CHESAPEAKE ENERGY CORP
Form 10-Q/A
July 30, 2010
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q/A

Amendment No. 1

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

For the Quarterly Period Ended March 31, 2010

[ ] 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 May 5, 2010, there were 650,913,021 shares of our $0.01 par value common stock outstanding.

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EXPLANATORY NOTE

We are filing this Amendment No. 1 on Form 10-Q/A to amend and restate in their entirety the following items of our Quarterly Report on Form 10-Q for the quarter ended March 31, 2010 as originally filed with the Securities and Exchange Commission on May 10, 2010 (the Original Form 10-Q): (i) Item 1 of Part I Financial Information, (ii) Item 2 of Part I, Management s Discussion and Analysis of Financial Condition and Results of Operations, (iii) Item 4 of Part I, Controls and Procedures, and (iv) Item 6 of Part II, Exhibits , and we have also updated the signature page, the certifications of our Chief Executive Officer and Chief Financial Officer in Exhibits 31.1, 31.2, 32.1 and 32.2, and our financial statements formatted in Extensible Business Reporting Language (XBRL) in Exhibits 101. No other sections were affected, but for the convenience of the reader, this report on Form 10-Q/A restates in its entirety, as amended, our Original Form 10-Q. This report on Form 10-Q/A is presented as of the filing date of the Original Form 10-Q and does not reflect events occurring after that date, or modify or update disclosures in any way other than as required to reflect the restatement described below.

We have determined that our previously reported results for the quarter ended March 31, 2010 erroneously included the cumulative effect of the accounting change associated with our adoption of new authoritative guidance for variable interest entities on January 1, 2010. Our results included the cumulative effect of the accounting change as an adjustment in arriving at net income in our condensed consolidated statement of operations and our condensed consolidated statement of comprehensive income rather than reflecting it solely as an adjustment directly to retained earnings. The condensed consolidated statement of operations and condensed consolidated statement of comprehensive income for the quarter ended March 31, 2010 included in this Form 10-Q/A have been restated to remove the effects of the $142 million (net of tax) cumulative effect of accounting change. This adjustment does not affect previously reported total retained earnings or operating cash flows, although certain adjustments have been made in our condensed consolidated statement of equity and our condensed consolidated statement of cash flows to correspond to the income statement adjustment as described in Note 1 of the notes to our condensed consolidated financial statements included in this filing. We have made necessary conforming changes in Management s Discussion and Analysis of Financial Condition and Results of Operations resulting from the correction of this error.

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CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES

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CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

	March 31, 2010	December 31, 2009
	($ in millions)	
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 516	$ 307
Accounts receivable	1,419	1,325
Short-term derivative instruments	1,297	692
Deferred income tax asset		24
Other	103	98
Total Current Assets	3,335	2,446
PROPERTY AND EQUIPMENT:		
Natural gas and oil properties, at cost based on full-cost accounting:		
Evaluated natural gas and oil properties	35,720	35,007
Unevaluated properties	10,118	10,005
Less: accumulated depreciation, depletion and amortization of natural gas and oil properties	(24,523)	(24,220)
Total natural gas and oil properties, at cost based on full-cost accounting	21,315	20,792
Other property and equipment:		
Natural gas gathering systems and treating plants	1,590	3,516
Buildings and land	1,674	1,673
Drilling rigs and equipment	723	687
Natural gas compressors	351	325
Other	568	550
Less: accumulated depreciation and amortization of other property and equipment	(566)	(833)
Total other property and equipment	4,340	5,918
Total Property and Equipment	25,655	26,710
OTHER ASSETS:		
Investments	1,005	404
Long-term derivative instruments	15	60
Other assets	278	294
Total Other Assets	1,298	758
TOTAL ASSETS	$ 30,288	$ 29,914

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)

	March 31, 2010	December 31, 2009
	($ in millions)	
LIABILITIES AND EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$ 1,296	$ 957
Short-term derivative instruments	14	27
Accrued liabilities	812	920
Deferred income taxes	212	
Income taxes payable		1
Revenues and royalties due others	637	565
Accrued interest	152	218
Total Current Liabilities	3,123	2,688
LONG-TERM LIABILITIES:		
Long-term debt, net	12,204	12,295
Deferred income tax liabilities	1,295	1,059
Asset retirement obligations	283	282
Long-term derivative instruments	699	787
Revenues and royalties due others	78	73
Other liabilities	390	389
Total Long-Term Liabilities	14,949	14,885
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 March 31, 2010 and December 31, 2009, 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 March 31, 2010 and December 31, 2009, entitled in liquidation to $209 million	209	209
5.00% cumulative convertible preferred stock (series 2005), 5,000 shares issued and outstanding as of March 31, 2010 and December 31, 2009, entitled in liquidation to $1 million	1	1
Common stock, $0.01 par value, 1,000,000,000 shares authorized, 651,823,247 and 648,549,165 shares issued at March 31, 2010 and December 31, 2009, respectively	7	6
Paid-in capital	12,160	12,146
Retained earnings (deficit)	(665)	(1,261)
Accumulated other comprehensive income, net of tax of ($161) million and ($62) million, respectively	265	102
Less: treasury stock, at cost; 943,220 and 877,205 common shares as of March 31, 2010 and December 31, 2009, respectively	(17)	(15)
Total Chesapeake Stockholders Equity	12,216	11,444

Noncontrolling interest		897
Total Equity	12,216	12,341
TOTAL LIABILITIES AND EQUITY	$ 30,288	$ 29,914

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 March 31,	
	2010 (Restated)	2009
	($ in millions except per share data)	
REVENUES:		
Natural gas and oil sales	$ 1,898	$ 1,397
Marketing, gathering and compression sales	844	552
Service operations revenue	56	46
Total Revenues	2,798	1,995
OPERATING COSTS:		
Production expenses	207	238
Production taxes	48	23
General and administrative expenses	109	90
Marketing, gathering and compression expenses	815	523
Service operations expense	49	40
Natural gas and oil depreciation, depletion and amortization	308	447
Depreciation and amortization of other assets	50	57
Impairment of natural gas and oil properties and other assets		9,630
Total Operating Costs	1,586	11,048
INCOME (LOSS) FROM OPERATIONS	1,212	(9,053)
OTHER INCOME (EXPENSE):		
Other income	15	8
Interest expense (income)	(25)	14
Impairment of investments		(153)
Loss on exchanges of Chesapeake debt	(2)	
Total Other Income (Expense)	(12)	(131)
INCOME (LOSS) BEFORE INCOME TAXES	1,200	(9,184)
INCOME TAX EXPENSE (BENEFIT):		
Current income taxes		
Deferred income taxes	462	(3,444)
Total Income Tax Expense (Benefit)	462	(3,444)

NET INCOME (LOSS)	738	(5,740)
Net (income) loss attributable to noncontrolling interest		
NET INCOME (LOSS) ATTRIBUTABLE TO CHESAPEAKE	738	(5,740)
Preferred stock dividends	(6)	(6)
NET INCOME (LOSS) AVAILABLE TO CHESAPEAKE COMMON STOCKHOLDERS	$ 732	$ (5,746)
EARNINGS (LOSS) PER COMMON SHARE		
Basic	$ 1.17	$ (9.63)
Assuming dilution	$ 1.14	$ (9.63)
CASH DIVIDEND DECLARED PER COMMON SHARE	$ 0.075	$ 0.075
WEIGHTED AVERAGE COMMON AND COMMON EQUIVALENT SHARES OUTSTANDING (in millions):		
Basic	630	597
Assuming dilution	647	597

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)

	Three Months Ended March 31, 2010 (Restated)	2009
	($ in millions)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
NET INCOME (LOSS) ATTRIBUTABLE TO CHESAPEAKE	$ 738	$ (5,740)
ADJUSTMENTS TO RECONCILE NET INCOME (LOSS) TO CASH PROVIDED BY OPERATING ACTIVITIES:		
Depreciation, depletion and amortization	358	504
Deferred income tax expense (benefit)	462	(3,444)
Unrealized gains on derivatives	(342)	(145)
Realized gains on financing derivatives	(94)	(19)
Stock-based compensation	32	34
Accretion of discount on contingent convertible notes	19	20
(Gain) loss from equity investments	(13)	1
Loss on exchanges of Chesapeake debt	2	
Impairment of natural gas and oil properties and other fixed assets		9,630
Impairment of investments		153
Other	4	5
Change in assets and liabilities	17	262
Cash provided by operating activities	1,183	1,261
CASH FLOWS FROM INVESTING ACTIVITIES:		
Exploration and development of natural gas and oil properties	(1,020)	(1,347)
Acquisitions of natural gas and oil proved and unproved properties and leasehold	(1,030)	(413)
Additions to other property and equipment	(279)	(667)
Additions to investments	(6)	(8)
Proceeds from divestitures of proved and unproved properties and leasehold	1,044	
Proceeds from sales of volumetric production payments	180	
Proceeds from sale of other assets	56	
Proceeds from sale of compressors		68
Deposits for divestitures	21	
Other	20	
Cash used in investing activities	(1,014)	(2,367)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from credit facilities borrowings	2,924	1,575
Payments on credit facilities borrowings	(2,944)	(3,120)
Proceeds from issuance of senior notes, net of offering costs		1,346
Cash paid for common stock dividends	(47)	(44)
Cash paid for preferred stock dividends	(6)	(6)
Derivative settlements	94	1

Net increase (decrease) in outstanding payments in excess of cash balance	45	(287)
Other	(26)	(25)
Cash provided by (used in) financing activities	40	(560)
Net increase (decrease) in cash and cash equivalents	209	(1,666)
Cash and cash equivalents, beginning of period	307	1,749
Cash and cash equivalents, end of period	$ 516	$ 83

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CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)

(Unaudited)

	Three Months Ended March 31, 2010	Three Months Ended March 31, 2009
	($ in millions)	
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION OF CASH PAYMENTS FOR:		
Interest, net of capitalized interest	$ 89	$ 27
Income taxes, net of refunds received	$ (8)	$ 114

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

SUPPLEMENTAL SCHEDULE OF SIGNIFICANT NON-CASH INVESTING AND FINANCING ACTIVITIES:

As of March 31, 2010 and 2009, dividends payable on our common and preferred stock were $53 million and $51 million, respectively.

For the three months ended March 31, 2010 and 2009, natural gas and oil properties were adjusted by $1 million and ($62) million, respectively, as a result of an increase (decrease) in accrued exploration and development costs.

For the three months ended March 31, 2010 and 2009, other property and equipment were adjusted by $1 million and $13 million, respectively, as a result of an increase in accrued costs.

We recorded non-cash asset additions (reductions) to natural gas and oil properties of ($1) million and $2 million for the three months ended March 31, 2010 and 2009, respectively, for asset retirement obligations.

During the three months ended March 31, 2010, holders of our 2.25% Contingent Convertible Senior Notes due 2038 exchanged approximately $11 million in aggregate principal amount for an aggregate of 298,500 shares of our common stock in privately negotiated exchanges.

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.

During the three months ended March 31, 2009, we issued 14,360,642 shares of common stock, valued at $240 million, for the purchase of proved and unproved properties and leasehold pursuant to an acquisition shelf registration statement.

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)

	Three Months Ended March 31,	
	2010 (Restated)	2009
	($ in millions)	
PREFERRED STOCK:		
Balance, beginning of period	$ 466	$ 505
Exchange of common stock for 0 and 3,033 shares of 4.125% preferred stock		(3)
Balance, end of period	466	502
COMMON STOCK:		
Balance, beginning of period	6	6
Issuance of 0 and 14,360,642 shares of common stock for the purchase of proved and unproved properties and leasehold		
Exchange of 0 and 182,887 shares of common stock for preferred stock		
Exercise of stock options and other	1	
Balance, end of period	7	6
PAID-IN CAPITAL:		
Balance, beginning of period	12,146	11,680
Issuance of 0 and 14,360,642 shares of common stock for the purchase of proved and unproved properties and leasehold		232
Exchange of 298,500 and 0 shares of common stock for convertible notes	9	
Exchange of 0 and 182,887 shares of common stock for preferred stock		3
Stock-based compensation	57	53
Exercise of stock options	1	1
Dividends on common stock	(47)	(45)
Dividends on preferred stock	(6)	(6)
Tax benefit (reduction in tax benefit) from exercise of stock-based compensation		(8)
Balance, end of period	12,160	11,910
RETAINED EARNINGS (DEFICIT):		
Balance, beginning of period	(1,261)	4,569
Net income (loss)	738	(5,740)
Cumulative effect of deconsolidation of investment in CMP	(142)	
Balance, end of period	(665)	(1,171)
ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS):		
Balance, beginning of period	102	267
Hedging activity	166	266

Investment activity	(3)	49
Balance, end of period	265	582
TREASURY STOCK COMMON:		
Balance, beginning of period	(15)	(10)
Purchase of 70,177 and 64,242 shares for company benefit plans	(2)	(1)
Release of 4,162 and 1,972 shares for company benefit plans		
Balance, end of period	(17)	(11)
TOTAL CHESAPEAKE STOCKHOLDERS EQUITY	12,216	11,818
NONCONTROLLING INTEREST:		
Balance, beginning of period	897	
Deconsolidation of investment in CMP	(897)	
Balance, end of period		
TOTAL EQUITY	$ 12,216	$ 11,818

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 March 31,	
	2010 (Restated)	2009
	($ in millions)	
Net income (loss)	$ 738	$ (5,740)
Other comprehensive income (loss), net of income tax:		
Change in fair value of derivative instruments, net of income taxes of $152 million and $296 million	249	484
Reclassification of gain on settled contracts, net of income taxes of ($53) million and ($112) million	(87)	(184)
Ineffective portion of derivatives qualifying for cash flow hedge accounting, net of income taxes of $2 million and ($21) million	4	(34)
Unrealized (gain) loss on marketable securities, net of income taxes of ($2) million and $4 million	(3)	6
Reclassification of loss on investments, net of income taxes of $0 and $26 million		43
Comprehensive income (loss)	901	(5,425)
(Income) loss attributable to noncontrolling interest		
Comprehensive income (loss) available to Chesapeake	$ 901	$ (5,425)

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, 2009 (2009 Form 10-K) includes certain definitions and a summary of significant accounting policies and should be read in conjunction with this Form 10-Q. 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 months ended March 31, 2010 are not necessarily indicative of the results to be expected for the full year. This Form 10-Q relates to the three months ended March 31, 2010 (the Current Quarter) and the three months ended March 31, 2009 (the Prior Quarter).

Cumulative Effect of Accounting Change

Beginning January 1, 2010, in accordance with new authoritative guidance for variable interest entities, we no longer consolidate our midstream joint venture, Chesapeake Midstream Partners, L.L.C. (CMP). Because we have shared control with our 50% partner, Global Infrastructure Partners, our investment in CMP is now accounted for under the equity method (See Note 9). Adoption of this new guidance resulted in an after-tax cumulative effect charge to retained earnings of $142 million, which is reflected in our condensed consolidated statement of equity for the quarter ended March 31, 2010. This charge reflects the difference between the carrying value of our initial investment in the joint venture, which was recorded at carryover basis as an entity under common control, and the fair value of our equity in the joint venture as of the formation date.

Restatement of Financial Statements

Our condensed consolidated statement of operations and our condensed consolidated statement of comprehensive income for the quarter ended March 31, 2010 have been restated to remove the effects of the $142 million (net of tax) cumulative effect of accounting change associated with our adoption of the new authoritative guidance for variable interest entities on January 1, 2010, the adoption of which is discussed in the preceding paragraph. Our previously reported results erroneously included the cumulative effect as an adjustment in arriving at net income in our condensed consolidated statement of operations and our condensed consolidated statement of comprehensive income rather than reflecting it solely as an adjustment directly to retained earnings. This adjustment does not affect previously reported total retained earnings or operating cash flows although certain adjustments have been made in our condensed consolidated statement of equity and our condensed consolidated statement of cash flows to correspond to the income statement adjustment as noted below. The following table summarizes the effects of our restatement resulting from the correction of this error.

	Three Months Ended March 31, 2010		
	Previously Reported	Adjustment	Restated
	($ in millions, except per share data)		
CONDENSED CONSOLIDATED STATEMENT OF OPERATIONS:			
Income (loss) before cumulative effect of accounting change, net of tax	$ 738	$ (738)	$
Cumulative effect of accounting change, net of income taxes of $89 million	$ (142)	$ 142	$
Net income (loss) attributable to Chesapeake	$ 596	$ 142	$ 738
Net income (loss) available to Chesapeake common stockholders	$ 590	$ 142	$ 732
Earnings (loss) per common share basic	$ 0.94	$ 0.23	$ 1.17
Earnings (loss) per common share assuming dilution	$ 0.92	$ 0.22	$ 1.14

CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS:						
Net income (loss) attributable to Chesapeake	$	596	$	142	$	738
Cumulative effect of deconsolidation of investment in CMP	$	142	$	(142)	$	
CONDENSED CONSOLIDATED STATEMENT OF EQUITY:						
Net income (loss)	$	596	$	142	$	738
Cumulative effect of deconsolidation of investment in CMP	$		$	(142)	$	(142)
CONDENSED CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME:						
Net income	$	596	$	142	$	738
Comprehensive income	$	759	$	142	$	901
Comprehensive income available to Chesapeake	$	759	$	142	$	901

Critical Accounting Policies

We consider accounting policies related to hedging, natural gas and oil properties and income taxes to be critical policies. These policies are summarized in Management s Discussion and Analysis of Financial Condition and Results of Operations in our 2009 Form 10-K.

CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

2. Financial Instruments and Hedging Activities

Natural Gas and Oil Derivatives

Our results of operations and operating cash flows are impacted by changes in market prices for natural gas and oil. To mitigate a portion of the exposure to adverse market changes, we have entered into various derivative instruments. These instruments allow us to predict with greater certainty the effective natural gas and oil prices to be received for our hedged production. Although derivatives often fail to achieve 100% effectiveness for accounting purposes, we believe our derivative instruments continue to be highly effective in achieving our risk management objectives. As of March 31, 2010 and December 31, 2009, 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. Three-way collars include an additional put option in exchange for a more favorable strike price on the collar. This eliminates the counterparty s downside exposure below the second put option.

Call options: Chesapeake sells call options in exchange for a premium from the counterparty. At the time of settlement, if the market price exceeds the fixed price of the call option, Chesapeake pays the counterparty such excess and 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. At the time of settlement, if the market price falls below the fixed price of the put option, Chesapeake pays the counterparty such shortfall, and if the market price settles above the fixed price of the put option, no payment is due from either party.

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.

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 March 31, 2010 and December 31, 2009 are provided below. The associated carrying values of these instruments are equal to the estimated fair values.

	March 31, 2010		December 31, 2009	
	Volume	Fair Value ($ in millions)	Volume	Fair Value ($ in millions)
Natural gas (bbtu):				
Fixed-price swaps	501,297	$ 1,362	492,053	$ 662
Fixed-price collars	31,040	91	74,240	92
Call options	1,129,316	(426)	996,750	(541)
Put options	(51,220)	(57)	(69,620)	(50)
Fixed-price knockout swaps	38,370	15	38,370	17
Basis protection swaps	123,176	(54)	125,469	(50)
Total natural gas	1,771,979	931	1,657,262	130
Oil (mbbl):				
Fixed-price swaps	10,422	(23)	5,475	3
Call options	23,302	(243)	14,975	(144)
Fixed-price knockout swaps	5,402	34	6,572	32
Total oil	39,126	(232)	27,022	(109)
Total estimated fair value		$ 699		$ 21

Pursuant to accounting guidance for derivatives and hedging, certain derivatives qualify for designation as cash flow hedges. Following this guidance, 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.

The components of natural gas and oil sales for the Current Quarter and the Prior Quarter are presented below.

	Three Months Ended March 31,	
	2010	2009
	($ in millions)	
Natural gas and oil sales	$ 1,184	$ 778
Realized gains (losses) on natural gas and oil derivatives	399	519

Unrealized gains (losses) on non-qualifying natural gas and oil derivatives	321	46
Unrealized gains (losses) on ineffectiveness of cash flow hedges	(6)	54
Total natural gas and oil sales	$ 1,898	$ 1,397

Based upon the market prices at March 31, 2010, we expect to transfer approximately $369 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 March 31, 2010 are expected to mature by December 31, 2022.

We have 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. As of March 31, 2010, we had hedged a total of 1.9 tcfe under the 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

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outstanding under the facility by at least 1.65 times, and guarantees by certain 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.

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 March 31, 2010 and December 31, 2009, 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 March 31, 2010 and December 31, 2009 are provided below.

	March 31, 2010		December 31, 2009	
	Notional Amount	Fair Value	Notional Amount	Fair Value
	($ in millions)			
Interest rate				
Swaps	$ 2,825	$ (90)	$ 2,925	$ (113)

Collars	250		(4)	250		(6)
Call options	250		(1)	250		(2)
Swaptions	650		(2)	500		(11)
Totals	$ 3,975	$	(97)	$ 3,925	$	(132)

For interest rate derivative instruments designated as fair value hedges, 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.

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Realized 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 and the Prior Quarter are presented below.

	Three Months Ended March 31,	
	2010	2009
	($ in millions)	
Interest expense on senior notes	$ 192	$ 182
Interest expense on credit facilities	12	12
Capitalized interest	(161)	(161)
Realized (gains) losses on interest rate derivatives	(3)	(7)
Unrealized (gains) losses on interest rate derivatives	(27)	(45)
Amortization of loan discount and other	12	5
Total interest expense	$ 25	$ (14)

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 recognizing $104 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. The fair value of the cross currency swap is recorded on the condensed consolidated balance sheet as a liability of $3 million at March 31, 2010. The euro-denominated debt in notes payable has been adjusted to $811 million at March 31, 2010 using an exchange rate of $1.3526 to 1.00.

Additional Disclosures Regarding Derivative Instruments and Hedging Activities

In accordance with accounting guidance for derivatives and hedging, 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. Cash settlements of our derivative arrangements are generally classified as operating cash flows unless the derivative contains a significant financing element at contract inception, in which case, all cash settlements are classified as financing cash flows in the accompanying condensed consolidated statements of cash flows.

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The following table sets forth the fair value of each classification of derivative instrument as of March 31, 2010 and December 31, 2009, on a gross basis without regard to same-counterparty netting:

	Balance Sheet Location	Fair Value March 31, 2010	Fair Value December 31, 2009
		($ in millions)	
ASSET DERIVATIVES:			
Derivatives designated as hedging instruments:			
Commodity contracts	Short-term derivative instruments	$ 769	$ 417
Commodity contracts	Long-term derivative instruments	70	36
Foreign currency contracts	Long-term derivative instruments		43
Total		839	496
Derivatives not designated as hedging instruments:			
Commodity contracts	Short-term derivative instruments	569	318
Commodity contracts	Long-term derivative instruments	111	66
Total		680	384
LIABILITY DERIVATIVES:			
Derivatives designated as hedging instruments:			
Commodity contracts	Short-term derivative instruments	(5)	(1)
Commodity contracts	Long-term derivative instruments	(13)	
Interest rate contracts	Long-term derivative instruments	(4)	(11)
Foreign currency contracts	Long-term derivative instruments	(3)	
Total		(25)	(12)
Derivatives not designated as hedging instruments:			
Commodity contracts	Short-term derivative instruments	(39)	(42)
Commodity contracts	Long-term derivative instruments	(763)	(768)
Interest rate contracts	Short-term derivative instruments	(11)	(27)
Interest rate contracts	Long-term derivative instruments	(82)	(94)
Total		(895)	(931)
Total derivative instruments		$ 599	$ (63)

A consolidated summary of the effect of derivative instruments on the condensed consolidated statements of operations for the Current Quarter and the Prior Quarter is provided below, separating fair value, cash flow and non-qualifying derivatives.

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 March 31, 2010	Three Months Ended March 31, 2009
Interest rate contracts	Interest expense[a]	$ 8	$ 8

(a) Interest expense on the hedged items for the Current Quarter and the Prior Quarter was $10 million and $13 million respectively, which is included in interest expense on the condensed consolidated statements of operations.

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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):

		Three Months Ended March 31,	
Cash Flow Derivatives	**Location of Gain (Loss)**	**2010**	**2009**
Gain (Loss) Recognized in AOCI (Effective Portion)			
Commodity contracts	AOCI	$ 405	$ 682
Foreign currency contracts	AOCI	2	43
		$ 407	$ 725
Gain (Loss) Reclassified from AOCI (Effective Portion)			
Commodity contracts	Natural gas and oil sales	$ 140	$ 296
		$ 140	$ 296
Gain (Loss) Recognized (Ineffective Portion and Amount Excluded from Effectiveness Testing)[a]			
Commodity contracts	Natural gas and oil sales	$ 30	$ 54
		$ 30	$ 54

(a) In the Current Quarter and the Prior Quarter, the amount of gain (loss) recognized in net income (loss) represents ($6) million and $54 million related to the ineffective portion of our cash flow derivatives and $36 million and $0, respectively, related to the amount excluded from the assessment of hedge effectiveness.

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):

		Three Months Ended March 31,	
Non-Qualifying Derivatives	**Location of Gain (Loss)**	**2010**	**2009**
Commodity contracts	Natural gas and oil sales	$ 544	$ 269
Interest rate contracts	Interest expense	22	44

Total	$ 566	$ 313

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 prices, interest rate volatility and exchange rate exposure. 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 March 31, 2010, our derivative instruments were spread among 14 counterparties. Additionally, our multi-counterparty secured hedging facility described previously 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 Prior Quarter we recognized $0 and $8 million, respectively, of bad debt expense related to potentially uncollectible receivables.

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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. The company has filed a motion to dismiss which has been fully briefed. 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. The derivative action is stayed pending resolution of the motion to dismiss in the class action.

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 in the Civil Court of Appeals of the State of Oklahoma.

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 has filed a motion to dismiss which was heard on February 1, 2010. On February 28, 2010, the court ordered that plaintiffs claims be dismissed and granted plaintiffs leave to file an amended petition within 90 days. Plaintiffs chose not to amend and on April 9, 2010, at plaintiffs request, the court entered an order certifying that the February 28, 2010 dismissal was a final, appealable order. Plaintiffs are appealing the dismissal in the Supreme Court of the State of Oklahoma.

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, various 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 many of the suits but some remain pending and one case has been taken under advisement by the trial judge following trial in March 2010. 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.

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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 has an initial term of five years which 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 annual cash salary and bonus compensation at 2008 levels through 2013. 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, or in the event of his incapacity, death or retirement at or after age 55. The 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 annual 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 of employment without cause, a voluntary termination by the executive due to a material breach of contract by the company, or termination due to incapacity or death.

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 March 31, 2010.

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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 $88 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 March 31, 2010, the minimum aggregate undiscounted future rig lease payments were approximately $500 million.

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 $370 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 $46 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 March 31, 2010, the minimum aggregate undiscounted future compressor lease payments were approximately $328 million.

Transportation Contracts

Chesapeake has various firm pipeline transportation service agreements with expiration dates ranging from 2010 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 undiscounted amounts of such required demand payments as of March 31, 2010, were as follows ($ in millions):

2010	$	194
2011		302
2012		296
2013		277
2014		262
After 2014		1,378
Total	$	2,709

Drilling Contracts

Currently, Chesapeake has contracts with various drilling contractors to lease approximately 37 rigs with terms of six months to three years. These commitments are not recorded in the accompanying condensed consolidated balance sheets. As of March 31, 2010, the aggregate

undiscounted drilling rig commitment was approximately $251 million.

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Natural Gas and Oil Purchase Obligations

Our marketing 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 purchase any natural gas and oil associated with certain volumetric production payment transactions. The purchase commitments are based on market prices at the time of production, and the purchased natural gas and oil is resold.

Minimum Volume Commitment

Pursuant to our gas gathering agreement with our equity investee, CMP, we have committed to deliver specified minimum volumes of natural gas from our Barnett Shale production for each year through December 31, 2018 and for the six-month period ending June 30, 2019. At the end of the term or annually, Chesapeake will be invoiced for any shortfalls in such volume commitments at the rate specified in the agreement. Obligations are as follows:

	Mmcf
2010	335,498
2011	312,963
2012	324,908
2013	338,282
2014	351,265
After 2014	1,686,290
Total	3,349,206

In addition, Chesapeake has entered into commitments to deliver a total volume of 630 bcf from July 2010 through September 2021 to third party midstream companies.

4. Net Income Per Share

Accounting guidance for Earnings Per Share (EPS), requires presentation of basic and diluted earnings per share on the face of the statements of operations for all entities with complex capital structures as well as a reconciliation of the numerator and denominator of the basic and diluted EPS computations.

For the Current Quarter, no securities were antidilutive in the calculation of diluted EPS. 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 EPS for the Prior Quarter, as the effect was antidilutive.

	Shares (in millions)	Net Income Adjustments ($ in millions)
Three Months Ended March 31, 2009:		

Outstanding stock options	1	$	
Unvested restricted stock	2	$	
Common stock equivalent of our preferred stock outstanding:			
4.50% cumulative convertible preferred stock	6	$	3
5.00% cumulative convertible preferred stock (series 2005B)	5	$	3
6.25% mandatory convertible preferred stock	1	$	1

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A reconciliation of basic EPS and EPS assuming dilution for the Current Quarter is as follows:

	Income (Numerator) (Restated)	Weighted Average Shares (Denominator)	Per Share Amount (Restated)
		(in millions, except per share data)	
Three Months Ended March 31, 2010:			
Basic EPS income available to Chesapeake common stockholders	$ 732	630	$ 1.17
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 5.00% cumulative convertible preferred stock (series 2005B)	3	5	
Common shares assumed issued for 4.50% cumulative convertible preferred stock	3	6	
Employee stock options		1	
Restricted stock		5	
Diluted EPS income available to Chesapeake common stockholders and assumed conversions	$ 738	647	$ 1.14

For the Prior Quarter, both 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, were 597 million shares as a result of the net loss to common stockholders. The basic and diluted loss per common share was $9.63.

5. Stockholders Equity, Restricted Stock and Stock Options

Common Stock

The following is a summary of the changes in our common shares issued for the three months ended March 31, 2010 and 2009:

	2010	2009
	(in thousands)	
Shares issued at January 1	648,549	607,953
Stock option exercises	133	100
Restricted stock issuances (net of forfeitures)	2,843	2,858
Convertible note exchanges	298	

Preferred stock conversions/exchanges		183
Common stock issued for the purchase of leasehold and unproved properties		14,361
Shares issued at March 31	651,823	625,455

In the Current Quarter, we privately exchanged approximately $11 million in aggregate principal amount of our 2.25% Contingent Convertible Senior Notes due 2038 for an aggregate of 298,500 shares of our common stock valued at approximately $9 million. Through these transactions, we were able to retire this debt for common stock valued at approximately 80% of the face value of the notes. Associated with these exchanges, we recorded a loss of $2 million. In connection with accounting guidance for debt with conversion and other options, we are required to account for the liability and equity components of our convertible debt instruments separately. Of the $11 million principal amount of convertible notes exchanged in the Current Quarter, $7 million was allocated to the debt component and the remaining $4 million was allocated to the equity conversion feature and was recorded as an adjustment to paid-in-capital. The difference between the debt component and value of the common stock exchanged in these transactions resulted in the $2 million loss. In addition, we expensed a nominal amount of deferred charges associated with the exchanges.

During the Prior Quarter, we issued 14,360,642 shares of common stock, valued at $240 million, for the purchase of proved and unproved properties and leasehold pursuant to an acquisition shelf registration statement.

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Preferred Shares

The following is a summary of the changes in our preferred shares outstanding for the three months ended March 31, 2010 and 2009:

	4.50%	5.00% (2005B)	5.00% (2005)	6.25%	4.125%
			(in thousands)		
Shares outstanding at January 1, 2010 and March 31, 2010	2,559	2,096	5		
Shares outstanding at January 1, 2009	2,559	2,096	5	144	3
Conversion/exchange of preferred for common stock					(3)
Shares outstanding at March 31, 2009	2,559	2,096	5	144	

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 pursuant to the company s mandatory conversion rights.

Dividends

Dividends declared on our common stock and preferred stock are reflected as adjustments to retained earnings to the extent a surplus of retained earnings will exist after giving effect to the dividends. To the extent retained earnings are insufficient to fund the distributions, such payments constitute a return of contributed capital rather than earnings and are accounted for as a reduction to paid-in capital.

Stock-Based Compensation

Chesapeake s stock-based compensation programs consist of restricted stock and stock options issued to employees and non-employee directors. To the extent compensation cost relates to employees directly involved in natural gas and oil exploration and development activities, such amounts are capitalized to natural gas and oil properties. Amounts not capitalized are recognized as general and administrative expenses, production expenses, marketing, gathering and compression expenses or service operations expense. We recorded the following stock-based compensation during the Current Quarter and the Prior Quarter:

	Three Months Ended March 31, 2010	Three Months Ended March 31, 2009
	($ in millions)	
Natural gas and oil properties	$ 37	$ 29
General and administrative expenses	22	19
Production expenses	10	9
Marketing, gathering and compression expenses	4	4
Service operations expense	2	2

Total	$ 75	$ 63

Restricted Stock. Chesapeake regularly issues shares of restricted common stock to employees and to non-employee directors. The fair value of the awards issued is determined based on the fair market value of the shares on the date of grant. This value is amortized over the vesting period, which is generally four or five years from the date of grant for employees and three years for non-employee directors.

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(Unaudited)

A summary of the changes in unvested shares of restricted stock during the Current Quarter is presented below:

	Number of Unvested Restricted Shares (in thousands)	Weighted-Average Grant-Date Fair Value
Unvested shares as of January 1, 2010	19,225	$ 31.89
Granted	4,093	$ 28.03
Vested	(2,577)	$ 28.13
Forfeited	(293)	$ 32.28
Unvested shares as of March 31, 2010	20,448	$ 31.58

The aggregate intrinsic value of restricted stock vested during the Current Quarter was approximately $66 million based on the stock price at the time of vesting.

As of March 31, 2010, there was $463 million of total unrecognized compensation cost related to unvested restricted stock. The cost is expected to be recognized over a weighted average period of 2.47 years.

The vesting of certain restricted stock grants results in state and federal income tax benefits related to the difference between the market price of the common stock at the date of vesting and the date of grant. During the Current Quarter and the Prior Quarter we recognized a reduction in tax benefits related to restricted stock of $1 million and $8 million, respectively, which were recorded as adjustments to additional paid-in capital and deferred income taxes.

Stock Options. We granted stock options prior to 2006 under several stock compensation plans. Outstanding options expire ten years from the date of grant and vested over a four-year period. All stock options outstanding are fully vested and exercisable.

The following table provides information related to stock option activity during the Current Quarter:

	Number of Shares Underlying Options (in thousands)	Weighted Average Exercise Price Per Share	Weighted Average Contract Life in Years	Aggregate Intrinsic Value[(a)] ($ in millions)
Outstanding at January 1, 2010	2,283	$ 8.36	2.75	$ 40
Exercised	(133)	$ 5.66		$
Expired		$		

Outstanding at March 31, 2010	2,150	$ 8.53	2.58	$ 32
Exercisable at March 31, 2010	2,150	$ 8.53	2.58	$ 32

(a) The intrinsic value of a stock option is the amount by which the current market value or the market value upon exercise of the underlying stock exceeds the exercise price of the option.

During the Current Quarter and the Prior Quarter we recognized excess tax benefits related to stock options of $1 million and a nominal amount, respectively, which were recorded as adjustments to additional paid-in capital and deferred income taxes.

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6. Debt

Our total debt consisted of the following at March 31, 2010 and December 31, 2009:

	March 31, 2010	December 31, 2009
	($ in millions)	
7.5% senior notes due 2013	$ 364	$ 364
7.625% senior notes due 2013	500	500
7.0% senior notes due 2014	300	300
7.5% senior notes due 2014	300	300
6.375% senior notes due 2015	600	600
9.5% senior notes due 2015	1,425	1,425
6.625% senior Notes due 2016	600	600
6.875% senior notes due 2016	670	670
6.25% Euro-denominated senior notes due 2017[a]	811	860
6.5% senior notes due 2017	1,100	1,100
6.25% senior notes due 2018	600	600
7.25% senior notes due 2018	800	800
6.875% senior notes due 2020	500	500
2.75% contingent convertible senior notes due 2035[b]	451	451
2.5% contingent convertible senior notes due 2037[b]	1,378	1,378
2.25% contingent convertible senior notes due 2038[b]	752	763
Corporate revolving bank credit facility	1,835	1,892
Midstream revolving bank credit facility	37	
Midstream joint venture revolving bank credit facility[c]		44
Discount on senior notes[d]	(894)	(921)
Interest rate derivatives[e]	75	69
Total notes payable and long-term debt	$ 12,204	$ 12,295

(a) The principal amount shown is based on the dollar/euro exchange rate of $1.3526 to 1.00 and $1.4332 to 1.00 as of March 31, 2010 and December 31, 2009, respectively. See Note 2 for information on our related foreign currency derivatives.

(b) The holders of our contingent convertible senior notes may require us to repurchase, in cash, all or a portion of their notes at 100% of the principal amount of the notes on any of four dates that are five, ten, fifteen and twenty years before the maturity date. The notes are convertible, at the holder s option, prior to maturity under certain circumstances into cash and, if applicable, shares of our common stock using a net share settlement process. One such triggering circumstance is when the price of our common stock exceeds a threshold amount during a specified period in a fiscal quarter. Convertibility based on common stock price is measured quarter by quarter. In the first quarter of 2010, the price of our common stock was below the threshold level for each series of the contingent convertible senior notes during the specified period and, as a result, the holders do not have the option to convert their notes into cash and common stock in the second quarter of 2010 under this provision. The notes are also convertible, at the holder s option, during specified five-day periods if the trading price of the notes is below certain levels determined by reference to the trading price of our common stock. In general, upon conversion of a

contingent convertible senior note, the holder will receive cash equal to the principal amount of the note and common stock for the note s conversion value in excess of such principal amount. We will pay contingent interest on the convertible senior notes after they have been outstanding at least ten years, under certain conditions. We may redeem the convertible senior notes once they have been outstanding for ten years at a redemption price of 100% of the principal amount of the notes, payable in cash. The optional repurchase dates, the common stock price conversion threshold amounts and the ending date of the first six-month period contingent interest may be payable for the contingent convertible senior notes are as follows:

Contingent Convertible Senior Notes	Repurchase Dates	Common Stock Price Conversion Thresholds	Contingent Interest First Payable (if applicable)
2.75% due 2035	November 15, 2015, 2020, 2025, 2030	$ 48.71	May 14, 2016
2.5% due 2037	May 15, 2017, 2022, 2027, 2032	$ 64.36	November 14, 2017
2.25% due 2038	December 15, 2018, 2023, 2028, 2033	$ 107.36	June 14, 2019

(c) Effective January 1, 2010, our midstream joint venture, CMP, was no longer consolidated in accordance with the new authoritative guidance. See Note 1 for further details.

CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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(d) Included in this discount is $771 million at March 31, 2010 and $794 million at December 31, 2009 associated with the equity component of our contingent convertible senior notes.

(e) See Note 2 for discussion related to these instruments.

Senior Notes

Our senior notes are unsecured senior obligations of Chesapeake and rank equally in right of payment with all of our other existing and future senior indebtedness and rank senior in right of payment to all of our future subordinated indebtedness. Chesapeake is a holding company and owns no operating assets and has no significant operations independent of its subsidiaries. Our senior note obligations are guaranteed by certain of our wholly owned subsidiaries. See Note 11 for condensed consolidating financial information regarding our guarantor and non-guarantor subsidiaries. We may redeem the senior notes, other than the contingent convertible senior notes, at any time at specified make-whole or redemption prices. Senior notes issued before July 2005 are governed by indentures containing covenants that limit our ability and our restricted subsidiaries ability to incur additional indebtedness; pay dividends on our capital stock or redeem, repurchase or retire our capital stock or subordinated indebtedness; make investments and other restricted payments; incur liens; enter into sale/leaseback transactions; create restrictions on the payment of dividends or other amounts to us from our restricted subsidiaries; engage in transactions with affiliates; sell assets; and consolidate, merge or transfer assets. Senior notes issued after June 2005 are governed by indentures containing covenants that limit our ability and our subsidiaries ability to incur certain secured indebtedness; enter into sale/leaseback transactions; and consolidate, merge or transfer assets.

We are required to account for the liability and equity components of our convertible debt instruments separately and to reflect interest expense at the interest rate of similar nonconvertible debt at the time of issuance. These rates for our 2.75% Contingent Convertible Senior Notes due 2035, our 2.5% Contingent Convertible Senior Notes due 2037 and our 2.25% Contingent Convertible Senior Notes due 2038 are 6.86%, 8.0% and 8.0%, respectively.

During the Current Quarter, holders of our 2.25% Contingent Convertible Senior Notes due 2038 exchanged approximately $11 million in aggregate principal amount for an aggregate of 298,500 shares of our common stock in privately negotiated exchanges.

No scheduled principal payments are required under our senior notes until 2013 when $864 million is due.

Bank Credit Facilities

We utilize two bank credit facilities, described below, as sources of liquidity.

	Corporate Credit Facility[a]	Midstream Credit Facility[b]
	($ in millions)	
Borrowing capacity	$ 3,500	$ 250
Maturity date	November 2012	September 2012
Facility structure	Senior secured revolving	Senior secured revolving
Amount outstanding as of March 31, 2010	$ 1,835	$ 37

Letters of credit outstanding as of March 31, 2010	$ 41	$

(a) Borrowers are Chesapeake Exploration, L.L.C. and Chesapeake Appalachia, L.L.C.

(b) Borrower is Chesapeake Midstream Operating, L.L.C., a wholly owned subsidiary of Chesapeake Midstream Development, L.P.

Our credit facilities do not contain material adverse change or adequate assurance covenants. Although the applicable interest rates under our general corporate credit facility fluctuate slightly based on our long-term senior unsecured credit ratings, none of our credit facilities contain provisions which would trigger an acceleration of amounts due under the facilities or a requirement to post additional collateral in the event of a downgrade of our credit ratings.

CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Corporate Credit Facility

Our $3.5 billion syndicated revolving bank credit facility is used for general corporate purposes. Borrowings under the facility are secured by certain producing natural gas and oil properties and bear interest at our option at either (i) the greater of the reference rate of Union Bank, N.A. or the federal funds effective rate plus 0.50%, both of which are subject to a margin that varies from 0.00% to 0.75% per annum according to our senior unsecured long-term debt ratings, or (ii) the London Interbank Offered Rate (LIBOR), plus a margin that varies from 1.50% to 2.25% per annum according to our senior unsecured long-term debt ratings. The collateral value and borrowing base are determined periodically. The unused portion of the facility is subject to a commitment fee of 0.50%. Interest is payable quarterly or, if LIBOR applies, it may be payable at more frequent intervals.

The credit facility agreement contains various covenants and restrictive provisions which limit our ability to incur additional indebtedness, make investments or loans and create liens. The credit facility agreement requires us to maintain an indebtedness (excluding discount on senior notes) to total capitalization ratio (as defined) not to exceed 0.70 to 1 and an indebtedness to EBITDA ratio (as defined) not to exceed 3.75 to 1. As defined by the credit facility agreement, our indebtedness to total capitalization ratio was 0.41 to 1 and our indebtedness to EBITDA ratio was 3.05 to 1 at March 31, 2010. 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. Such acceleration, if involving a principal amount of $10 million ($50 million in the case of our senior notes issued after 2004), would constitute an event of default under our senior note indentures, which could in turn result in the acceleration of a significant portion of our senior note indebtedness. The credit facility agreement also has cross default provisions that apply to other indebtedness of Chesapeake and its restricted subsidiaries with an outstanding principal amount in excess of $75 million.

The facility is fully and unconditionally guaranteed, on a joint and several basis, by Chesapeake and all of our other wholly owned restricted subsidiaries.

Midstream Credit Facility

Our $250 million midstream syndicated revolving bank credit facility is used to fund capital expenditures to build natural gas gathering and other systems for our drilling program and for general corporate purposes associated with our midstream operations. Borrowings under the midstream credit facility are secured by all of the assets of the wholly owned subsidiaries (the restricted subsidiaries) of Chesapeake Midstream Development, L.P. (CMD), itself a wholly owned subsidiary of Chesapeake, and bear interest at our option at either (i) the greater of the reference rate of Wells Fargo Bank, National Association, the federal funds effective rate plus 0.50%, and the one-month LIBOR plus 1.00%, all of which are subject to a margin that varies from 2.00% to 2.75% per annum according to the most recent indebtedness to EBITDA ratio (as defined) or (ii) the LIBOR plus a margin that varies from 3.00% to 3.75% per annum according to the most recent indebtedness to EBITDA ratio (as defined). The unused portion of the facility is subject to a commitment fee of 0.50% per annum according to the most recent indebtedness to EBITDA ratio (as defined). Interest is payable quarterly or, if LIBOR applies, it may be payable at more frequent intervals.

The midstream credit facility agreement contains various covenants and restrictive provisions which limit the ability of CMD and its restricted subsidiaries to incur additional indebtedness, make investments or loans and create liens. The credit facility agreement requires maintenance of an indebtedness to EBITDA ratio (as defined) not to exceed 3.50 to 1, and an EBITDA (as defined) to interest expense coverage ratio of not less than 3.00 to 1. As defined by the credit facility agreement, our indebtedness to EBITDA ratio was 0.49 to 1 and our EBITDA to interest expense coverage ratio was 6.75 to 1 at March 31, 2010. If CMD or its restricted subsidiaries should fail to perform their 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. The midstream credit facility agreement also has cross default provisions that apply to other indebtedness CMD and its restricted subsidiaries may have with an outstanding principal amount in excess of $15 million.

CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Other Financings

In 2009, we financed 113 real estate surface assets in the Barnett Shale area 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. This lease transaction was recorded as a financing lease and the cash received was recorded with an offsetting long-term liability on the condensed consolidated balance sheet. Chesapeake exercised its option to repurchase two of the assets in the Current Quarter. As of March 31, 2010, 111 assets were leased and the minimum aggregate undiscounted future lease payments were approximately $840 million.

In 2009, we financed our regional Barnett Shale headquarters building in Fort Worth, Texas 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.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

7. Segment Information

In accordance with accounting guidance for disclosures about segments of an enterprise and related information, we have two reportable operating segments. Our exploration and production operational segment and natural gas and oil midstream segment are managed separately because of the nature of their products and services. The exploration and production segment is responsible for finding and producing natural gas and oil. The midstream segment is responsible for marketing, g