CHESAPEAKE ENERGY CORP
Form 10-Q/A
September 18, 2003
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q/A

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended June 30, 2003

¨ **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	**73118**

Oklahoma City, Oklahoma	
(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 is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). YES x NO ¨

At August 11, 2003, there were 216,057,569 shares of our $0.01 par value common stock outstanding.

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AMENDMENT NO. 1

EXPLANATORY NOTE

As described in Note 11 to the Condensed Consolidated Financial Statements, Chesapeake Energy Corporation has reclassified certain amounts previously reported Condensed Consolidated Statement of Operations and has made the corresponding revisions to the Notes to Consolidated Financial Statements for the three and six months ended June 30, 2003 and 2002. The revisions had no effect on previously reported net income or net income per share.

Corresponding changes resulting from these revisions of classifications in the financial statements were also made to Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations and Item 3. Quantitative and Qualitative Disclosures About Market Risk .

In light of the refiling of this report for the purpose of revising the financial statements, we have also revised other disclosures from the original filing in response to comments of the staff of the Securities and Exchange Commission.

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CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

	June 30, 2003	December 31, 2002
	($ in thousands)	
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 35,909	$ 247,637
Restricted cash		82
Accounts receivable:		
Oil and gas sales	190,453	109,246
Joint interest, net of allowance of $2,644,000 and $1,433,000, respectively	24,973	22,760
Short-term derivatives	342	16,498
Related parties	3,853	2,155
Other	27,647	13,471
Deferred income tax asset	6,479	8,109
Short-term derivative instruments	31,331	
Inventory and other	12,480	15,359
Total Current Assets	333,467	435,317
PROPERTY AND EQUIPMENT:		
Oil and gas properties, at cost based on full cost accounting:		
Evaluated oil and gas properties	5,575,048	4,334,833
Unevaluated properties	177,837	72,506
Less: accumulated depreciation, depletion and amortization	(2,280,690)	(2,123,773)
	3,472,195	2,283,566
Other property and equipment	175,817	154,092
Less: accumulated depreciation and amortization	(52,846)	(47,774)
Total Property and Equipment	3,595,166	2,389,884
OTHER ASSETS:		
Deferred income tax asset		2,071
Long-term derivative instruments	24,873	2,666
Long-term investments	29,075	9,075
Other assets	30,779	36,595
Total Other Assets	84,727	50,407
TOTAL ASSETS	$ 4,013,360	$ 2,875,608
LIABILITIES AND STOCKHOLDERS EQUITY		

CURRENT LIABILITIES:		
Accounts payable	$ 128,579	$ 86,001
Accrued interest	47,787	35,025
Derivative payable	2,296	
Short-term derivative instruments	42,384	33,697
Other accrued liabilities	83,665	56,465
Revenues and royalties due others	111,160	54,364
Total Current Liabilities	415,871	265,552
OTHER LIABILITIES:		
Long-term debt, net	1,968,447	1,651,198
Revenues and royalties due others	14,882	13,797
Long-term derivative instruments	3,442	30,174
Asset retirement obligation	44,699	
Other liabilities	10,479	7,012
Deferred income taxes payable	92,068	
Total Other Liabilities	2,134,017	1,702,181
CONTINGENCIES AND COMMITMENTS (Note 3)		
STOCKHOLDERS EQUITY:		
Preferred Stock, $0.01 par value, 10,000,000 shares authorized, 6.75% cumulative convertible preferred stock, 2,998,000 shares issued and outstanding at June 30, 2003 and December 31, 2002, entitled in liquidation to $149.9 million	149,900	149,900
6.00% cumulative convertible preferred stock, 4,600,000 and 0 shares issued and outstanding at June 30, 2003 and December 31, 2002, entitled in liquidation to $230.0 million	230,000	
Common Stock, $.01 par value, 350,000,000 shares authorized, 220,933,661 and 194,936,912 shares issued at June 30, 2003 and December 31, 2002, respectively	2,209	1,949
Paid-in capital	1,387,352	1,205,554
Accumulated deficit	(296,644)	(426,085)
Accumulated other comprehensive income (loss), net of tax of $(7,812,000) and $2,307,000, respectively	12,746	(3,461)
Less: treasury stock, at cost; 5,071,571 and 4,792,529 common shares at June 30, 2003 and December 31, 2002, respectively	(22,091)	(19,982)
Total Stockholders Equity	1,463,472	907,875
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 4,013,360	$ 2,875,608

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,	
	2003	**2002**	**2003**	**2002**
	($ in thousands, except per share data) (Revised Note 11)			
REVENUES:				
Oil and gas sales	$ 319,519	$ 150,905	$ 605,538	$ 213,561
Oil and gas marketing sales	110,296	42,785	200,604	70,118
Total Revenues	429,815	193,690	806,142	283,679
OPERATING COSTS:				
Production expenses	34,263	24,242	65,720	46,302
Production taxes	17,101	7,911	35,698	13,127
General and administrative	6,000	3,859	11,665	8,153
Oil and gas marketing expenses	106,857	41,181	196,215	67,688
Oil and gas depreciation, depletion and amortization	91,570	50,778	168,184	99,397
Depreciation and amortization of other assets	4,122	3,652	7,806	6,762
Total Operating Costs	259,913	131,623	485,288	241,429
INCOME FROM OPERATIONS	169,902	62,067	320,854	42,250
OTHER INCOME (EXPENSE):				
Interest and other income	781	3,992	1,544	5,537
Interest expense	(38,036)	(24,067)	(75,040)	(51,180)
Loss on repurchases of Chesapeake debt		(273)		(864)
Total Other Income (Expense)	(37,255)	(20,348)	(73,496)	(46,507)
INCOME (LOSS) BEFORE INCOME TAX AND CUMULATIVE EFFECT OF ACCOUNTING CHANGE	132,647	41,719	247,358	(4,257)
INCOME TAX EXPENSE (BENEFIT):				
Current				
Deferred	50,407	16,686	93,998	(1,704)
Total Income Tax Expense (Benefit)	50,407	16,686	93,998	(1,704)
NET INCOME (LOSS) BEFORE CUMULATIVE EFFECT OF ACCOUNTING CHANGE	82,240	25,033	153,360	(2,553)
Cumulative effect of accounting change, net of income taxes of $1,464,000			2,389	

NET INCOME (LOSS)	82,240	25,033	155,749	(2,553)
Preferred stock dividends	(5,979)	(2,530)	(9,505)	(5,062)
NET INCOME (LOSS) AVAILABLE TO COMMON SHAREHOLDERS	$ 76,261	$ 22,503	$ 146,244	$ (7,615)
EARNINGS (LOSS) PER COMMON SHARE BASIC:				
Income (loss) before cumulative effect of accounting change	$ 0.36	$ 0.14	$ 0.70	$ (0.05)
Cumulative effect of accounting change			0.01	
Net income (loss)	$ 0.36	$ 0.14	$ 0.71	$ (0.05)
EARNINGS (LOSS) PER COMMON SHARE ASSUMING DILUTION:				
Income (loss) before cumulative effect of accounting change	$ 0.31	$ 0.13	$ 0.62	$ (0.05)
Cumulative effect of accounting change			0.01	
Net income (loss)	$ 0.31	$ 0.13	$ 0.63	$ (0.05)
WEIGHTED AVERAGE COMMON AND COMMON EQUIVALENT SHARES OUTSTANDING (in thousands):				
Basic	214,341	165,963	205,995	165,669
Assuming dilution	263,919	191,947	247,391	165,669

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,	
	2003	**2002**
	($ in thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
NET INCOME (LOSS)	$ 155,749	$ (2,553)
ADJUSTMENTS TO RECONCILE NET INCOME (LOSS) TO NET CASH PROVIDED BY OPERATING ACTIVITIES:		
Depreciation, depletion and amortization	172,543	103,770
Unrealized (gains) losses on derivatives	(30,794)	79,949
Deferred income taxes	93,998	(1,702)
Amortization of loan costs and bond discount	4,110	2,899
Cumulative effect of accounting change	(2,389)	
Other	565	167
Cash provided by operating activities before changes in assets and liabilities	393,782	182,530
Changes in assets and liabilities	(17,149)	32,295
Cash provided by operating activities	376,633	214,825
CASH FLOWS FROM INVESTING ACTIVITIES:		
Exploration and development of oil and gas properties	(307,090)	(176,386)
Acquisition of unproved oil and gas properties	(123,122)	(7,167)
Acquisition of proved oil and gas properties	(863,050)	(124,305)
Sales of proved oil and gas properties	19,667	
Investment in Pioneer Drilling Company	(20,000)	
Additions to other property, plant and equipment and other	(22,179)	(16,714)
Cash used in investing activities	(1,315,774)	(324,572)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from long-term borrowings	296,000	45,000
Payments on long-term borrowings	(270,000)	
Cash received from issuance of senior notes	297,306	
Cash paid for issuance costs of senior notes	(6,367)	
Proceeds from issuance of preferred stock, net of issuance costs	222,893	
Proceeds from issuance of common stock, net of issuance costs	177,444	
Net increase in outstanding payments in excess of cash balances	29,474	
Cash paid for common stock dividend	(12,125)	
Cash paid for preferred stock dividend	(8,893)	(5,118)
Cash paid to repurchase senior notes		(43,220)
Cash paid for treasury stock	(2,109)	
Cash received from exercise of stock options and warrants	6,326	1,956
Other	(2,536)	(169)

Cash provided by (used in) financing activities	727,413	(1,551)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(211,728)	(111,298)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	247,637	117,594
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 35,909	$ 6,296

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,		Six Months Ended June 30,	
	2003	2002	2003	2002
	($ in thousands)			
Net income (loss)	$ 82,240	$ 25,033	$ 155,749	$ (2,553)
Other comprehensive income (loss), net of income tax:				
Change in fair value of derivative instruments	11,696	(2,242)	(36,859)	(12,972)
Reclassification of (gain) or loss on settled contracts	2,461	(1,683)	53,352	(15,769)
Ineffective portion of derivatives qualifying for cash flow hedge accounting	(256)	815	(286)	1,309
Comprehensive income (loss)	$ 96,141	$ 21,923	$ 171,956	$ (29,985)

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 consolidated financial statements of Chesapeake Energy Corporation and Subsidiaries have been prepared in accordance with the instructions to Form 10-Q as prescribed by the Securities and Exchange Commission. All material adjustments (consisting solely of normal recurring adjustments) which, in the opinion of management, are necessary for a fair presentation of the results for the interim periods have been reflected. The results for the three and six months ended June 30, 2003 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, 2002 (the Prior Quarter and Prior Period , respectively) and the three and six months ended June 30, 2003 (the Current Quarter and Current Period , respectively).

Stock Options

Chesapeake has elected to follow APB No. 25, *Accounting for Stock Issued to Employees,* and related interpretations in accounting for its employee stock options. Under APB No. 25, compensation expense is recognized for the difference between the option price and market value on the measurement date. In March 2000, the Financial Accounting Standards Board issued FASB Interpretation No. 44 which provided clarification regarding the application of APB No. 25. FIN 44 specifically addressed the accounting consequences of various modifications to the terms of a previously granted fixed price stock option. Pursuant to FIN 44, we recognized no compensation adjustment in the Prior Quarter and compensation expense of $387,900, $365,300 and $162,500 in the Current Quarter, the Current Period and the Prior Period, respectively, as a result of modifications to fixed-price stock options that were made during the years ended December 31, 2001 and 2000. No compensation income or expense has been recognized for stock options issued in 2003 or 2002 because the exercise price of the stock options granted under the plans equaled the market price of the underlying stock on the date of grant and there have been no modifications to these options.

Presented below is pro forma financial information assuming that Chesapeake had applied the fair value method under SFAS No. 123:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
	($ in thousands)			
Net Income (Loss)				
As reported [1]	$ 82,240	$ 25,033	$ 155,749	$ (2,553)

Compensation expense, net of tax	(2,539)	(2,088)	(5,014)	(4,155)
Pro forma	$ 79,701	$ 22,945	$ 150,735	$ (6,708)
Basic earnings (loss) per common share				
As reported	$ 0.36	$ 0.14	$ 0.71	$ (0.05)
Compensation expense, net of tax	(0.01)	(0.01)	(0.02)	(0.02)
Pro forma	$ 0.35	$ 0.13	$ 0.69	$ (0.07)
Diluted earnings (loss) per common share				
As reported	$ 0.31	$ 0.13	$ 0.63	$ (0.05)
Compensation expense, net of tax	(0.01)	(0.01)	(0.02)	(0.02)
Pro forma	$ 0.30	$ 0.12	$ 0.61	$ (0.07)

(1) Net income includes adjustments related to FIN 44 of $387,900, $365,300 and $162,500 of expense in the Current Quarter, the Current Period and the Prior Period, respectively.

For purposes of the pro forma disclosures, the estimated fair value of the options is amortized to expense over the options vesting period, which is four years. Because our stock options vest over four years and additional awards are typically made each year, the above pro forma disclosures are not likely to be representative of the effects on pro forma net income for future quarters.

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Critical Accounting Policies

We consider accounting policies related to stock options, hedging, oil and gas 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 annual report on Form 10-K for the year ended December 31, 2002, except for our accounting policy related to stock options which is summarized in Note 1 of the notes to the consolidated financial statements included in our annual report on Form 10-K.

Statement of Financial Accounting Standards No. 141, *Business Combinations* and Statement of Financial Accounting Standards No. 142, *Goodwill and Intangible Assets* were issued by the Financial Accounting Standards Board in June 2001 and became effective for us on July 1, 2001 and January 1, 2002, respectively. SFAS 141 requires all business combinations initiated after June 30, 2001 to be accounted for using the purchase method. Additionally, SFAS 141 requires companies to disaggregate and report separately from goodwill certain intangible assets. SFAS 142 establishes new guidelines for accounting for goodwill and other intangible assets. Under SFAS 142, goodwill and certain other intangible assets are not amortized, but rather are reviewed annually for impairment.

Oil and gas mineral rights held under lease and other contractual arrangements representing the right to extract such reserves for both undeveloped and developed leaseholds may have to be classified separately from oil and gas properties as intangible assets on our condensed consolidated balance sheets. In addition, the disclosures required by SFAS 141 and 142 relative to intangibles would be included in the notes to the condensed consolidated financial statements. Historically, we, like many other oil and gas companies, have included these rights as part of oil and gas properties, even after SFAS 141 and 142 became effective.

As it applies to companies like us that have adopted full cost accounting for oil and gas activities, we understand that this interpretation of SFAS 141 and 142 would only affect our balance sheet classification of proved oil and gas leaseholds acquired after June 30, 2001 and all of our unproved oil and gas leaseholds. We would not be required to reclassify proved reserve leasehold acquisitions prior to June 30, 2001 because we did not separately value or account for these costs prior to the adoption date of SFAS 141. Our results of operations and cash flows would not be affected, since these oil and gas mineral rights held under lease and other contractual arrangements representing the right to extract oil and gas reserves would continue to be amortized in accordance with full cost accounting rules.

As of June 30, 2003 and December 31, 2002, we had undeveloped leaseholds of approximately $177.8 million and $72.5 million, respectively, that would be classified on our condensed consolidated balance sheet as intangible undeveloped leasehold and developed leaseholds of an estimated $1,423.0 million and $581.9 million, respectively, that would be classified as intangible developed leasehold if we applied the interpretation discussed above.

We will continue to classify our oil and gas mineral rights held under lease and other contractual rights representing the right to extract such reserves as tangible oil and gas properties until further guidance is provided.

2. Financial Instruments and Hedging Activities

Oil and Gas Hedging Activities

Our results of operations and operating cash flows are impacted by changes in market prices for oil and gas. To mitigate a portion of the exposure to adverse market changes, we have entered into various derivative instruments. As of June 30, 2003, our oil and gas derivative instruments were comprised of swaps, cap-swaps and basis protection swaps. These instruments allow us to predict with greater certainty the effective oil and gas 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.

For swap instruments, we receive a fixed price for the hedged commodity and pay a floating market price, as defined in each instrument, to the counterparty. The fixed-price payment and the floating-price payment are netted, resulting in a net amount due to or from the counterparty.

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. Because this derivative includes a written put option (i.e., the cap), cap-swaps do not qualify

for designation as cash flow hedges (in accordance with SFAS 133) since the combination of the hedged item and the written option do not provide as much potential for favorable cash flows as exposure to unfavorable cash flows.

Basis protection swaps are arrangements that guarantee a price differential of oil or gas from a specified delivery point. 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.

Chesapeake enters into counter-swaps from time to time for the purpose of locking-in the value of a swap or cap-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. 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 oil and gas prices. Any locked-in gain or loss is recorded in accumulated other comprehensive income and reclassified to oil and gas sales in the month of related production.

When Chesapeake enters into a counter-swap with the same counterparty, to the extent that a right of setoff exists in accordance with FASB Interpretation No. 39, we net the value of the swap and the counter-swap.

With respect to counter-swaps that are designed to lock-in the value of cap-swaps, the counter-swap is effective in locking-in the value of the cap-swap until the floating price reaches the cap (or floor) stipulated in the cap-swap agreement. The value of a counter-swap will increase (or decrease), but in the opposite direction, as the value of the cap-swap decreases (or increases) until the floating price reaches the pre-determined cap (or floor) stipulated in the cap-swap agreement. However, because of the written put option embedded in the cap-swap, the changes in value of the cap-swap are not completely effective in offsetting changes in the value of the corresponding counter-swap.

Chesapeake enters into oil and gas derivative transactions in order to mitigate a portion of its exposure to adverse market changes in oil and gas commodity prices. Accordingly, we believe that any associated gains or losses from the derivative transactions should be reflected as adjustments to oil and gas sales on the condensed consolidated statement of operations. 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 oil and gas sales. Unrealized gains (losses) included in oil and gas sales in the Current Period and Prior Period were $33.0 million and ($80.4) million, respectively.

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 attributed to the hedged risk, are recorded in other comprehensive income. Any change in fair value resulting from ineffectiveness is recognized currently in oil and gas sales. These amounts totaled to a gain of $0.5 million in the Current Period and a loss of $2.2 million in the Prior Period, a gain of $0.4 million in the Current Quarter and a loss of $1.4 million in the Prior Quarter.

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The estimated fair values of our oil and gas derivative instruments as of June 30, 2003 are provided below. The associated carrying values of these instruments are equal to the estimated fair values.

	June 30, 2003
	($ in thousands)
Derivative assets (liabilities):	
Fixed-price gas swaps	$ 21,393
Fixed-price gas cap-swaps	(49,558)
Fixed-price gas counter-swaps	45,799
Fixed-price gas locked swaps	(1,429)
Gas basis protection swaps	33,429
Fixed-price crude oil cap-swaps	(3,431)
Estimated fair value	$ 46,203

Based upon the market prices at June 30, 2003, we expect to transfer approximately $13.7 million of the gain included in the balance in accumulated other comprehensive income to earnings during the next 12 months when the hedged transactions actually close. All transactions hedged as of June 30, 2003 will mature by 2007, with the exception of the basis protection swaps which extend to 2009.

Additional information concerning the fair value of our oil and gas derivative instruments is as follows:

	2003
	($ in thousands)
Fair value of contracts outstanding at January 1	$ (14,533)
Change in fair value of contracts during the period	(30,952)
Contracts realized or otherwise settled during the period	91,688
Fair value of new contracts when entered into during the period	
Fair value of contracts outstanding at June 30	$ 46,203

Interest Rate Hedging

We also utilize hedging strategies to manage interest rate exposure. Results from interest rate hedging transactions are reflected as adjustments to interest expense in the corresponding months covered by the derivative agreement.

In July 2002, we closed two interest rate swaps for a cash settlement of $8.6 million. As of June 30, 2003, the remaining balance to be amortized as a reduction to interest expense was $0.4 million. During the Current Quarter and Current Period, $0.2 million and $0.3 million, respectively, was recorded as a reduction to interest expense.

In March 1997, Chesapeake issued $150.0 million of 8.5% senior notes due 2012, of which $7.3 million were subsequently repurchased and retired. The 8.5% senior notes include a call option whereby Chesapeake may redeem the debt at declining redemption prices beginning in March 2004. This call option, also referred to as a right of optional redemption, allows Chesapeake to redeem the notes prior to their stated maturity date beginning in March 2004. This right of optional redemption has value depending upon changes in interest rates. Due to a decline in interest rates, Chesapeake effectively sold this optional redemption right to an unrelated third party (or counterparty) for $7.8 million in April 2002. In exchange for $7.8 million, Chesapeake gave the counterparty the option to elect whether or not to enter into an interest rate swap with Chesapeake on March 11, 2004. This transaction is more commonly referred to as a swaption. The terms of the interest rate swap, if executed by the counterparty, would be as follows:

Term	Notional Amount	Fixed Rate	Floating Rate
March 2004 March 2012	$142,665,000	8.5%	U.S. six-month LIBOR plus 75 basis points

The interest rate swap would require Chesapeake to pay a fixed rate of 8.5% while the counterparty pays Chesapeake a floating rate of 6 month LIBOR in arrears plus 0.75%. Additionally, if the counterparty elects to enter into the interest rate swap on March 11, 2004, it may also elect to force Chesapeake to settle the transaction at the then current value of the interest rate swap.

This transaction does not alter Chesapeake s ability to redeem the 8.5% senior notes. Instead, it locks-in the economics of a future call. If interest rates are high and the swaption is not in-the-money , the counterparty will likely not elect to enter into the interest rate swap, the swaption will expire, and Chesapeake will amortize the $7.8

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million premium as a reduction to interest expense over the remaining life of the notes. If interest rates are low and the swaption is in-the-money , the counterparty will likely exercise the swaption and force Chesapeake to settle the transaction at the then current value of the interest rate swap, and Chesapeake will amortize both the $7.8 million premium and the amount paid to the counterparty to interest expense over the remaining life of the notes. If Chesapeake elects to refinance the 8.5% senior notes, any unamortized premium or loss remaining related to the swaption would be included in the gain (or loss) on the early extinguishment of debt.

According to SFAS 133, a fair value hedge relationship exists between the embedded call option in the 8.5% senior notes and the swaption agreement. The fair value of the swaption is recorded on the condensed consolidated balance sheets as a liability, and the debt s carrying amount is adjusted by the change in the fair value of the call option subsequent to the initiation of the swaption. Any resulting differences are recorded currently as ineffectiveness in the condensed consolidated statements of operations as an adjustment to interest expense.

We have recorded an adjustment to the carrying amount of the debt of $25.3 million as of June 30, 2003. Since the inception of the swaption, we recorded the change in the fair market value of the swaption from a $7.8 million liability to a $37.8 million liability, an increase of $30.0 million. As part of recording the fair value hedge, we also recorded, as an adjustment to the carrying value of the debt, a $25.3 million increase in the fair value of the embedded call option. The difference between the two adjustments, $4.7 million representing ineffectiveness, was recorded as additional interest expense. Results of the interest rate swap, if initiated, will be reflected as adjustments to interest expense in the corresponding months.

Fair Value of Financial Instruments

The following disclosure of the estimated fair value of financial instruments is made in accordance with the requirements of Statement of Financial Accounting Standards No. 107, *Disclosures About Fair Value of Financial Instruments*. We have determined the estimated fair values using available market information and valuation methodologies. Considerable judgment is required in interpreting market data to develop the estimates of fair value. The use of different market assumptions or valuation methodologies may have a material effect on the estimated fair value amounts.

The carrying values of items comprising current assets and current liabilities approximate fair values due to the short-term maturities of these instruments. We estimate the fair value of our long-term, fixed-rate debt using primarily quoted market prices. Our carrying amount for such debt, excluding the value of the interest rate swaps and the call option on the 8.5% senior notes, at June 30, 2003 and December 31, 2002 was $1,967.3 million and $1,669.3 million, respectively, compared to approximate fair values of $2,131.3 million and $1,744.7 million, respectively. The carrying amount for our 6.75% convertible preferred stock at June 30, 2003 and December 31, 2002 was $149.9 million, with a fair value of $227.1 million and $181.5 million, respectively. The carrying amount of our 6.00% convertible preferred stock was $230.0 million which approximated its fair value as of June 30, 2003.

Concentration of Credit Risk

A significant portion of our liquidity is concentrated in cash and cash equivalents and derivative instruments that enable us to hedge a portion of our exposure to price volatility from producing oil and natural gas. These arrangements expose us to credit risk from our counterparties. Other financial instruments which potentially subject us to concentrations of credit risk consist principally of investments in debt and equity instruments and accounts receivable. Our accounts receivable are primarily from purchasers of oil and natural gas products and exploration and

production companies which own interests in properties we operate. The 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 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. Cash and cash equivalents are deposited with major banks or institutions and may at times exceed the federally insured limits.

3. Contingencies and Commitments

Royalty Owner Litigation. Royalty owners have commenced litigation against a number of oil and gas producers claiming that amounts paid for production attributable to the royalty owners interest violated the terms of applicable leases and state law, that deductions from the proceeds of oil and gas production were unauthorized under the leases, and that amounts received by upstream sellers should be used to compute the amounts paid to the royalty owners. Typically this litigation has taken the form of class action suits. There are presently four such suits filed against Chesapeake, two in Texas and two in Oklahoma. No class has been certified in any of them. In one of the

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Oklahoma cases, we determined that a portion of the marketing fee we had charged royalty owners should be refunded. We have deposited with the court the aggregate amount of the fees we estimated should be refunded, $3.6 million, in an interest-bearing account for distribution to affected royalty owners. This amount has been charged to general and administrative expenses, of which $0.3 million was charged in the Current Period and the remainder was recorded in 2002. We do not believe any other claims made by royalty owners in the cases pending against us are valid. Even if the claims were upheld, we believe any damages awarded would not be material. This is a developing area of the law, however, and as new cases are decided, our potential liability relating to the marketing of oil and gas may increase or decrease. We will continue to monitor court decisions to ensure that our operations and practices minimize any exposure and to recognize any charges that may be appropriate when we can reasonably estimate a liability.

Chesapeake is currently involved in various other routine disputes incidental to its business operations. Management, after consultation with legal counsel, is of the opinion that the final resolution of all such currently pending or threatened litigation is not likely to have a material adverse effect on our consolidated financial position or results of operations.

Chesapeake has employment agreements with its chief executive officer, chief operating officer, chief financial officer and various other senior management personnel, which provide for annual base salaries, bonus compensation and various benefits. The agreements provide for the continuation of salary and benefits for varying terms in the event of termination of employment without cause. The agreements with the chief executive officer and chief operating officer have terms of five years commencing July 1, 2002. The term of each agreement is automatically extended for one additional year on each June 30 unless one of the parties provides 30 days notice of non-extension. The agreements with the chief financial officer and other senior managers expire on June 30, 2006. The company s employment agreements for executive officers provide for payments in the event of a change of control. The chief executive officer and chief operating officer are each entitled to receive a payment in the amount of five times his base compensation and the prior year s benefits, plus a tax gross-up payment, and the chief financial officer and other officers are each entitled to receive a payment in the amount of his or her base compensation plus bonuses paid during the prior year.

Due to the nature of the oil and gas 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 its environmental risk profile. These reviews evaluate whether there is a probable 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 the 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 June 30, 2003.

4. Net Income (Loss) Per Share

Statement of Financial Accounting Standards No. 128, *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. SFAS 128 requires a reconciliation of the numerator and denominator of the basic and diluted EPS computations.

The following securities were not included in the calculation of diluted earnings per share, as the effect was antidilutive:

For the Prior Quarter, the Current Quarter, the Prior Period and the Current Period, outstanding warrants to purchase 1.1 million, 0.4 million, 1.1 million and 0.4 million shares of common stock at a weighted-average exercise price of $12.61, $14.55, $12.61 and $14.55, respectively, were antidilutive because the exercise prices of the warrants were greater than the average market price of the common stock.

For the Prior Quarter, the Current Quarter, the Prior Period and the Current Period, outstanding options to purchase 0.3 million, 0.4 million, 0.4 million and 0.3 million shares of common stock at a weighted-average exercise price of $15.30, $15.47, $14.44 and $16.33, respectively, were antidilutive because the

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exercise prices of the options were greater than the average market price of the common stock.

As a result of the Prior Period s net loss to common shareholders, the diluted shares do not include the effect of outstanding stock options to purchase 5.9 million shares of common stock at a weighted-average exercise price of $3.90, the assumed conversion of the outstanding 6.75% preferred stock (convertible into 19.5 million common shares), the common stock equivalent of preferred stock outstanding prior to conversion (11,480 shares), or warrants to purchase 6,574 shares of common stock at a weighted-average exercise price of $0.05 as the effects were antidilutive.

A reconciliation for the three months ended June 30, 2003 and 2002 and the six months ended June 30, 2003 is as follows:

	Income (Numerator)	Shares (Denominator)	Per Share Amount
	(in thousands, except per share data)		
For the Three Months Ended June 30, 2003:			
Basic EPS			
Income available to common shareholders	$ 76,261	214,341	$ 0.36
Effect of Dilutive Securities			
Assumed conversion at the beginning of the period of preferred shares outstanding during the period:			
Preferred dividends	5,979		
Common shares assumed issued for 6.00% preferred stock		22,358	
Common shares assumed issued for 6.75% preferred stock		19,468	
Employee stock options		7,752	
Diluted EPS			
Income available to common shareholders and assumed conversions	$ 82,240	263,919	$ 0.31
For the Three Months Ended June 30, 2002:			
Basic EPS			
Income available to common shareholders	$ 22,503	165,963	$ 0.14
Effect of Dilutive Securities			
Assumed conversion at the beginning of the period of preferred shares outstanding during the period:			
Preferred dividends	2,530		
Common shares assumed issued for 6.75% preferred stock		19,478	
Employee stock options		6,500	
Warrants assumed in Gothic acquisition		6	
Diluted EPS			
Income available to common shareholders and assumed conversions	$ 25,033	191,947	$ 0.13
For the Six Months Ended June 30, 2003:			
Basic EPS			
Income available to common shareholders	$ 146,244	205,995	$ 0.71

Effect of Dilutive Securities			
Assumed conversion at the beginning of the period of preferred shares outstanding during the period:			
Preferred dividends	9,505		
Common shares assumed issued for 6.00% preferred stock		14,576	
Common shares assumed issued for 6.75% preferred stock		19,468	
Employee stock options		7,352	
Diluted EPS			
Income available to common shareholders and assumed conversions	$ 155,749	247,391	$ 0.63

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5. Senior Notes and Revolving Credit Facility

At June 30, 2003, our long-term debt consisted of the following ($ in thousands):

7.875% senior notes, due 2004	$ 42,137(1)
8.375% senior notes, due 2008	250,000
8.125% senior notes, due 2011	800,000
8.500% senior notes, due 2012	142,665
9.000% senior notes, due 2012	300,000
7.500% senior notes, due 2013	300,000
7.750% senior notes, due 2015	150,000
Revolving bank credit facility	26,000
Discount on senior notes	(17,513)
Call option on 8.5% senior notes	(25,267)(2)
Interest rate swaps	425
Total	$ 1,968,447

(1) This amount has been classified as long-term debt based on our ability to satisfy this obligation with funding from our bank credit facility.
(2) See Note 2 of the notes to the condensed consolidated financial statements included in this report for further discussion on the call option.

On March 5, 2003, we issued $300.0 million principal amount of 7.50% senior notes due 2013, which have not been registered under the Securities Act of 1933**.**

On June 30, 2003, we had a $350 million revolving bank credit facility (with a committed borrowing base of $350 million) which matures in May 2007. As of June 30, 2003, we had $26.0 million in outstanding borrowings under this facility and were using $25.3 million of the facility to secure various letters of credit. Borrowings under the facility are collateralized by certain producing oil and gas properties and bear interest at either the reference rate of Union Bank of California, N.A., or London Interbank Offered Rate (LIBOR), at our option, plus a margin that varies according to our senior unsecured long-term debt ratings issued by Standard & Poor s Ratings Services and Moody s Investor Service. The unused portion of the facility is subject to an annual commitment fee also based on our senior unsecured long-term debt ratings. Interest is payable quarterly. The collateral value and borrowing base are redetermined periodically.

The credit agreement contains various covenants and restrictive provisions which limit our ability to incur additional indebtedness, sell properties, pay dividends, purchase or redeem our capital stock, make investments or loans, purchase certain of our senior notes and create liens. The credit agreement requires us to maintain a current ratio of at least 1 to 1 (as defined in the credit facility) and a fixed charge coverage ratio for the trailing twelve month period of at least 2.5 to 1. At June 30, 2003, our current ratio was 1.6 to 1 and our fixed charge coverage ratio was 3.6 to 1. If we should fail to perform our obligations under these and other covenants, the revolving credit commitment could be terminated and any outstanding borrowings under the facility could be declared immediately due and payable. If such an acceleration involved principal in excess of $10.0 million, the acceleration would constitute an event of default under our senior note indentures, which could in turn result in the acceleration of our senior note indebtedness. The credit agreement also has cross default provisions that apply to other indebtedness we may have with an outstanding principal amount in excess of $25.0 million.

Our senior notes are unsecured senior obligations of Chesapeake and rank equally with all of our other unsecured indebtedness. The senior note indentures contain covenants limiting us and our guarantor subsidiaries with respect to asset sales; the incurrence of additional indebtedness and

the issuance of preferred stock; liens; sale and leaseback transactions; lines of business; dividend and other payment restrictions affecting guarantor subsidiaries; mergers or consolidations; and transactions with affiliates. The senior note indentures also limit our ability to make restricted payments (as defined), including the payment of cash dividends, unless the debt incurrence and other tests are met. We may redeem the senior notes at any time at specified make-whole or redemption prices as provided in the indentures.

Chesapeake is a holding company and owns no operating assets and has no significant operations independent of its subsidiaries. Our obligations under our outstanding senior notes have been fully and unconditionally guaranteed, on a joint and several basis, by each of our restricted subsidiaries (as defined in the respective indentures governing these notes) (collectively, the guarantor subsidiaries). Each guarantor subsidiary is a direct or indirect wholly-owned subsidiary.

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Set forth below are condensed consolidating financial statements of the parent, guarantor subsidiaries and Chesapeake Energy Marketing, Inc., a wholly-owned subsidiary which is not a guarantor of the senior notes and was a non-guarantor subsidiary for all periods presented. All of our other wholly-owned subsidiaries were guarantor subsidiaries during all periods presented.

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CONDENSED CONSOLIDATED BALANCE SHEET

AS OF JUNE 30, 2003

($ in thousands)

	Guarantor Subsidiaries	Non-Guarantor Subsidiary	Parent	Eliminations	Consolidated
ASSETS					
CURRENT ASSETS:					
Cash and cash equivalents	$ (493)	$ 36,361	$ 41	$	$ 35,909
Accounts receivable	194,334	133,415	11,837	(92,660)	246,926
Short-term derivative receivable	342				342
Short-term derivative instruments	31,331				31,331
Deferred income tax asset			6,479		6,479
Inventory and other	10,724	1,746	10		12,480
Total Current Assets	236,238	171,522	18,367	(92,660)	333,467
PROPERTY AND EQUIPMENT:					
Evaluated oil and gas properties	5,575,048				5,575,048
Unevaluated properties	177,837				177,837
Other property and equipment	70,083	35,078	70,656		175,817
Less: accumulated depreciation, depletion and amortization	(2,306,654)	(21,910)	(4,972)		(2,333,536)
Net Property and Equipment	3,516,314	13,168	65,684		