 1,082 |
| Other | 152 | 137 |
| Total Current Assets | 2,508 | 4,292 |
| **PROPERTY AND EQUIPMENT:** | | |
| Natural gas and oil properties, at cost based on full-cost accounting: | | |
| Evaluated natural gas and oil properties | 33,513 | 28,965 |
| Unevaluated properties | 9,708 | 11,379 |
| Less: accumulated depreciation, depletion and amortization of natural gas and oil properties | (22,489) | (11,866) |
| Total natural gas and oil properties, at cost based on full-cost accounting | 20,732 | 28,478 |
| Other property and equipment: | | |
| Natural gas gathering systems and treating plants | 3,307 | 2,717 |
| Buildings and land | 1,656 | 1,513 |
| Drilling rigs and equipment | 610 | 430 |
| Natural gas compressors | 301 | 184 |
| Other | 538 | 482 |
| Less: accumulated depreciation and amortization of other property and equipment | (766) | (496) |
| Total other property and equipment | 5,646 | 4,830 |
| Total Property and Equipment | 26,378 | 33,308 |
| **OTHER ASSETS:** | | |
| Investments | 422 | 444 |
| Long-term derivative instruments | 89 | 261 |
| Other assets | 322 | 288 |
| Total Other Assets | 833 | 993 |
| **TOTAL ASSETS** | $ 29,719 | $ 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 BALANCE SHEETS (Continued)**

**(Unaudited)**

| | September 30, 2009 | December 31, 2008 (Adjusted) |
|---|---|---|
| | ($ in millions) | |
| **LIABILITIES AND EQUITY** | | |
| **CURRENT LIABILITIES:** | | |
| Accounts payable | $ 932 | $ 1,611 |
| Short-term derivative instruments | 28 | 66 |
| Accrued liabilities | 838 | 880 |
| Deferred income taxes | 172 | 358 |
| Income taxes payable | 1 | 108 |
| Revenues and royalties due others | 392 | 431 |
| Accrued interest | 151 | 167 |
| Total Current Liabilities | 2,514 | 3,621 |
| **LONG-TERM LIABILITIES:** | | |
| Long-term debt, net | 12,073 | 13,175 |
| Deferred income tax liabilities | 1,316 | 4,200 |
| Asset retirement obligations | 282 | 269 |
| Long-term derivative instruments | 256 | 111 |
| Other liabilities | 449 | 200 |
| Total Long-Term Liabilities | 14,376 | 17,955 |
| **CONTINGENCIES AND COMMITMENTS (Note 3)** | | |
| **EQUITY:** | | |
| Chesapeake 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 September 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 September 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 September 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 September 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 September 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, 645,273,711 and 607,953,437 shares issued at September 30, 2009 and December 31, 2008, respectively | 6 | 6 |
| Paid-in capital | 11,981 | 11,680 |
| Retained earnings (deficit) | (737) | 4,569 |
| | 274 | 267 |

| | | |
|---|---|---|
| Accumulated other comprehensive income (loss), net of tax of ($167) million and ($163) million, respectively | | |
| Less: treasury stock, at cost; 766,554 and 657,276 common shares as of September 30, 2009 and December 31, 2008, respectively | (12) | (10) |
| Total Chesapeake Stockholders Equity | 11,978 | 17,017 |
| Noncontrolling interest | 851 | |
| Total Equity | 12,829 | 17,017 |
| **TOTAL LIABILITIES AND EQUITY** | $ 29,719 | $ 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 September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2009 | 2008 (Adjusted) | 2009 | 2008 (Adjusted) |
| | ($ in millions except per share data) | | | |
| **REVENUES:** | | | | |
| Natural gas and oil sales | $ 1,187 | $ 6,408 | $ 3,681 | $ 5,587 |
| Marketing, gathering and compression sales | 575 | 1,038 | 1,660 | 2,934 |
| Service operations revenue | 49 | 45 | 139 | 127 |
| Total Revenues | 1,811 | 7,491 | 5,480 | 8,648 |
| **OPERATING COSTS:** | | | | |
| Production expenses | 218 | 239 | 670 | 658 |
| Production taxes | 25 | 87 | 71 | 250 |
| General and administrative expenses | 95 | 108 | 259 | 288 |
| Marketing, gathering and compression expenses | 546 | 1,014 | 1,569 | 2,864 |
| Service operations expense | 49 | 37 | 136 | 104 |
| Natural gas and oil depreciation, depletion and amortization | 295 | 480 | 1,037 | 1,518 |
| Depreciation and amortization of other assets | 62 | 48 | 177 | 124 |
| Impairment of natural gas and oil properties and other assets | 86 | | 9,721 | |
| Loss on sale of other property and equipment | 38 | | 38 | |
| Restructuring costs | | | 34 | |
| Total Operating Costs | 1,414 | 2,013 | 13,712 | 5,806 |
| **INCOME (LOSS) FROM OPERATIONS** | 397 | 5,478 | (8,232) | 2,842 |
| **OTHER INCOME (EXPENSE):** | | | | |
| Other income (expense) | (30) | (12) | (25) | (23) |
| Interest expense | (43) | (34) | (52) | (186) |
| Impairment of investments | | | (162) | |
| Loss on exchanges of Chesapeake debt | (17) | (31) | (19) | (31) |
| Total Other Income (Expense) | (90) | (77) | (258) | (240) |
| **INCOME (LOSS) BEFORE INCOME TAXES** | 307 | 5,401 | (8,490) | 2,602 |
| **INCOME TAX EXPENSE (BENEFIT):** | | | | |
| Current income taxes | | 193 | 1 | 196 |
| Deferred income taxes | 115 | 1,886 | (3,185) | 806 |
| Total Income Tax Expense (Benefit) | 115 | 2,079 | (3,184) | 1,002 |
| **NET INCOME (LOSS)** | 192 | 3,322 | (5,306) | 1,600 |
| Net income (loss) attributable to noncontrolling interest | | | | |

| | | | | |
|---|---|---|---|---|
| **NET INCOME (LOSS) ATTRIBUTABLE TO CHESAPEAKE** | 192 | 3,322 | (5,306) | 1,600 |
| Preferred stock dividends | (6) | (6) | (18) | (27) |
| Loss on conversion/exchange of preferred stock | | (25) | | (67) |
| **NET INCOME (LOSS) AVAILABLE TO CHESAPEAKE COMMON STOCKHOLDERS** | $ 186 | $ 3,291 | $ (5,324) | $ 1,506 |
| **EARNINGS (LOSS) PER COMMON SHARE:** | | | | |
| Basic | $ 0.30 | $ 5.94 | $ (8.78) | $ 2.88 |
| Assuming dilution | $ 0.30 | $ 5.62 | $ (8.78) | $ 2.76 |
| **CASH DIVIDEND DECLARED PER COMMON SHARE** | $ 0.075 | $ 0.075 | $ 0.225 | $ 0.2175 |
| **WEIGHTED AVERAGE COMMON AND COMMON EQUIVALENT SHARES OUTSTANDING (in millions):** | | | | |
| Basic | 619 | 554 | 606 | 523 |
| Assuming dilution | 626 | 588 | 606 | 557 |

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)**

| | Nine Months Ended September 30, 2009 | 2008 (Adjusted) |
|---|---|---|
| | ($ in millions) | |
| **CASH FLOWS FROM OPERATING ACTIVITIES:** | | |
| **NET INCOME (LOSS)** | $ (5,306) | $ 1,600 |
| **ADJUSTMENTS TO RECONCILE NET INCOME (LOSS) TO CASH PROVIDED BY OPERATING ACTIVITIES:** | | |
| Depreciation, depletion and amortization | 1,214 | 1,642 |
| Deferred income tax expense (benefit) | (3,185) | 806 |
| Impairments | 9,883 | |
| Loss on sale of other property and equipment | 38 | |
| Unrealized (gains) losses on derivatives | 295 | (89) |
| Realized (gains) losses on financing derivatives | (53) | 59 |
| Stock-based compensation | 104 | 100 |
| Accretion of discount on contingent convertible notes | 60 | 57 |
| Restructuring costs | 12 | |
| Loss from equity investments | 32 | 34 |
| Loss on exchanges of Chesapeake debt | 19 | 31 |
| Other | 8 | 5 |
| Change in assets and liabilities | 10 | 142 |
| Cash provided by operating activities | 3,131 | 4,387 |
| **CASH FLOWS FROM INVESTING ACTIVITIES:** | | |
| Exploration and development of natural gas and oil properties | (2,767) | (4,621) |
| Acquisitions of natural gas and oil companies, proved and unproved properties and leasehold, net of cash acquired | (1,371) | (7,691) |
| Proceeds from sales of volumetric production payments | 408 | 1,210 |
| Proceeds from divestitures of proved and unproved properties and leasehold | 1,321 | 4,666 |
| Additions to other property and equipment | (1,362) | (1,969) |
| Additions to investments | (40) | (61) |
| Proceeds from sale of drilling rigs and equipment | | 46 |
| Proceeds from sale of compressors | 68 | 114 |
| Proceeds from sale of other assets | 89 | 21 |
| Proceeds from sale of investments | | 2 |
| Cash used in investing activities | (3,654) | (8,283) |
| **CASH FLOWS FROM FINANCING ACTIVITIES:** | | |
| Proceeds from credit facilities borrowings | 5,563 | 12,831 |
| Payments on credit facilities borrowings | (7,866) | (11,307) |
| Proceeds from issuance of senior notes, net of offering costs | 1,346 | 2,136 |
| Proceeds from issuance of common stock, net of offering costs | | 2,598 |
| Cash paid to repurchase Chesapeake debt | | (312) |
| Cash paid for common stock dividends | (135) | (106) |

| | | |
|---|---|---|
| Cash paid for preferred stock dividends | (18) | (29) |
| Proceeds from sale of noncontrolling interest in midstream joint venture | 588 | |
| Derivative settlements | 19 | (146) |
| Net increase (decrease) in outstanding payments in excess of cash balance | (305) | 210 |
| Proceeds from mortgage of building | 54 | |
| Proceeds from financing of real estate surface assets | 145 | |
| Excess tax benefit from stock-based compensation | | 42 |
| Other | (97) | (58) |
| Cash provided (used in) by financing activities | (706) | 5,859 |
| Net increase (decrease) in cash and cash equivalents | (1,229) | 1,963 |
| Cash and cash equivalents, beginning of period | 1,749 | 1 |
| Cash and cash equivalents, end of period | $ 520 | $ 1,964 |

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)**

| | Nine Months Ended September 30, 2009 | Nine Months Ended September 30, 2008 (Adjusted) |
|---|---|---|
| | ($ in millions) | |
| **SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION OF CASH PAYMENTS FOR:** | | |
| Interest, net of $467 million and $390 million of capitalized interest, respectively | $ 111 | $ 133 |
| Income taxes, net of refunds received | $ 176 | $ 5 |
| **SUPPLEMENTAL SCHEDULE OF SIGNIFICANT NON-CASH INVESTING AND FINANCING ACTIVITIES:** | | |

As of September 30, 2009 and 2008, dividends payable on our common and preferred stock were $52 million and $48 million, respectively.

For the nine months ended September 30, 2009 and 2008, natural gas and oil properties were adjusted by a nominal amount and $13 million, respectively, for net income tax liabilities related to acquisitions.

For the nine months ended September 30, 2009 and 2008, natural gas and oil properties were adjusted by ($77) million and ($3) million, respectively, as a result of an increase (decrease) in accrued exploration and development costs.

For the nine months ended September 30, 2009 and 2008, other property and equipment were adjusted by ($31) million and $23 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 ($3) million and $6 million for the nine months ended September 30, 2009 and 2008, respectively, for asset retirement obligations.

We recorded non-cash asset additions to natural gas gathering systems of $3 million and $6 million for the nine months ended September 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.

During the nine months ended September 30, 2009, holders of our 2.25% Contingent Convertible Senior Notes due 2038 exchanged approximately $238 million in aggregate principal amount for an aggregate of 6,707,321 shares of our common stock in privately negotiated exchanges.

During the nine months ended September 30, 2009, we issued 24,822,832 shares of common stock, valued at $429 million, for the purchase of proved and unproved properties and leasehold pursuant to an acquisition shelf registration statement.

During the nine months ended September 30, 2008, holders of our 5.0% Cumulative Convertible Preferred Stock (Series 2005B) exchanged 3,654,385 shares for 10,443,642 shares of common stock in privately negotiated exchanges.

During the nine months ended September 30, 2008, a holder of our 4.5% Cumulative Convertible Preferred Stock exchanged 891,100 shares for 2,227,750 shares of common stock in a privately negotiated exchange.

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 EQUITY**

**(Unaudited)**

| | Nine Months Ended September 30, 2009 | 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 29 shares of 4.125% preferred stock | (3) | |
| Exchange of common stock for 0 and 891,100 shares of 4.50% preferred stock | | (89) |
| Exchange of common stock for 0 and 3,654,385 shares of 5.00% preferred stock (series 2005B) | | (366) |
| Balance, end of period | 466 | 505 |
| **COMMON STOCK:** | | |
| Balance, beginning of period | 6 | 5 |
| Issuance of 24,822,832 and 0 shares of common stock for the purchase of proved and unproved properties and leasehold | | |
| Issuance of 0 and 51,750,000 shares of common stock | | 1 |
| Exchange of 6,707,321 and 0 shares of common stock for convertible notes | | |
| Exchange of 1,422,425 and 12,673,135 shares of common stock for preferred stock | | |
| Balance, end of period | 6 | 6 |
| **PAID-IN CAPITAL:** | | |
| Balance, beginning of period | 11,680 | 7,532 |
| Issuance of 24,822,832 shares and 0 shares of common stock for the purchase of proved and unproved properties and leasehold | 420 | |
| Issuance of 0 and 51,750,000 shares of common stock | | 2,698 |
| Issuance of 2.25% contingent convertible senior notes due 2038 | | 345 |
| Exchange of 6,707,321 and 0 shares of common stock for convertible notes | 164 | |
| Exchange of 1,422,425 and 12,673,135 shares of common stock for preferred stock | 39 | 454 |
| Stock-based compensation | 140 | 124 |
| Exercise of stock options | 3 | 8 |
| Offering expenses | | (113) |
| Dividends on common stock | (138) | |
| Dividends on preferred stock | (17) | |
| Allocation of joint venture capital to Global Infrastructure Partners | (263) | |
| Tax benefit (reduction in tax benefit) from exercise of stock-based compensation | (47) | 42 |
| Balance, end of period | 11,981 | 11,090 |
| **RETAINED EARNINGS (DEFICIT):** | | |
| Balance, beginning of period | 4,569 | 4,145 |
| Net income (loss) | (5,306) | 1,600 |
| Dividends on common stock | | (115) |

| | | |
|---|---|---|
| Dividends on preferred stock | | (15) |
| Balance, end of period | (737) | 5,615 |
| **ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS):** | | |
| Balance, beginning of period | 267 | (11) |
| Hedging activity | (60) | 54 |
| Investment activity | 67 | 1 |
| Balance, end of period | 274 | 44 |
| **TREASURY STOCK COMMON:** | | |
| Balance, beginning of period | (10) | (6) |
| Purchase of 115,430 and 87,056 shares for company benefit plans | (2) | (3) |
| Release of 6,152 and 1,098 shares for company benefit plans | | |
| Balance, end of period | (12) | (9) |
| **TOTAL CHESAPEAKE STOCKHOLDERS EQUITY** | 11,978 | 17,251 |
| **NONCONTROLLING INTEREST:** | | |
| Sale of noncontrolling interest in midstream joint venture | 588 | |
| Allocation of joint venture capital to Global Infrastructure Partners | 263 | |
| Balance, end of period | 851 | |
| **TOTAL EQUITY** | $ 12,829 | $ 17,251 |

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 September 30, 2009 | Three Months Ended September 30, 2008 (Adjusted) | Nine Months Ended September 30, 2009 | Nine Months Ended September 30, 2008 (Adjusted) |
|---|---|---|---|---|
| | ($ in millions) | | | |
| Net income (loss) | $ 192 | $ 3,322 | $ (5,306) | $ 1,600 |
| Other comprehensive income (loss), net of income tax: | | | | |
| Change in fair value of derivative instruments, net of income taxes of $38 million, $728 million, $372 million and ($105) million | 62 | 1,187 | 609 | (170) |
| Reclassification of (gain) loss on settled contracts, net of income taxes of ($144) million, $65 million, ($377) million, and $117 million | (236) | 104 | (617) | 189 |
| Ineffective portion of derivatives qualifying for cash flow hedge accounting, net of income taxes of $2 million, ($29) million, ($31) million and $20 million | 5 | (46) | (52) | 34 |
| Unrealized (gain) loss on investments, net of income taxes of $4 million, ($16) million, $14 million and $1 million | 6 | (27) | 24 | 1 |
| Reclassification of loss on investments, net of income taxes of $0, $0, $26 million and $0 | | | 43 | |
| Comprehensive income (loss) attributable to Chesapeake stockholders | 29 | 4,540 | (5,299) | 1,654 |
| Comprehensive income attributable to noncontrolling interest | | | | |
| Comprehensive income (loss) | $ 29 | $ 4,540 | $ (5,299) | $ 1,654 |

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 condensed 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 nine months ended September 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 nine months ended September 30, 2009 (the Current Quarter and the Current Period , respectively) and the three and nine months ended September 30, 2008 (the Prior Quarter and the Prior Period , respectively). Any material subsequent events have been considered for disclosure through November 9, 2009, the filing date of this Form 10-Q.

*Change in Accounting Principle*

On January 1, 2009, we adopted and applied retrospectively the provisions of Accounting Standards Codification (ASC), 470-20 *Debt with Conversion and Other Options*. 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. Under SEC regulations, the excess above the ceiling is not expensed (or is reduced) if, subsequent to the end of the period, but prior to the release of the financial statements, natural gas and oil prices increase sufficiently such that an excess above the ceiling would have been eliminated (or reduced) if the increased prices were used in the calculations.

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 September 30, 2009, which consisted of swaps and collars, covered 126 bcfe and 74 bcfe in 2009 and 2010, 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 $3.30 per mcf and $70.21 per barrel, respectively, as of September 30, 2009, these cash flow hedges increased the full-cost ceiling by $968 million, thereby reducing any potential ceiling test write-down by the same amount before the effect of income taxes.

As of September 30, 2009, our ceiling test calculation indicated an impairment of our natural gas and oil properties of approximately $1.2 billion, net of tax. Based on natural gas and oil prices at November 4, 2009 of $4.49 per mcf and $80.64 per barrel, respectively, as well as the corresponding adjusted impact from our cash flow hedges of $738 million, we no longer had an impairment. Therefore, we were not required to record a write-down of our natural gas and oil properties under the full-cost method of accounting in the Current Quarter.

As of March 31, 2009, capitalized costs of natural gas and oil properties exceeded the estimated present value of future net revenues from our proved reserves, net of related income tax considerations, resulting in a write-down in the carrying value of natural gas and oil properties of $6.0 billion, net of tax.

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**CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

*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.

**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 our risk management objectives. As of September 30, 2009 and December 31, 2008, our natural gas and oil derivative instruments were comprised of the following types of instruments:

Swaps: Chesapeake receives a fixed price and pays a floating market price to the counterparty for the hedged commodity.

Collars: These instruments 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 put and the call strike price, no payments are due from either party. On occasion, we make a three-way collar by selling an additional put option with the collar in exchange for a more favorable strike price on the collar. This eliminates the counterparty s downside exposure below the second put option.

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.

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.

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 either party.

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 either party.

Basis protection swaps: These instruments are arrangements that guarantee a price differential to NYMEX for natural gas 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.

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**CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

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

| | September 30, 2009 | | December 31, 2008 | |
|---|---|---|---|---|
| | Volume Hedged | Fair Value ($ in millions) | Volume Hedged | Fair Value ($ in millions) |
| Natural gas (bbtu): | | | | |
| Fixed-price natural gas swaps | 192,026 | $ 344 | 466,800 | $ 863 |
| Fixed-price natural gas collars | 127,290 | 205 | 457,715 | 402 |
| Fixed-price natural gas knockout swaps | 95,010 | 53 | 532,660 | 141 |
| Natural gas call options | 522,165 | (125) | 551,555 | (178) |
| Natural gas put options | (82,200) | (43) | (73,000) | (39) |
| Natural gas basis protection swaps | 140,328 | (45) | 219,487 | 93 |
| Total natural gas | 994,619 | $ 389 | 2,155,217 | $ 1,282 |
| Oil (mbbls): | | | | |
| Fixed-price oil swaps | (230) | | (310) | 31 |
| Fixed-price oil collars | | | 730 | 5 |
| Fixed-price oil knockout swaps | 7,860 | 50 | 12,248 | 19 |
| Fixed-price oil cap-swaps | | | 362 | 3 |
| Oil call options | 11,515 | (55) | 19,355 | (35) |
| Total oil | 19,145 | $ (5) | 32,385 | $ 23 |
| Total estimated fair value[a] | | $ 384 | | $ 1,305 |

(a) After adjusting for $392 million and $736 million of unrealized premiums, the value to be realized for these derivatives as of September 30, 2009 and December 31, 2008 was $776 million and $2.041 billion, respectively.

Pursuant to ASC 815, certain derivatives qualify for designation as cash flow hedges. Following these provisions, 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 as the physical transactions being hedged occur. Any change in fair value resulting from ineffectiveness is currently recognized in natural gas and oil sales as unrealized gains (losses). 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 natural gas and oil sales. Realized gains (losses) are included in natural gas and oil sales in the month of related production.

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. 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 ASC 815. 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 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.

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CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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 September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2009 | 2008 | 2009 | 2008 |
| | ($ in millions) | | | |
| Natural gas and oil sales | $ 785 | $ 2,036 | $ 2,280 | $ 5,961 |
| Realized gains (losses) on natural gas and oil derivatives | 687 | (246) | 1,802 | (454) |
| Unrealized gains (losses) on non-qualifying natural gas and oil derivatives | (278) | 4,543 | (484) | 134 |
| Unrealized gains (losses) on ineffectiveness of cash flow hedges | (7) | 75 | 83 | (54) |
| Total natural gas and oil sales | $ 1,187 | $ 6,408 | $ 3,681 | $ 5,587 |

Based upon the market prices at September 30, 2009, we expect to transfer approximately $340 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 September 30, 2009 are expected to mature by December 31, 2022.

We began 2009 with six secured hedging facilities, each of which permitted 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 of the facilities were collateralized by certain of our natural gas and oil properties that did not secure any of our other obligations. On June 11, 2009, we entered into a multi-counterparty hedge facility with 13 counterparties that have committed to provide approximately 3.9 tcfe of trading capacity and an aggregate mark-to-market capacity of $10.4 billion under the terms of the facility. The new multi-counterparty facility was intended to consolidate and replace the six secured hedge facilities. As of September 30, 2009, there were trades outstanding on three of the six secured hedge facilities with a fair value of $86 million, and trades covering 122.9 bcfe had been novated into the multi-counterparty facility. As of November 6, 2009, all remaining trades had been novated and pledged collateral transferred to the multi-counterparty facility, resulting in 905.7 bcfe hedged and collateral value of approximately $4.1 billion. These trades 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 multi-counterparty facility allows us to enter into cash-settled natural gas and oil price and basis hedges with the counterparties. Our obligations under the multi-counterparty facility are 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 corporate revolving bank credit facility and indentures. The counterparties obligations under the facility must 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 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.

**CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

To mitigate our exposure to the fluctuation in prices of diesel fuel which is used in our exploration and development activities, we have entered into diesel swaps from October 2009 to March 2010 for a total of 19,800,000 gallons with an average fixed price of $1.58 per gallon. Chesapeake pays the fixed price and receives floating price. The fair value of these swaps as of September 30, 2009 was an asset of $6 million.

*Interest Rate Derivatives*

To mitigate our exposure to volatility in interest rates related to our senior notes and bank credit facilities, we enter into interest rate derivatives. As of September 30, 2009 and December 31, 2008, our interest rate derivative instruments were comprised of the following types of instruments:

Swaps: Chesapeake enters into fixed-to-floating interest rate swaps (we receive a fixed interest rate and pay a floating market rate) to mitigate our exposure to changes in the fair value of our senior notes. We enter into floating-to-fixed interest rate swaps (we receive a floating market rate and pay a fixed interest rate) to manage our interest rate exposure related to our bank credit facilities borrowings.

Collars: These instruments contain a fixed floor rate (floor) and a ceiling rate (cap). If the floating rate is above the cap, we have a net receivable from the counterparty and if the floating rate is below the floor, we have a net payable to the counterparty. If the floating rate is between the floor and the cap, there is no payment due from either party. Collars are used to manage our interest rate exposure related to our bank credit facilities borrowings.

Call options: Occasionally we sell call options for a premium when we think it is more likely that the option will expire unexercised. The option allows the counterparty to terminate an open swap at a specific date.

Swaptions: Occasionally we sell an option to a counterparty for a premium which allows the counterparty to enter into a swap with us on a specific date.

The notional amount of debt hedged and the estimated fair value of our interest rate derivatives outstanding as of September 30, 2009 and December 31, 2008 are provided below.

| | September 30, 2009 | | December 31, 2008 | |
|---|---|---|---|---|
| | Notional Amount | Fair Value | Notional Amount | Fair Value |
| | ($ in millions) | | | |
| Interest rate | | | | |
| Swaps | $ 3,325 | $ (74) | $ 1,575 | $ 88 |
| Collars | 250 | (8) | 800 | (35) |
| Call options | 250 | (9) | 750 | (105) |
| Swaptions | | | 750 | (10) |
| Totals | $ 3,825 | $ (91) | $ 3,875 | $ (62) |

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**CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

For interest rate derivative instruments designated as fair value hedges (in accordance with ASC 815), 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 currently reported in the condensed consolidated statements of operations as unrealized gains (losses) within interest expense.

Gains or losses from interest rate derivative transactions are reflected as adjustments to interest expense in the condensed consolidated statements of operations. The components of interest expense for the Current Quarter, the Prior Quarter, the Current Period and the Prior Period are presented below.

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2009 | 2008 | 2009 | 2008 |
| | ($ in millions) | | | |
| Interest expense on senior notes | $ 195 | $ 171 | $ 572 | $ 472 |
| Interest expense on credit facilities | 18 | 23 | 47 | 83 |
| Capitalized interest | (153) | (166) | (467) | (390) |
| Realized (gains) losses on interest rate derivatives | (7) | 5 | (19) | 1 |
| Unrealized (gains) losses on interest rate derivatives | (20) | (8) | (106) | (9) |
| Amortization of loan discount and other | 10 | 9 | 25 | 29 |
| Total interest expense | $ 43 | $ 34 | $ 52 | $ 186 |

Our qualifying interest rate swaps are considered 100% effective and therefore no ineffectiveness was recorded for the periods presented above.

Gains and losses related to terminated qualifying interest rate derivative transactions will be amortized as an adjustment to interest expense over the remaining term of the related senior notes. Over the next eleven years we will be realizing $109 million in gains related to such trades.

*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 ASC 815. The fair value of the cross currency swap is recorded on the condensed consolidated balance sheet as an asset of $44 million at September 30, 2009. The euro-denominated debt in notes payable has been adjusted to $878 million at September 30, 2009 using an exchange rate of $1.4630 to 1.00.

*Additional Disclosures About Derivative Instruments and Hedging Activities*

In accordance with ASC 815 and ASC 210, 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. Derivative instruments reflected as current in the condensed consolidated balance sheet represent the estimated fair value of derivatives scheduled to settle over the next twelve months based on market prices/rates as of the balance sheet date. The derivative settlement amounts are not due until the month in which the related underlying hedged transaction occurs.

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**CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

Pursuant to ASC 815, the following table sets forth the fair value of each classification of derivative instrument as of September 30, 2009 on a gross basis without regard to same-counterparty netting:

| | September 30, 2009 Balance Sheet Location | Fair Value ($ in millions) |
|---|---|---|
| **ASSET DERIVATIVES:** | | |
| Derivatives designated as hedging instruments under ASC 815: | | |
| Commodity contracts | Short-term derivative instruments | $ 378 |
| Commodity contracts | Long-term derivative instruments | 25 |
| Foreign exchange contracts | Long-term derivative instruments | 44 |
| Total | | 447 |
| Derivatives not designated as hedging instruments under ASC 815: | | |
| Commodity contracts | Short-term derivative instruments | 237 |
| Commodity contracts | Long-term derivative instruments | 51 |
| Interest rate contracts | Long-term derivative instruments | 10 |
| Total | | 298 |
| **LIABILITY DERIVATIVES:** | | |
| Derivatives designated as hedging instruments under ASC 815: | | |
| Commodity contracts | Short-term derivative instruments | (5) |
| Interest rate contracts | Long-term derivative instruments | (30) |
| Total | | (35) |
| Derivatives not designated as hedging instruments under ASC 815: | | |
| Commodity contracts | Short-term derivative instruments | (73) |
| Commodity contracts | Long-term derivative instruments | (223) |
| Interest rate contracts | Short-term derivative instruments | (27) |
| Interest rate contracts | Long-term derivative instruments | (44) |
| Total | | (367) |
| Total derivative instruments | | $ 343 |

A consolidated summary of the effect of derivative instruments on the condensed consolidated statements of operations for the three and nine months ended September 30, 2009 is provided below, separating fair value, cash flow and non-qualifying derivatives (as defined by ASC 815).

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

| Fair Value Derivatives | Location of Gain (Loss) | Three Months Ended September 30, 2009 | Nine Months Ended September 30, 2009 |
|---|---|---|---|
| Interest rate contracts | Interest expense[(a)] | $ 13 | $ 31 |

(a) Interest expense on the hedged items for the Current Quarter and the Current Period was $33 million and $66 million, respectively, which is included in interest expense on the condensed consolidated statement of operations.

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CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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 designated as cash flow derivatives ($ in millions):

| Cash Flow Derivatives | Location of Gain (Loss) | Three Months Ended September 30, 2009 | Nine Months Ended September 30, 2009 |
|---|---|---|---|
| Gain (Loss) Recognized in AOCI (Effective Portion) | | | |
| Commodity contracts | AOCI | $ 107 | $ 819 |
| Foreign exchange contracts | AOCI | 1 | 79 |
| | | $ 108 | $ 898 |
| Gain (Loss) Reclassified from AOCI (Effective Portion) | | | |
| Commodity contracts | Natural gas and oil sales | $ 381 | $ 994 |
| Foreign exchange contracts | Other income | | |
| | | $ 381 | $ 994 |
| Gain (Loss) Recognized (Ineffective Portion)[a] | | | |
| Commodity contracts | Natural gas and oil sales | $ (7) | $ 83 |
| Foreign exchange contracts | Other income | | |
| | | $ (7) | $ 83 |

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

The following table presents the gain (loss) recognized in net income (loss) for instruments not qualifying as cash flow or fair value derivatives ($ in millions):

| Non-Qualifying Derivatives | Location of Gain (Loss) | Three Months Ended September 30, 2009 | Nine Months Ended September 30, 2009 |
|---|---|---|---|
| Commodity contracts | Natural gas and oil sales | $ 28 | $ 324 |
| Interest rate contracts | Interest expense | 14 | 94 |
| | Total | $ 42 | $ 418 |

*Concentration of Credit Risk*

A significant portion of our liquidity is concentrated in derivative instruments that enable us to hedge a portion of our exposure to natural gas and oil price and interest rate volatility. These arrangements expose us to credit risk from our counterparties. To mitigate this risk, we enter into derivative contracts only with investment-grade rated counterparties deemed by management to be competent and competitive market makers, and we attempt to limit our exposure to non-performance by any single counterparty. On September 30, 2009, our commodity and interest rate derivative instruments were spread among 14 counterparties. Additionally, our multi-counterparty secured hedging facility described above requires our counterparties to secure their natural gas and oil hedging obligations in excess of defined thresholds. We now use this facility for all of our commodity hedging.

Other financial instruments which potentially subject us to concentrations of credit risk consist principally of investments in equity instruments and accounts receivable. Our accounts receivable are primarily from purchasers of natural gas and oil and exploration and production companies which own interests in properties we operate. This industry concentration has the potential to impact our overall exposure to credit risk, either positively or negatively, in that our customers may be similarly affected by changes in economic, industry or other conditions. We monitor the creditworthiness of all our counterparties. We generally require letters of credit for receivables from customers which are judged to have sub-standard credit, unless the credit risk can otherwise be mitigated. During the Current Quarter and the Current Period, we recognized a nominal amount and $13 million, respectively, of bad debt expense related to potentially uncollectible receivables.

**CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

**3. Contingencies and Commitments**

*Litigation*

On February 25, 2009, a putative class action was filed in the U.S. District Court for the Southern District of New York against the company and certain of its officers and directors along with certain underwriters of the company s July 2008 common stock offering. Following the appointment of a lead plaintiff and counsel, the plaintiff filed an amended complaint on September 11, 2009 alleging that the registration statement for the offering contained material misstatements and omissions and seeking damages under Sections 11, 12 and 15 of the Securities Act of 1933 of an unspecified amount and rescission. The action was transferred to the U.S. District Court for the Western District of Oklahoma on October 13, 2009. A derivative action was also filed in the District Court of Oklahoma County, Oklahoma on March 10, 2009 against the company s directors and certain of its officers alleging breaches of fiduciary duties relating to the disclosure matters alleged in the securities case.

On March 26, 2009, a shareholder filed a petition in the District Court of Oklahoma County, Oklahoma seeking to compel inspection of company books and records relating to compensation of the company s CEO. On August 20, 2009, the court denied the inspection demand, dismissed the petition and entered judgment in favor of Chesapeake. The shareholder is appealing the court s ruling.

Three derivative actions were filed in the District Court of Oklahoma County, Oklahoma on April 28, May 7, and May 20, 2009 against the company s directors alleging breaches of fiduciary duties relating to compensation of the company s CEO and alleged insider trading, among other things, and seeking unspecified damages, equitable relief and disgorgement. These three derivative actions were consolidated and a Consolidated Derivative Shareholder Petition was filed on June 23, 2009. Chesapeake is named as a nominal defendant. Chesapeake filed a motion to dismiss the petition on August 7, 2009. The court has not set a date to hear the motion.

It is inherently difficult to predict the outcome of litigation, and we are currently unable to estimate the amount of any potential liabilities associated with the foregoing cases, which are all in preliminary stages.

Chesapeake is also involved in various other lawsuits and disputes incidental to its business operations, including commercial disputes, personal injury claims, claims for underpayment of royalties, property damage claims and contract actions. With regard to the latter, several mineral or leasehold owners have filed lawsuits against us seeking specific performance to require us to acquire their oil and natural gas interests and pay acreage bonus payments, damages based on breach of contract and/or, in certain cases, punitive damages based on alleged fraud. The company has satisfactorily resolved several of the suits but some remain pending. The remaining leasehold acquisition cases are in various stages of discovery. The company believes that it has substantial defenses to the claims made in all these cases.

The company records an associated liability when a loss is probable and the amount is reasonably estimable. Although the outcome of litigation cannot be predicted with certainty, management is of the opinion that no pending or threatened lawsuit or dispute incidental to its business operations is likely to have a material adverse effect on the company s consolidated financial position, results of operations or cash flows. The final resolution of such matters could exceed amounts accrued, however, and actual results could differ materially from management s estimates.

*Employment Agreements with Officers*

Chesapeake has employment agreements with its chief executive officer, chief operating officer, chief financial officer and other executive officers, which provide for annual base salaries, various benefits and eligibility for bonus compensation. The agreement with the chief executive officer expires on December 31, 2013 unless extended. The term of the agreement is automatically extended for one additional year on each December 31 unless the company provides 30 days notice of non-extension. The agreement contains a cap on cash salary and bonus compensation for the next five years at 2008 levels. In the event of termination of employment without cause, the chief executive officer s base compensation (defined as base salary plus bonus compensation received during the preceding 12 months) and benefits would continue during the remaining term of the agreement. The chief executive officer is entitled to receive a payment in the amount of three times his base compensation upon the happening of certain events following a change of control. The agreement further provides that any stock-based awards held by the chief executive officer and deferred compensation will immediately become 100% vested upon termination of employment without cause, incapacity, death or retirement at or after age 55. The agreement also provides for a one-time $75 million well cost incentive award with a five-year clawback. The well cost incentive award was fully applied against the CEO s obligations under the Founder Well Participation Program as of March 31, 2009. The

**CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

agreements with the chief operating officer, chief financial officer and other executive officers expire on September 30, 2012. The agreements with our COO, CFO and other executive vice presidents contain a cap on cash salary for the three-year term of the agreement. In addition, annual cash bonuses will not exceed the sum of the individual EVP s cash bonus compensation for (a) the last half of 2008 and (b) the first half of 2009. These agreements provide for the continuation of salary for one year in the event of termination of employment without cause or death and, in the event of a change of control, a payment in the amount of two times the executive officer s base compensation. These executive officers are entitled to receive a lump sum payment equal to 26 weeks of cash salary following termination of employment as a result of incapacity. Any stock-based awards held by such executive officers will immediately become 100% vested upon termination of employment without cause, a change of control, death or retirement at or after age 55. The agreements also provide for a 2008 incentive award payable in four equal annual installments, the first of which was paid on September 30, 2009. The payment of each installment of the award is subject to the individual s continued employment on the date of payment, except that the unpaid installments of the award would be accelerated and paid in lump sum in the event of a change of control or a termination by the executive for good reason, as defined in the agreements.

*Environmental Risk*

Due to the nature of the natural gas and oil business, Chesapeake and its subsidiaries are exposed to possible environmental risks. Chesapeake has implemented various policies and procedures to avoid environmental contamination and risks from environmental contamination. Chesapeake conducts periodic reviews, on a company-wide basis, to identify changes in our environmental risk profile. These reviews evaluate whether there is a contingent liability, its amount, and the likelihood that the liability will be incurred. The amount of any potential liability is determined by considering, among other matters, incremental direct costs of any likely remediation and the proportionate cost of employees who are expected to devote a significant amount of time directly to any possible remediation effort. We manage our exposure to environmental liabilities on properties to be acquired by identifying existing problems and assessing the potential liability. Depending on the extent of an identified environmental problem, Chesapeake may exclude a property from the acquisition, require the seller to remediate the property to our satisfaction, or agree to assume liability for the remediation of the property. Chesapeake has historically not experienced any significant environmental liability, and is not aware of any potential material environmental issues or claims at September 30, 2009.

*Rig Leases*

In a series of transactions in 2006, 2007 and 2008, our drilling subsidiaries sold 83 drilling rigs and related equipment for $677 million and entered into a master lease agreement under which we agreed to lease the rigs from the buyer for initial terms of seven to ten years for lease payments of approximately $95 million annually. The lease obligations are guaranteed by Chesapeake and its other material restricted subsidiaries. These transactions were recorded as sales and operating leasebacks and any related gain or loss is being amortized to service operations expense over the lease term. Under the rig leases, we can exercise an early purchase option after six or seven years or on the expiration of the lease term for a purchase price equal to the then fair market value of the rigs. Additionally, we have the option to renew the rig lease for a negotiated renewal term at a periodic lease payment equal to the fair market rental value of the rigs as determined at the time of renewal. Commitments related to rig lease payments are not recorded in the accompanying condensed consolidated balance sheets. As of September 30, 2009, the minimum aggregate future rig lease payments were approximately $539 million. As of September 30, 2009, Chesapeake s drilling subsidiary had committed to acquire one rig by the end of 2009 and had incurred costs of $9 million as of that date. The total remaining cost of the rig is estimated to be approximately $5 million. Our intent is to sell and lease back owned rigs when acceptable leasing arrangements are available to us.

*Compressor Leases*

In a series of transactions in 2007, 2008 and 2009, our compression subsidiary sold a significant portion of its compressor fleet, consisting of 1,685 compressors, for $372 million and entered into a master lease agreement. The term of the agreement varies by buyer ranging from seven to ten years for aggregate lease payments of approximately $47 million annually. The lease obligations are guaranteed by Chesapeake and its other material restricted subsidiaries. These transactions were recorded as sales and operating leasebacks and any related gain or loss is being amortized to marketing, gathering and compression expenses over the lease term. Under the leases, we can exercise an early purchase option after five to nine years or we can purchase the compressors at expiration of the lease for the fair market value at the time. In addition, we have the option to renew the lease for negotiated new terms at the expiration of the lease. Commitments related to compressor lease payments are not recorded in the accompanying condensed consolidated balance sheets. As of September 30, 2009, the minimum aggregate future

**CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

compressor lease payments were approximately $355 million. As of September 30, 2009, 218 new compressors were on order for approximately $92 million. Our intent is to sell and lease back owned compressors when acceptable leasing arrangements are available to us.

*Real Estate Surface Asset Leases*

In April 2009, we financed 113 real estate surface assets in the Barnett Shale area in and around Fort Worth, Texas for approximately $145 million and entered into a 40-year master lease agreement under which we agreed to lease the sites for approximately $15 million to $27 million annually. These lease transactions were recorded as a financing lease and the cash received was recorded with an offsetting long-term liability on the condensed consolidated balance sheet. As of September 30, 2009, the minimum aggregate future lease payments were approximately $862 million. Chesapeake has the option to repurchase up to a specified number of assets at any time during the term of the lease.

*Transportation Contracts*

Chesapeake has various firm pipeline transportation service agreements with expiration dates ranging from 2009 to 2099. These commitments are not recorded in the accompanying condensed consolidated balance sheets. Under the terms of these contracts, we are obligated to pay demand charges as set forth in the transporter s Federal Energy Regulatory Commission (FERC) gas tariff. In exchange, the company receives rights to flow natural gas production through pipelines located in highly competitive markets. The aggregate amounts of such required demand payments as of September 30, 2009, excluding demand charges for pipeline projects that are currently seeking regulatory approval, were as follows ($ in millions):

| | | |
|---|---|---|
| 2009 | $ | 60 |
| 2010 | | 231 |
| 2011 | | 251 |
| 2012 | | 240 |
| 2013 | | 222 |
| After 2013 | | 1,278 |
| Total | $ | 2,282 |

*Drilling Contracts*

Currently, Chesapeake has contracts with various drilling contractors to lease approximately 20 rigs with terms of one to three years. These commitments are not recorded in the accompanying condensed consolidated balance sheets. As of September 30, 2009, the aggregate drilling rig commitment was approximately $175 million.

*Natural Gas and Oil Purchase Obligations*

Our midstream segment regularly commits to purchase natural gas from other owners in our properties and such commitments typically are short-term in nature. We have also committed to purchasers of our volumetric production payment transactions (VPPs) that we will purchase natural gas and oil associated with the VPPs. Our VPP purchase commitments are based on market prices at the time of production and extend over 11 to 15 year terms. As of September 30, 2009, we were obligated to purchase 468 bcfe under the terms of the VPPs. We resell the natural gas and oil we purchase at market prices.

*Other Commitments*

In the Current Period, we financed one of our buildings for approximately $54 million with a five-year term loan which has a floating rate of prime plus 275 basis points. At our option, we may prepay in full without penalty beginning in year four. The payment obligation is guaranteed by Chesapeake.

We own a 49% interest in Mountain Drilling Company, a company that specializes in hydraulic drilling rigs which are designed for drilling in urban areas. Due to a meaningful decline in the overall activity in the drilling market and poor operating performance of Mountain Drilling Company, we determined that an impairment had occurred and we fully impaired our investment at March 31, 2009. Chesapeake has an agreement to lend Mountain Drilling Company up to $19 million. At September 30, 2009, Mountain Drilling owed Chesapeake $19 million under this agreement.

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CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES

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(Unaudited)

We invested in Ventura Refining and Transmission LLC in early 2007 in an effort to improve the market for our oil and condensate production in western Oklahoma. Due to worsening economic conditions, the lack of third party credit available to Ventura and poor operating performance in the second half of 2008, management determined that an impairment had occurred and we wrote off our investment at December 31, 2008. During the Current Period, we paid an additional $17 million to fund various costs associated with Ventura s operations. These payments were expensed as incurred.

**4. Net Income Per Share**

ASC 260, *Earnings Per Share*, requires presentation of basic and diluted earnings per share, as defined, on the face of the statements of operations for all entities with complex capital structures. ASC 260 requires a reconciliation of the numerator and denominator of the basic and diluted EPS computations. The following securities and associated adjustments to net income comprised of dividends and loss on conversions/exchanges were not included in the calculation of diluted earnings per share, as the effect was antidilutive:

| | Shares (in millions) | Net Income Adjustments ($ in millions) |
|---|---|---|
| **Three Months Ended September 30, 2009:** | | |
| Common stock equivalent of our preferred stock outstanding: | | |
| 5.00% cumulative convertible preferred stock (series 2005) | | $ |
| 5.00% cumulative convertible preferred stock (series 2005B) | 5 | $ 3 |
| 4.50% cumulative convertible preferred stock | 6 | $ 3 |
| **Three Months Ended September 30, 2008:** | | |
| Common stock equivalent of our preferred stock outstanding prior to conversion: | | |
| 5.00% cumulative convertible preferred stock (series 2005B) | 1 | $ 13 |
| 4.50% cumulative convertible preferred stock | 1 | $ 12 |
| **Nine Months Ended September 30, 2009:** | | |
| Employee stock options | 1 | $ |
| Restricted stock | 5 | $ |
| Common stock equivalent of our preferred stock outstanding: | | |
| 5.00% cumulative convertible preferred stock (series 2005) | | $ |
| 5.00% cumulative convertible preferred stock (series 2005B) | 5 | $ 8 |
| 4.50% cumulative convertible preferred stock | 6 | $ 9 |
| Common stock equivalent of our preferred stock outstanding prior to conversion: | | |
| 4.125% cumulative convertible preferred stock | | $ |
| 6.25% mandatory convertible preferred stock | 1 | $ 1 |
| **Nine Months Ended September 30, 2008:** | | |
| Common stock equivalent of our preferred stock outstanding prior to conversion: | | |
| 5.00% cumulative convertible preferred stock (series 2005B) | 5 | $ 62 |
| 4.50% cumulative convertible preferred stock | 2 | $ 14 |

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**CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

For the Current Period there was no difference between basic weighted average shares outstanding, which are used in computing basic EPS, and diluted weighted average shares, which are used in computing EPS assuming dilution as a result of the net loss to common stockholders.

Reconciliations for the Current Quarter, Prior Quarter and Prior Period are as follows:

| | Income (Numerator) | Shares (Denominator) | Per Share Amount |
|---|---|---|---|
| | | (in millions, except per share data) | |
| **Three Months Ended September 30, 2009:** | | | |
| Basic EPS: | | | |
| Income available to Chesapeake common stockholders | $ 186 | 619 | $ 0.30 |
| **Effect of Dilutive Securities** | | | |
| Employee stock options | | 1 | |
| Restricted stock | | 6 | |
| **Diluted EPS income available to Chesapeake common stockholders and assumed conversions** | $ 186 | 626 | $ 0.30 |
| **Three Months Ended September 30, 2008:** | | | |
| Basic EPS: | | | |
| Income available to Chesapeake common stockholders | $ 3,291 | 554 | $ 5.94 |
| **Effect of Dilutive Securities** | | | |
| Assumed conversion as of the beginning of the period of preferred shares outstanding during the period: | | | |
| Common shares assumed issued for 4.50% cumulative convertible preferred stock | 3 | 6 | |
| Common shares assumed issued for 5.00% cumulative convertible preferred stock (series 2005B) | 3 | 5 | |
| Common shares assumed issued for 6.25% mandatory convertible preferred stock | | 1 | |
| Effect of contingent convertible senior notes outstanding during the period | 9 | 13 | |
| Employee stock options | | 2 | |
| Restricted stock | | 7 | |
| **Diluted EPS income available to Chesapeake common stockholders and assumed conversions** | $ 3,306 | 588 | $ 5.62 |
| **Nine Months Ended September 30, 2008:** | | | |
| Basic EPS: | | | |
| Income available to Chesapeake common stockholders | $ 1,506 | 523 | $ 2.88 |

| | | | |
|---|---|---|---|
| **Effect of Dilutive Securities** | | | |
| Assumed conversion as of the beginning of the period of preferred shares outstanding during the period: | | | |
| Common shares assumed issued for 4.50% cumulative convertible preferred stock | 8 | 6 | |
| Common shares assumed issued for 5.00% cumulative convertible preferred stock (series 2005B) | 8 | 5 | |
| Common shares assumed issued for 6.25% mandatory convertible preferred stock | 2 | 1 | |
| Effect of contingent convertible senior notes outstanding during the period | 12 | 13 | |
| Employee stock options | | 2 | |
| Restricted stock | | 7 | |
| **Diluted EPS income available to Chesapeake common stockholders and assumed conversions** | $ 1,536 | 557 | $ 2.76 |

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**CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

**5.**