

Chesapeake
Energy
Corporation

Annual
Report

94



SELECTED FINANCIAL DATA

FISCAL YEAR ENDED JUNE 30,		1994	1993	1992
INCOME DATA (\$ IN THOUSANDS, EXCEPT PER SHARE DATA)				
	Oil and gas sales	\$ 22,404	\$ 11,602	\$ 10,520
	Service operations and other	7,420	6,406	8,198
	Total revenues	29,824	18,008	18,718
	Production expenses	3,647	2,890	2,103
	Oil and gas property depreciation, depletion and amortization	8,141	4,184	2,910
	Other depreciation and amortization	1,871	557	974
	Service operations	5,199	3,653	4,113
	General and administrative	3,135	3,620	3,314
	Interest and other	2,676	2,282	2,577
	Provision for legal and other settlements	-	1,286	-
	Total costs and expenses	24,669	18,472	15,991
	Income (loss) before income taxes	5,155	(464)	2,727
	Income tax expense (benefit)	1,250	(99)	1,337
	Net income (loss)	3,905	(365)	1,390
	Earnings per share	\$ 0.73	\$ (0.20)	\$ 0.45
	Operating cash flow per share	\$ 2.83	\$ 1.18	\$ 2.13
	Weighted average shares outstanding	5,360	3,728	3,101
PROPERTY DATA (\$ IN THOUSANDS)				
	Oil reserves (MBbls)	4,154	9,622	11,147
	Gas reserves (MMcf)	117,006	79,763	68,618
	Reserves in equivalent thousand barrels	23,655	22,915	22,583
	Reserves in equivalent million cubic feet	141,992	137,495	135,500*
	Future net revenues discounted at 10% (before tax)	\$141,249	\$ 141,665	\$162,713*
	Oil production (MBbls)	537	276	374
	Gas production (MMcf)	6,927	2,677	1,252
	Production in equivalent thousand barrels	1,692	722	583
	Production in equivalent million cubic feet	10,152	4,333	3,496
	Average oil price (per Bbl)	\$ 15.09	\$ 20.20	\$ 21.85
	Average gas price (per Mcf)	\$ 2.06	\$ 2.25	\$ 1.88
	Average gas equivalent price (per Mcfe)	\$ 2.21	\$ 2.68	\$ 3.01

* As of October 1, 1992

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WHO WE ARE

Chesapeake Energy Corporation is an independent oil and natural gas exploration and production company headquartered in Oklahoma City, Oklahoma. It is traded on the Nasdaq National Market System under the symbol CSPK.

WHAT WE DO

Chesapeake utilizes advanced technological expertise in the drilling of vertical and horizontal wells to exploit areas of proven and potential hydrocarbon production. It teams with major oil companies and large independents to develop its growing inventory of 325 proved and probable drilling locations. The company focuses its efforts geographically in southern Texas and southern Oklahoma.



WHAT WE HAVE ACCOMPLISHED

Since incorporation in 1989, Chesapeake has

- increased earnings to \$4 million
- increased operating cash flow to \$15 million
- increased annual production to 10 BCFE
- increased annual revenue to \$30 million
- increased total assets to \$126 million
- increased proved oil and gas reserves to 142 BCFE.

WHAT IS AHEAD

Chesapeake's shareholders will continue to benefit from

- an accelerated drilling schedule
- larger retained working interests
- further advances in horizontal drilling technology
- a three-year inventory of undrilled locations
- management's substantial ownership of the company's outstanding common shares.

In our initial letter to Chesapeake's shareholders last year, we described how the combination of our large undeveloped leasehold inventory, our drilling expertise, and our strengthened balance sheet would generate substantial growth in the company's assets, production, cash flow and earnings. We are pleased to report that substantial growth did occur, and we believe Chesapeake is well-positioned to continue its growth in fiscal 1995 and beyond.

1994'S ACHIEVEMENTS

We established ambitious goals for the company in fiscal 1994 and believe we achieved all of them. During the year, Chesapeake:

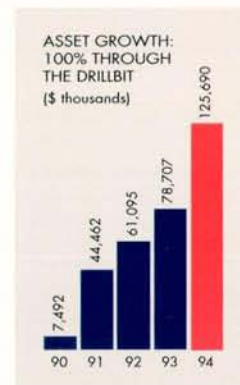
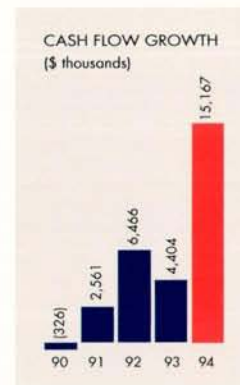
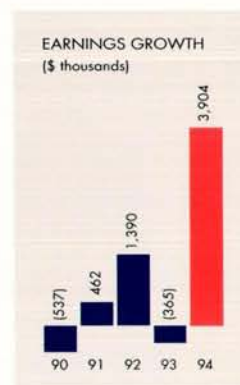
- Increased annual oil and gas production 134% to 10.2 billion cubic feet of gas equivalent (BCFE)
- Increased net income to \$3.9 million from a \$365,000 loss
- Increased operating cash flow 255% to \$15.1 million
- Increased operating cash flow margin 51% to \$1.50 per thousand feet of gas equivalent (MCFE)
- Increased capital through a \$47.5 million senior note offering
- Reduced general and administrative costs by 66% per MCFE
- Reduced depreciation, depletion and amortization costs by 17% per MCFE.
- Reduced production costs by 40% per MCFE

CHESAPEAKE'S GOAL: INDUSTRY LEADERSHIP

Our goal in fiscal 1995 is to lead the independent energy sector in:

- Technological advancement in deep horizontal drilling
- Growth in proved reserves per share
- Profit per unit-of-production
- Return on shareholders' equity

With Chesapeake's oil and gas production expected to double in fiscal 1995 and a relatively fixed cost structure, we believe this goal is achievable.



* Years represented on all graphs are fiscal years

CHESAPEAKE'S STRATEGY: GROWTH THROUGH THE DRILLBIT

We believe the strategy most likely to meet our goal is to drill new wells rather than to purchase other companies' old wells. We call this strategy "growth through the drillbit" and it is the foundation of all that we do. This strategy of growth through the drillbit and management's ownership of approximately 50% of the company are the two most important characteristics distinguishing Chesapeake from its competitors.

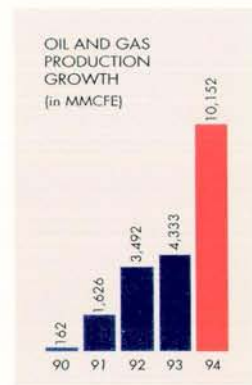
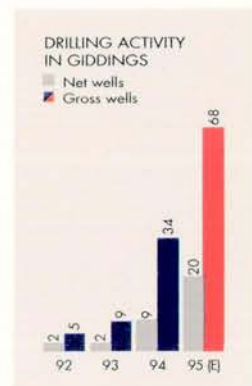
Our geoscientists and landmen have demonstrated the necessary skill to acquire drilling rights in areas where the economic returns from drilling new wells have proven to be greater than the returns from competing in the crowded acquisitions market. Furthermore, we believe Chesapeake's growth strategy of creating value through the drillbit is more sustainable than the alternative strategy, where success is defined by paying the highest price for a producing property.

A review of Chesapeake's fiscal 1994 results evidences the success of our strategy. During the year, Chesapeake drilled 92 wells with a 95% success rate. These new wells generated net production to the company of 5.2 BCFE, or 51% of Chesapeake's fiscal 1994 production. In addition, our drilling in 1994 developed net reserves of 41.7 BCFE at a total cost of \$20.8 million. This translates into a finding cost of \$0.50 per MCFE, which we believe is among the lowest in the industry.

RETAINING MORE OF THE VALUE WE CREATE

One of the reasons for our increasing rate of growth is the higher percentage of ownership Chesapeake now retains in its new wells. Because of capital constraints for most of fiscal 1993, the company drilled only five net wells in Chesapeake's primary operating areas. However, proceeds from the \$25.2 million IPO in February 1993, the \$47.5 million senior note offering in March 1994, and Chesapeake's rapidly increasing cash flow enabled the company to drill 21 net wells in fiscal 1994. We anticipate drilling 34 net wells in fiscal 1995, allowing the company to retain a much larger share of the value our operations team creates.

The combination of our larger working interests and the success of our drilling in the Navasota River area of the Giddings Field in southern Texas has had a substantial impact on our production. Chesapeake increased its average net production in the fourth quarter of fiscal 1994 to 2,160 barrels of oil per day (BOD) and 32 million cubic feet of natural gas per day (MMCFD), 159% and 397% increases over the fourth quarter of fiscal 1993. In addition, our oil and gas



production per share increased 63% and our proved reserves increased to 23 MCFE per share, among the highest in our peer group.

TEAMWORK + TECHNOLOGY = SUPERIOR PERFORMANCE

As reflected by the increases in production and reserves and the decreases in unit operating costs, Chesapeake’s operations team performed exceptionally well in fiscal 1994. We expect this performance to continue as we enhance Chesapeake’s position as an industry leader by implementing state-of-the-art horizontal drilling techniques in the Giddings Field.

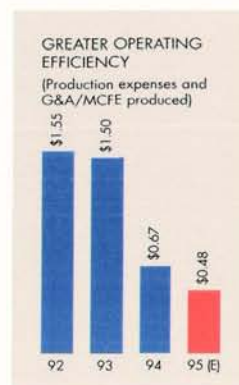
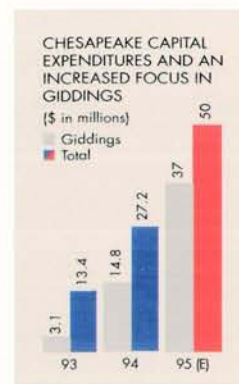
We have now drilled 63 horizontal wells in Giddings and have developed a specific expertise in the high pressure and high temperature environment of the downdip, or deeper, portion of the Giddings Field. Chesapeake is drilling or has drilled eight of the 12 deepest horizontal wells in the Giddings Field. The company is presently capable of drilling its Giddings wells to a combined vertical and horizontal depth in excess of 20,000 feet.

Since our IPO in February 1993, Chesapeake has drilled 52 horizontal wells in the Giddings Field. These wells have produced an average of 369 BOD and 5.1 MMCFD, have returned an average of 127% of their cost, and paid out in an average of six months. The strength of these wells has enabled Chesapeake to lead its peer group in per-well productivity, an important contributor to meeting our profitability goals.

Even more impressive are the 13 Giddings wells we have drilled in the Navasota River area, which was introduced in last year’s annual report as one of Chesapeake’s “New Areas”. Our first well in Navasota River began producing in February 1994, and since that time these 13 Navasota River wells have averaged 600 BOD and 10.7 MMCFD and paid out in less than three months. We believe these Navasota River wells are among the best wells drilled in the onshore U. S. by any company in 1994.

PRIMARY OPERATING AREAS

For the third consecutive year and for the foreseeable future, Chesapeake will focus its drilling activities on the Giddings Field of southern Texas and the Golden Trend Field of southern Oklahoma. In these fields, the company has developed a competitive advantage through its proprietary land and geophysical assets and its expertise in advanced drilling techniques. By utilizing sophisticated drilling and



completion technologies in the appropriate geological environment, Chesapeake has lowered its finding and production costs, reduced its financial risks, and increased its per-well reserve recoveries. We further believe Chesapeake's process of value creation will be sustainable in its primary operating areas for years to come.

THE GIDDINGS FIELD

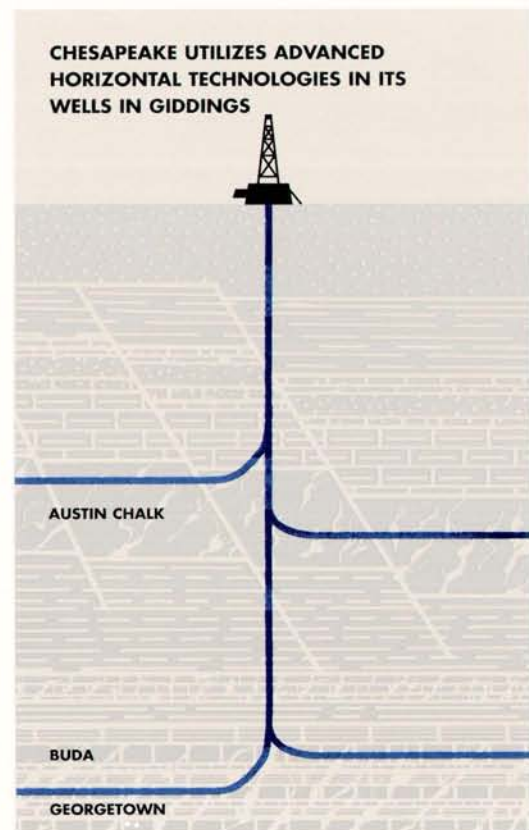
Chesapeake's most important assets are located in the Giddings Field, one of the most active and prolific fields in the nation. Since 1991, Chesapeake, Union Pacific Resources Company and others have drilled more than 1,000 horizontal wells in Giddings with a total capital investment in excess of \$1 billion.

Giddings is also one of the largest oil and gas fields in the nation, with a fairway of production 75 miles long and 25 miles wide. Giddings produces primarily from the Austin Chalk, Buda, and Georgetown formations, Cretaceous-age fractured carbonate reservoirs found at depths from 7,000 to 16,000 feet. Activity in the field can be divided into two areas—the updip portion, with producing depths above 11,000 feet where production is primarily oil, and the downdip portion, with producing depths ranging from 11,000 feet to the present limit of 15,000 feet where production is primarily natural gas.

UPDIP VS. DOWNDIP

The financial results and technological expertise associated with these two areas of the Austin Chalk are vastly different. The updip, or shallower, play has been the focus of operators who are using horizontal drilling as a method of secondary recovery. These operators are extracting the remaining oil reserves not recovered from the 7,500 vertical wells drilled in the updip area during the 1970's and early 1980's. Reserves and financial results per well are significantly lower in the updip area because of depletion caused by the earlier vertical drilling and by competition for reserves created by the smaller horizontal drilling units utilized in the updip area.

Chesapeake's drilling expertise and 175,000 gross acre leasehold position have enabled the company to lead the development of the downdip part of the field during the past year. The downdip play is characterized by higher reservoir pressures, a



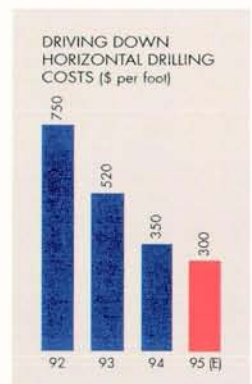
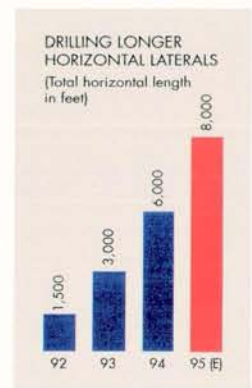
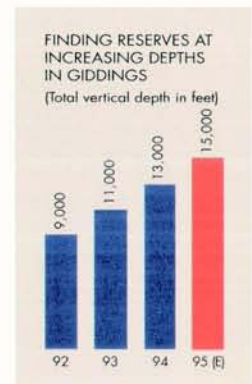
production stream weighted toward natural gas, more intense natural fracturing, and an absence of depletion. In addition, these downdip areas are being developed using more advanced drilling technologies and larger spacing units. The combination of higher reservoir quality and more sophisticated drilling practices has generated outstanding results. For the 13 Navasota River wells drilled in the downdip area, our finding costs have been \$0.27 per MCFE, far lower than the industry average of \$1.09. Equally important, the downdip wells have exhibited significantly flatter decline curves than the updip wells.

REQUIREMENTS FOR SUCCESS IN THE DOWNDIP AUSTIN CHALK

We believe Chesapeake has “broken the code” in the downdip Austin Chalk by developing a drilling strategy built around three distinguishing characteristics. First, Chesapeake has acquired large contiguous leasehold blocks. This allows Chesapeake to establish 700 to 1,000 acre drilling units resulting in wells that are spaced approximately one mile apart. These large spacing units help to protect against drainage from offsetting wells. By comparison, the typical spacing pattern for an updip well is 200 to 400 acres with wells commonly spaced one-half mile apart, thus increasing the likelihood of competition for reserves.

Secondly, Chesapeake has developed the drilling experience and geological expertise within the field to identify the most prolific 15 to 20 foot sections of the 100 foot thick lower Austin Chalk formation. Chesapeake identifies these sections through the integration of seismic interpretation with logging-while-drilling gamma ray tools to ensure that the drillbit stays within these narrowly defined pay zones. The company’s expertise in identifying and drilling within the most productive intervals of the Austin Chalk has helped Chesapeake enjoy higher per-well recoveries than any of its competitors in Giddings during the last eighteen months.

Finally, Chesapeake has participated in and contributed to the rapid rate of technological progress in horizontal drilling tools. Innovations in downhole motors, measurement-while-drilling tools, drillbit designs, and multiple lateral wellbore drilling have enabled Chesapeake to reduce its drilling costs per horizontal foot by almost 60% since 1992. The company’s expertise and creativity with this rapidly expanding technology have helped Chesapeake expand the boundaries of the downdip play in Giddings to 15,000 feet, creating significant additional drilling opportunities. In 1995, Chesapeake intends to further expand this downdip limit.



THE INITIAL DOWNDIP PLAY: FAYETTE COUNTY

Chesapeake has divided the downdip play in the Giddings Field into three areas: Fayette, Navasota River and Independence. In August 1991, Chesapeake acquired development rights to the 15,000-acre GeoSouthern block, our first acreage holding in the downdip Fayette area. After successfully drilling 12 wells on this block, we contributed the remaining undeveloped portion of the GeoSouthern acreage into a 20,000 acre joint venture with Union Pacific in October 1993. In this joint venture, Union Pacific and Chesapeake have cooperated in pioneering and further developing the advanced technology of drilling dual opposing laterals (two horizontal laterals drilled in opposite directions from the same vertical wellbore) and dual stacked laterals (two horizontal laterals drilled in the same direction but at different depths from the same vertical wellbore). To date, 11 wells have been drilled in this joint venture, generating cumulative gross production of 15 BCFE and estimated remaining reserves of 37 BCFE. For fiscal 1995, Chesapeake has budgeted \$5 million to drill three net (14 gross) wells in the Chesapeake/Union Pacific joint venture, with additional development contemplated in fiscal 1996 and beyond.

To the south (and further downdip) from the Chesapeake/Union Pacific joint venture, Chesapeake is participating in a 50/50 joint venture with Swift Energy Company to develop 8,000 gross acres known as the LCRA block. Adjacent to and on structural strike with the LCRA block, Chesapeake has also acquired 5,000 gross acres in the Fayetteville prospect. Drilling on these blocks is scheduled to begin in the second quarter of fiscal 1995 after our 3-D seismic data has been processed. For fiscal 1995, Chesapeake has budgeted \$4 million to drill three net (11 gross) wells in these two areas, leaving six potential wells to be drilled in fiscal 1996 and beyond.

Chesapeake is acquiring other acreage in the Fayette area and we believe this portion of the downdip Giddings Field will continue to play an important role in the company's future drilling plans.



THE SECOND DOWNDIP PLAY: NAVASOTA RIVER

Chesapeake believes its 13 wells in Navasota River demonstrate that this 45,000 acre block in the downdip portion of the Giddings Field may represent the best drilling opportunity in the United States. The Navasota River leasehold block, located in Brazos and Grimes Counties, Texas, was introduced in the “New Areas” section of last year’s annual report. We were hopeful that the drilling results in Navasota River would be as attractive as those we had experienced in the downdip Fayette area. However, the results from the 13 wells in Navasota River have significantly exceeded our expectations. Gross reserves per well have been estimated by our independent reservoir engineers to exceed an average of eight BCFE. For fiscal 1995, Chesapeake has budgeted \$18 million to drill nine net (24 gross) wells in Navasota River, leaving approximately 20 potential wells to be drilled in fiscal 1996 and beyond.

THE THIRD DOWNDIP PLAY:

INDEPENDENCE

The Independence area could become Chesapeake’s third downdip success based on the company’s geological model that has performed successfully in the downdip areas of Fayette and Navasota River. Located to the south and southwest of the Navasota River area in Grimes and Washington Counties, the Independence acreage block contains approximately 100,000 gross acres on which potentially 100 horizontal wells could be drilled. For fiscal 1995, we have budgeted approximately \$8 million to drill five net (19 gross) wells that will test

NAVASOTA RIVER DRILLING RESULTS (2/7/94 THROUGH 10/10/94)				
Well	Days On Line	Average Daily Oil (Bbls)	Average Daily Gas (Mcf)	Cumulative BOE
#1	248	1,215	7,052	592,815
#2	194	1,030	8,924	488,388
#3	193	212	16,319	565,850
#4	147	832	11,212	397,014
#5	114	1,195	5,511	240,978
#6	102	129	14,046	251,921
#7	85	43	13,847	199,808
#8	62	333	13,438	159,475
#9	50	12	12,688	106,322
#10	38	946	6,859	79,386
#11	37	1,172	4,927	73,741
#12	31	30	15,667	81,882
#13	10	640	8,522	20,607
AVERAGE	101	600	10,693	
TOTAL				3,258,157
CHESAPEAKE’S INVENTORY OF DOWNDIP UNDRILLED LOCATIONS				
FAYETTE				31
NAVASOTA RIVER				44
INDEPENDENCE				100

the block's potential. If these initial wells are successful, we believe Independence could add significantly to the company's oil and gas reserves. However, as with Navasota River last year, we have not included any reserve value from the Independence area in this year's reserve report.

ADDITIONAL OBJECTIVES

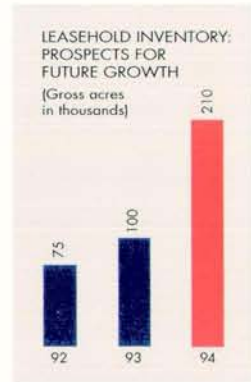
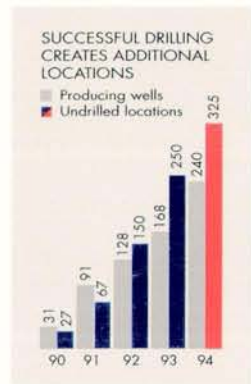
Although the Austin Chalk is the primary target of almost all horizontal wells in the Giddings Field, the Buda and Georgetown formations, other fractured carbonates of the Cretaceous age, are located within 1,000 feet of the base of the Austin Chalk. We believe the geological conditions that created the fracturing in the Austin Chalk also created similar fracturing in the Buda and Georgetown.

In May 1992, Chesapeake drilled the first producing horizontal Georgetown well in Grimes County, near the town of Iola, Texas. This well, located 15 miles north of Chesapeake's main Navasota River block, has produced approximately 2.8 BCFE in two years. As importantly, the well continues to produce in excess of its initial daily production rate of 3.4 MMCFD. In March 1994, Chesapeake drilled a vertical well 20 miles to the south of Iola on the southern edge of the main Navasota River block to further test the potential of the Georgetown. This vertical well tested 1.2 MMCFD from the Georgetown before being plugged back to establish initial production of 7.4 MMCFD from the Austin Chalk.

We believe these two wells provide evidence that the Buda and Georgetown may prove productive under a large portion of Chesapeake's 175,000 gross acres in the downdip Giddings play. To further evaluate our theory, Chesapeake has budgeted \$2 million in fiscal 1995 to drill two horizontal Buda and Georgetown wells in a 50/50 joint venture with Snyder Oil Corporation.

THE GOLDEN TREND

Chesapeake's second primary operating area is the Golden Trend Field of southern Oklahoma, one of the most active fields in the Mid-Continent region of the nation. During the last ten years, Chesapeake, Amerada Hess, Anadarko, Mobil, Phillips, OXY and others have drilled more than 450 wells in the Golden Trend with a total capital investment of approximately \$400 million.



Wells in the Golden Trend Field have many attractive characteristics, including reserves that are long-lived and weighted 85% towards liquids-rich natural gas. In addition, drilling costs are predictable and controllable, and multiple zone completions reduce geological and financial risk. Chesapeake has developed a significant geological and engineering niche in the Golden Trend, enabling the company to generate attractive finding costs and low lifting costs. Chesapeake excels in the drilling of these technically-demanding deep wells. In fact, in fiscal 1994, our 30 Golden Trend wells averaged 13,500 feet in depth, making Chesapeake the leader in average well depth drilled in Oklahoma.

Moreover, the company's land position in the Golden Trend continues to grow. After beginning the year with 150 undrilled locations in our Golden Trend inventory and after drilling 30 wells (23 operated by Chesapeake and seven by Anadarko), Chesapeake still controls more than 150 undrilled Golden Trend locations. For fiscal 1995, Chesapeake has budgeted \$11 million to drill 12 net (50 gross) wells in the Golden Trend.

In August 1994, Chesapeake renewed for a second three-year period its 50/50 joint venture with Amerada Hess in the Golden Trend. In this joint venture, Chesapeake drills and operates the wells and Amerada Hess assists with geophysical and engineering support. In addition to Amerada Hess, Chesapeake has smaller joint ventures in this field with Mobil, Texaco, Amoco, Phillips, Marathon, Chevron, and Noble Affiliates.

As in Giddings, Chesapeake continues to deepen the downdip limits of the Golden Trend Field. In fiscal 1994, Chesapeake drilled the first two wells that established production below 15,000 feet from the Sycamore, Woodford, Hunton, and Viola formations in the Knox area of the Golden Trend.

KNOX

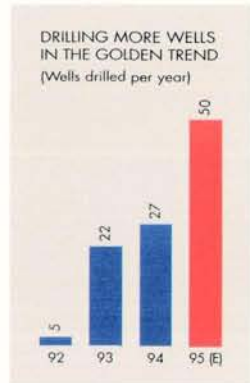
Knox is the second "New Area" we would like to introduce in this report. Knox is a southwest extension to the Golden Trend and represents a significant opportunity for Chesapeake to further increase the company's reserves. In fiscal 1995, through our Knox area development, Chesapeake will become the first company to establish



production from below 16,000 feet in the Sycamore, Woodford, Hunton and Viola formations in the Golden Trend. Our success in Knox demonstrates Chesapeake's ability to leverage its geological, engineering, and land expertise into new areas that have the potential to increase proved reserves.

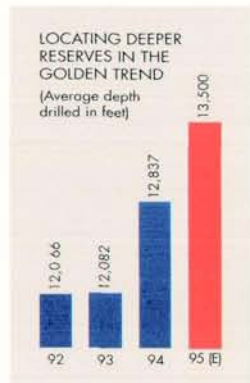
SHOLEM ALECHEM

In last year's annual report, we introduced our joint venture with Texaco in the Sholem Alechem area in Oklahoma as the second "New Area" after Navasota River. The Sholem Alechem area is located within southern Oklahoma's giant Sho-Vel-Tum Field. This field has produced more than one billion barrels of oil and one trillion cubic feet of gas since its discovery more than 80 years ago. We have drilled two successful wells in the Sholem Alechem joint venture and have budgeted \$2 million to drill two net (six gross) wells in fiscal 1995. If this year's drilling activities are successful, we believe the Sholem Alechem area is large enough to support the drilling of more than 50 horizontal wells. We believe our horizontal drilling joint venture with Texaco also demonstrates Chesapeake's ability to utilize its expertise in advanced technologies to develop strong relationships with major oil companies.



CONSISTENT STRATEGY

Our decision to reproduce last year's cover and continue the conservative theme for Chesapeake's annual report is evidence of the consistency of our corporate strategy. Since Chesapeake's inception in 1989, all of the company's reserves and assets have been built through drilling activities. We plan to continue this proven strategy of growth through the drillbit.



Our plan centers on an aggressive undeveloped leasehold acquisition program. It currently provides a three-year inventory of undrilled locations on which we intend to utilize advanced horizontal and vertical drilling technologies to generate continuing production and reserve growth. We believe this strategy will create substantial value for our shareholders.

LOOKING TO THE FUTURE

As impressive as our growth has been in fiscal 1994, we believe we have the appropriate strategy and infrastructure to improve further in fiscal 1995. Our large undeveloped acreage inventory, improving drilling technologies, and creative,

dedicated employee/shareholders should enable Chesapeake to reach our goals for fiscal 1995. Furthermore, because management owns approximately 50% of Chesapeake's stock, shareholders can be assured that we will remain focused on growth in reserves, cash flow, and earnings per share.


We again express our gratitude to our Board of Directors who have provided excellent counsel through their collective experience and business acumen. They have provided Chesapeake with invaluable insight and perspective during this period of exceptional growth. We also appreciate the talent and work ethic of our employees, all of whom are recognized on pages 14 and 15 of this report.

We also express our gratitude to our fellow shareholders. Our job is to make money for you and we will remain dedicated to this challenge. We promise to continue to work hard and make Chesapeake the standard by which other independent energy companies are measured.



Aubrey K. McClendon

Chairman of the Board and Chief Executive Officer



Tom L. Ward

President and Chief Operating Officer

October 10, 1994

DIRECTORS

Aubrey K. McClendon

*Chairman of the Board and Chief Executive Officer
Oklahoma City, Oklahoma*

Tom L. Ward

*President and Chief Operating Officer
Oklahoma City, Oklahoma*

Edgar F. Heizer, Jr.

*Private Venture Capitalist
Chicago, Illinois*

Breene M. Kerr

*Chairman and President
Kerr Consolidated
Easton, Maryland*

Shannon T. Self

*Partner
Self, Giddens & Lees, Inc.
Oklahoma City, Oklahoma*

Frederick B. Whittemore

*Advisory Director
Morgan Stanley & Co.
New York, New York*

Walter C. Wilson

*General Agent
Massachusetts Mutual Life Insurance Company
Houston, Texas*

PRINCIPAL OFFICERS

Aubrey K. McClendon

Chairman of the Board and Chief Executive Officer

Tom L. Ward

President and Chief Operating Officer

Marcus C. Rowland

Vice President—Finance and Chief Financial Officer

Steven C. Dixon

Vice President—Texas Exploration

J. Mark Lester

Vice President—Oklahoma Exploration

Henry J. Hood

Vice President—Land and Legal

Ronald A. Lefaive

Controller

Steven J. Clark

Treasurer

Thomas S. Price, Jr.

Vice President—Corporate Development

CHESAPEAKE EMPLOYEES

John Akins <i>Truck Driver</i>	James Burton <i>Truck Driver</i>	David DeSalvo <i>Pumper</i>	Kenneth Greer <i>Dozer Operator</i>	Richard Johnson <i>Mechanic</i>
Colene Aldridge <i>Land Secretary</i>	Dee Burdick <i>Executive Assistant</i>	Alton Dickey <i>Pumper</i>	Cheryl Hamilton <i>Staff Accountant</i>	Howard Jones <i>Roustabout</i>
Jason Allen <i>Roustabout</i>	John Calvin <i>Roustabout</i>	Tipton Dilbeck <i>Truck Driver</i>	Edward Hammond <i>Truck Driver</i>	Frank Jordan <i>Oklahoma Production Manager</i>
Sandra Alvarado <i>Lease Analyst</i>	William Camp <i>Roustabout</i>	Steve Dixon <i>Vice President— Texas Exploration</i>	Monte Harlen <i>Pumper</i>	Margaret Keeler <i>Secretary</i>
Colley Andrews <i>Texas Drilling Superintendent</i>	Donny Camp <i>Roustabout</i>	Allen Dobbins <i>Dozer Operator</i>	Charles Harris <i>Truck Driver</i>	James Keenan <i>Truck Driver</i>
Ricky Austin <i>Roustabout</i>	Alfred Chain <i>Truck Driver</i>	Janice Dobbs <i>Compliance Manager</i>	Marydith Harris <i>Accounting Assistant</i>	Clyde Kennedy <i>Field Inventory Manager</i>
Robby Austin <i>Roustabout</i>	Jimmy Chollett <i>Roustabout</i>	Penny Dodson <i>Revenue Supervisor</i>	Gaylon Havel <i>Dozer Operator</i>	David Kennedy <i>Truck Driver</i>
James Baker <i>Roustabout</i>	Melvin Church <i>Mechanic</i>	Dianne Eickenhorst <i>Administrative Assistant</i>	Bryon Haynes <i>Roustabout</i>	Sherry Kesler <i>Secretary</i>
Mark Baker <i>Roustabout</i>	Jerry Clark <i>Mechanic</i>	Jerry Edwards <i>Truck Driver</i>	Scotty Haynes <i>Service Company Supervisor</i>	William Kesler <i>Welder</i>
Barbara Bale <i>Regulatory Analyst</i>	Steve Clark <i>Treasurer</i>	Vicki Ervin <i>Accounting Assistant</i>	Duane Heckelsberg <i>Texas Staff Geologist</i>	Darvin Knapp <i>Texas Drilling Superintendent</i>
Marilyn Ball <i>JIB Coordinator</i>	Kimberly Coffman <i>Accounting Supervisor</i>	John Ferris <i>Service Company Manager</i>	Gilbert Hernandez <i>Roustabout</i>	Gregory Knight <i>Accounting Assistant</i>
Ralph Ball <i>MIS Coordinator</i>	Ronald Conner <i>Truck Driver</i>	Sam Flax <i>Truck Driver</i>	David Higgins <i>Production Foreman</i>	Wes Kruckenberg <i>Completion Foreman</i>
Melvin Bennett <i>Truck Driver</i>	Jerry Cordell <i>Mechanic</i>	Blas Flores <i>Truck Foreman</i>	Terry Holland <i>Dispatcher</i>	Charles Lampe <i>Truck Driver</i>
Rodney Beverly <i>Pumper</i>	Rose-Marie Coulter <i>Payroll/Benefits Assistant</i>	Joe Foster <i>Pumper</i>	Henry Hood <i>Vice President—Land and Legal</i>	Steve Lane <i>Texas Staff Geologist</i>
Jackson Billy <i>Roustabout</i>	Clayton Cramton <i>Welder</i>	Rick Foster <i>Draftsman</i>	Dennis Huckaby <i>Roustabout</i>	Tommy Lawson <i>Roustabout</i>
Daniel Bramlett <i>Welder</i>	Joe Crawford <i>Truck Driver</i>	Celia Gibson <i>Revenue Accountant</i>	Joe Hrnair <i>Texas Operations Coordinator</i>	John Layton <i>Roustabout</i>
James Brinkley <i>Welder</i>	Lorre Cronk <i>Land Clerk</i>	John Gomez <i>Roustabout</i>	Richard Hughes <i>Pumper</i>	Dan LeDonne <i>Administrative Services</i>
Carla Brittain <i>Geology Technician</i>	Doyle Davis <i>Foreman</i>	Patricia Goode <i>Oklahoma Landman</i>	Drayton Hulsey <i>Dozer Operator</i>	Ron Lefaive <i>Controller</i>
Beverly Brown <i>Land Technician</i>	William Davis <i>Truck Driver</i>	Ronnie Goree <i>Roustabout</i>	Brian Imes <i>Courier</i>	Jesse Lehman <i>Truck Driver</i>
James Brown <i>Truck Driver</i>	Sheree Davis <i>Staff Accountant</i>	Buddy Graham <i>Truck Driver</i>	Charles Imes <i>Director—MIS</i>	Anthony Lehoski <i>Welder</i>
Teresa Brunzman <i>Administrative Assistant</i>	Beth Decker <i>Division Order Analyst</i>	Patricia Greene <i>Accounting Assistant</i>	Albert Jarmon <i>Truck Driver</i>	Richard Lehoski <i>Welder</i>
David Burton <i>Dozer Operator</i>	Kevin Decker <i>Sr. Production Accountant</i>		Mike Johnson <i>Assistant Controller</i>	

Mark Lester <i>Vice President– Oklahoma Exploration</i>	Jose Morales <i>Roustabout</i>	Lawrence Rogers <i>Production Foreman</i>	Julie Turner <i>Dozer Operator</i>	Jamie Worden <i>Secretary</i>
Carol Locke <i>Dozer Operator</i>	Shannon Morrison <i>Truck Driver</i>	Marc Rowland <i>Vice President– Finance and CFO</i>	Ronald Vandver <i>Truck Driver</i>	Eddie Wright <i>Roustabout</i>
Beverly Long <i>Accounting Assistant</i>	Linda Mouser <i>Truck Driver</i>	Danny Ruthledge <i>Pumper</i>	Georgia Van Horn <i>Executive Assistant</i>	Dero Wright <i>Texas Yard Foreman</i>
Kinney Louthan <i>Texas Landman</i>	Jeff Neumann <i>Administrative Assistant</i>	William Sanders <i>Oklahoma Field Coordinator</i>	Kimberly Volk <i>Accounting Assistant</i>	
Marilyn Lynch <i>Lease Analyst Supervisor</i>	Roger Noel <i>Truck Driver</i>	Patti Schlegel <i>Lease Records Supervisor</i>	Peggy Vosika <i>Lease Analyst</i>	
Veryl McCall <i>Truck Driver</i>	Tonya Oliver <i>Accounting Assistant</i>	Paul Schoolfield <i>Dispatcher</i>	Jimmy Walleck <i>Truck Driver</i>	
Rich McClanahan <i>Texas Production Manager</i>	Greg Pearce <i>Texas Field Supervisor</i>	Kelly Shoemaker <i>Roustabout</i>	Ronnie Ward <i>Texas Land Manager</i>	
Aubrey McClendon <i>Chairman and CEO</i>	Jack Perkins <i>Dozer Operator</i>	Sue Shires <i>Accounting Assistant</i>	Steve Ward <i>Courier</i>	
Joe McClendon <i>Gas Contracts</i>	Linda Peterburs <i>Staff Accountant</i>	Steve Sims <i>Accounting Manager</i>	Tim Ward <i>Truck Driver</i>	
James McCurley <i>Truck Driver</i>	Billy Phillips <i>Roustabout</i>	Vivian Smith <i>Geology Technician</i>	Tom Ward <i>President and COO</i>	
Janelle McNeely <i>Title Analyst</i>	Randy Pierce <i>Purchasing Agent</i>	Daniel Smithey <i>Dispatcher</i>	Julie Washam <i>Executive Assistant</i>	
Franklin McGee <i>Roustabout</i>	Pat Pope <i>Sr. Accountant</i>	Debbie Stafford <i>Division Order Analyst</i>	Clarence Watts <i>Production Foreman</i>	
Danny McGee <i>Roustabout</i>	Tom Price, Jr. <i>Vice President– Corporate Development</i>	Kirsten Stanfield <i>Financial Analyst</i>	Louis Watts <i>Welder</i>	
Enrique Maldonado <i>Roustabout</i>	Wayne Psencik <i>Texas Drilling Engineer</i>	Willard Steakley <i>Truck Driver</i>	Melanie Weaver <i>Title Analyst</i>	
Felipe Maldonado <i>Roustabout</i>	Gary Ramsey <i>Welder</i>	Lisa Stewart <i>Secretary</i>	Janet Weeks <i>Receptionist</i>	
August May <i>Service Company Foreman</i>	James Randol <i>Roustabout</i>	John Striplin <i>Dozer Operator</i>	Randy Wells <i>Truck Driver</i>	
Steve Miller <i>Texas District Manager</i>	Lori Ray <i>Land Technician</i>	Randy Summers <i>Oklahoma Production Manager</i>	Luann Wernli <i>Accounting Assistant</i>	
Tommy Miller <i>Roustabout</i>	Deborah Richardson <i>Executive Assistant</i>	Deborah Teinert <i>Production Clerk</i>	Bobby Wheeler <i>Dispatcher</i>	
James Mitchell <i>Truck Driver</i>	Christie Rickey <i>Accounting Assistant</i>	Mike Thomas <i>Pumper</i>	Shelly White <i>Lease Records Assistant</i>	
Charles Mize <i>Truck Driver</i>	Mark Robins <i>Audit Manager</i>	Shannon Thompson <i>Production Clerk</i>	Ken Will <i>Oklahoma Drilling Superintendent</i>	
Augustin Morales <i>Roustabout</i>	Paul Robinson <i>Welder</i>	Joey Tipton <i>Truck Driver</i>	Cindi Williams <i>Engineering Technician</i>	
	Connie Robles <i>Division Order Manager</i>		Jeff Williams <i>Oklahoma Landman</i>	
			Dave Wittman <i>Texas Production Engineer</i>	

STOCK DATA	High	Low	Last
Fiscal 1993:			
Third Quarter (commencing February 4, 1993)	12 ¼	10 ½	12 ¼
Fourth Quarter	12	8 ¾	10 ¾
Fiscal 1994:			
First Quarter	11 ¾	6 ½	6 ¾
Second Quarter	7 ¾	4 ½	4 ¾
Third Quarter	6 ¾	4 ¼	6 ¼
Fourth Quarter	10 ¾	5 ¼	10 ¾
Fiscal 1995:			
First Quarter	22	8	21 ¼

COMMON STOCK

Chesapeake Energy Corporation common stock is listed on the Nasdaq National Market System under the symbol CSPK. At September 30, 1994, there were 812 beneficial owners of the common stock.

DIVIDENDS

The company's policy is to retain its earnings to support the growth of the company. Chesapeake's Board of Directors has not authorized the payment of cash dividends on its common stock.

FORM 10-K

Stockholders may obtain a copy of Chesapeake Energy Corporation's Form 10-K report as filed with the Securities and Exchange Commission by contacting Thomas S. Price, Jr. at the address of the corporate offices above or by calling (405) 848-8000, extension 257.

CORPORATE HEADQUARTERS

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Oklahoma City, Oklahoma 73118
(405) 848-8000

INDEPENDENT PUBLIC ACCOUNTANTS

Price Waterhouse LLP
15 North Robinson, Suite 400
Oklahoma City, Oklahoma 73102
(405) 272-9251

STOCK TRANSFER AGENT AND REGISTRAR

Liberty Bank & Trust Company of
Oklahoma City, N.A.
100 North Broadway Avenue
Oklahoma City, Oklahoma 73102
(405) 231-6764

Communication concerning the transfer of shares, lost certificates, duplicate mailings or change of address notifications should be directed to the transfer agent.

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SELECTED FINANCIAL DATA

The following table sets forth selected consolidated financial data of the company for each of the five fiscal years ended June 30, 1994. The data is derived from the financial statements of the company which have been audited by Price Waterhouse LLP, independent

accountants. The data set forth in this table should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the Consolidated Financial Statements and related notes included elsewhere in this report.

	1994	1993	YEARS ENDED JUNE 30,		1991	1990
			1992			
STATEMENT OF OPERATIONS DATA:						
(\$ IN THOUSANDS, EXCEPT PER SHARE DATA)						
Revenues:						
Oil and gas sales	\$ 22,404	\$ 11,602	\$ 10,520	\$ 4,334	\$ 389	
Oil and gas service operations	6,439	5,526	7,656	1,961	197	
Interest and other	981	880	542	148	38	
Total revenues	29,824	18,008	18,718	6,443	624	
Costs and expenses:						
Production expenses and taxes	3,647	2,890	2,103	760	43	
Oil and gas service operations	5,199	3,653	4,113	606	136	
Oil and gas depreciation, depletion and amortization	8,141	4,184	2,910	1,585	85	
Depreciation and amortization of other assets	1,871	557	974	351	126	
General and administrative	3,135	3,620	3,314	2,119	759	
Provision for legal and other settlements	—	1,286	—	—	—	
Interest and other	2,676	2,282	2,577	317	12	
Total costs and expenses	24,669	18,472	15,991	5,738	1,161	
Income (loss) before income taxes	5,155	(464)	2,727	705	(537)	
Income tax expense (benefit)	1,250	(99)	1,337	243	—	
Net income (loss)	\$ 3,905	\$ (365)	\$ 1,390	\$ 462	\$ (537)	
Dividends on preferred stock	\$ —	\$ 385	\$ —	\$ —	\$ —	
Net income (loss) per common share	\$.73	\$ (.20)	\$.45	\$.15	\$ (.17)	
CASH FLOW DATA:						
Cash provided by (used in) operating activities	\$ 19,423	\$ (1,499)	\$ 11,550	\$ 14,821	\$ 2,081	
Cash used in investing activities	29,211	15,142	26,987	21,928	1,006	
Cash provided by financing activities	21,162	20,802	12,779	9,247	133	
BALANCE SHEET DATA: (AT END OF PERIOD)						
Working capital (deficit)	\$ 2,391	\$ (9,994)	\$ (24,629)	\$ (15,661)	\$ (1,351)	
Total assets	125,690	78,707	61,095	44,462	7,492	
Long-term debt, net of current maturities	47,878	14,051	22,154	8,570	289	
Stockholders' equity (deficit)	31,260	31,432	132	(1,559)	(655)	

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

OVERVIEW

In March 1994, the company completed a private placement of \$47.5 million in Senior Notes and Warrants, which resulted in net cash proceeds to the company of approximately \$37.1 million. As part of this placement, the company issued \$8 million of Notes and Warrants in exchange for \$7.5 million of the company's Convertible Preferred Stock, including accrued but unpaid dividends, warrants to purchase 312,001 shares of the company's common stock and other consideration. The company used approximately \$20.4 million of these proceeds to retire existing indebtedness, including retirement of substantially all amounts outstanding under the company's vendor financing programs and to Union Bank.

With the balance remaining of approximately \$16.7 million, the company was able to expand its drilling operations while maintaining a larger working interest in wells. The company participated in 26 gross wells (5.3 net) in the fourth quarter of fiscal 1994 alone, of which 17 gross (3.8 net) were in the Giddings and Golden Trend Fields.

During fiscal 1994, the company participated in 92 gross wells (19.0 net), of which 49 were operated by the company. In its primary operating areas, the Giddings and Golden Trend Fields, the company's finding costs were approximately \$.49 per Mcfe, and approximately \$.51 per Mcfe for all areas in fiscal 1994. The company added an estimated 41 Bcfe of proved developed reserves as a result of this drilling, well in excess of its 10.2 Bcfe of production.

A significant development for the company during fiscal 1994 was the drilling of several successful exploratory wells in the Navasota River area of the Giddings Field. Three of these wells were drilled more than five miles from existing production and one well resulted in a productive completion at 13,200 feet. The company believes this to have been the deepest producing Austin Chalk well at the

time of completion. As a result of this success, the company accelerated development of this new area and currently has five rigs operating in the area. Over 67 Bcfe of proved reserves were added as of June 30, 1994 to the company's interest in the Navasota River area. The company expects to drill as many as forty wells within the Navasota River area in fiscal 1995 and 1996, of which only twenty-one were proved as of June 30, 1994.

Due to the company's success in the deeper Austin Chalk drilling program, the company has significantly expanded its acreage acquisition program. To date, the company has assembled over 75,000 gross acres of prospective, exploratory acreage, in Grimes, Brazos, Washington and Fayette Counties in Texas. The company believes that this acreage could provide as many as 100 drilling locations.

Another development during fiscal 1994 of significance to the company was the expansion of the Golden Trend Field into the deeper Knox area. The company successfully completed two re-entry exploratory prospects (1.3 net wells) at 14,000 feet, and is currently drilling one new well. This area could provide up to twenty prospective locations, and the company is actively acquiring additional acreage in the area.

The company continues to attract significant partners to participate with it in its exploration and development efforts. In June and September 1994, Chesapeake entered into agreements with Belco Oil & Gas Corp. ("Belco") initially covering substantially all of the company's leasehold in the Independence area within the Giddings Field. These agreements provide for Belco to participate with the company in acreage acquisition, exploration and development activities, with the company receiving cash consideration upon acreage acquisition and overriding royalty interests as the wells are drilled.

The following table sets forth certain operating data of the company for the periods presented:

	1994	YEARS ENDED JUNE 30, 1993	1992
Net Production Data:			
Oil (MBbl)	537	276	374
Gas (MMcf)	6,927	2,677	1,252
Gas equivalent (MMcfe)	10,152	4,333	3,496
Oil and Gas Sales (\$ in thousands):			
Oil	\$ 8,111	\$ 5,576	\$ 8,170
Gas	14,293	6,026	2,350
Total oil and gas sales	\$ 22,404	\$ 11,602	\$ 10,520
Average Sales Price:			
Oil (\$ per Bbl)	\$ 15.09	\$ 20.20	\$ 21.85
Gas (\$ per Mcf)	\$ 2.06	\$ 2.25	\$ 1.88
Gas equivalent (\$ per Mcfe)	\$ 2.21	\$ 2.68	\$ 3.01
Oil and Gas Costs (\$ per Mcfe):			
Production expenses and taxes	\$.36	\$.67	\$.60
General and administrative	\$.31	\$.84	\$.95
Depreciation, depletion and amortization	\$.80	\$.97	\$.83
Net Wells Drilled:			
Horizontal wells	11.1	3.4	11.3
Vertical wells	7.9	4.5	3.7
Net Wells at End of Period	57.9	39.1	32.4

RESULTS OF OPERATIONS

GENERAL For the fiscal year ended June 30, 1994, the company realized net income of \$3.9 million, or \$.73 per common share, on total revenues of \$29.8 million. This compares with a net loss of \$365,000, or \$.20 per common share, on total revenues of \$18 million in fiscal 1993, and net income of \$1.4 million, or \$.45 per common share, on total revenues of \$18.7 million in fiscal 1992. The significantly higher earnings in fiscal 1994 were largely the result of higher production, and lower costs per unit of production for depreciation, depletion and amortization, production expenses and taxes, and general and administrative expenses.

OIL AND GAS SALES During fiscal 1994, oil and gas sales increased 93% to \$22.4 million versus \$11.6 million for fiscal 1993 and 114% from the fiscal 1992 amount of \$10.5 million. The increase in oil and gas sales resulted from strong growth in production volumes. For fiscal 1994, the company produced 10.2 Bcfe, at a weighted

average price of \$2.21 per Mcfe, compared to 4.3 Bcfe produced in fiscal 1993 at a weighted average price of \$2.68 per Mcfe, and 3.5 Bcfe produced in fiscal 1992 at a weighted average price of \$3.01 per Mcfe. This represents production growth of 134% for fiscal 1994 over 1993, and 190% over 1992.

These increases in production volumes reflect the company's successful exploration and development program, particularly in the Navasota River area of the Giddings Field. The first eight Navasota River wells, although completed in the third and fourth quarters of fiscal 1994, represented approximately 2.4 Bcfe, or 23% of the company's annual production. In the fourth quarter alone, Navasota River represented approximately 51% of the company's production volumes.

The company's gas production represented approximately 68% of the company's total production volume on an equivalent basis in fiscal 1994. This is compared to 62% in fiscal 1993 and only 36% in 1992.

This is a result of the company's drilling in deeper, more gas proven areas of the Giddings and Golden Trend Fields. This change in production mix, along with decreasing average oil prices realized by the company, contributed to the decrease in average realized prices per Mcfe from fiscal 1992 to 1994.

For fiscal 1994, the company realized an average price per barrel of \$15.09, as compared to \$20.20 in fiscal 1993 and \$21.85 in fiscal 1992. Oil prices remained volatile in fiscal 1994, reaching a low in early calendar 1994 of approximately \$12.00 per barrel, but rebounding to above \$18.00 for oil sold by the company in June 1994. The company markets its oil on day-to-day spot price contracts, and typically receives approximately the price posted for West Texas intermediate crude oil.

The company realized an average \$2.06 per Mcf of natural gas sold during fiscal 1994, down approximately 8% from fiscal 1993, but up approximately 10% from 1992. Much of the company's natural gas is processed for natural gas liquids, which the company accounts for as natural gas revenues and production. The lower prices realized in 1994 were partially the result of low natural gas liquids prices that accompanied lower crude oil prices. The company typically sells its natural gas under three year contracts that provide for monthly price adjustments to reflect market conditions. Frequently the contracts provide for the company to share in natural gas liquids processed from the natural gas stream. This liquid sharing, along with frequently high Btu content, allows the company often to receive gas prices per Mcf in excess of spot prices.

OIL AND GAS SERVICE OPERATIONS Revenues from oil and gas service operations were \$6.4 million in fiscal 1994, up 17% from \$5.5 million in 1993, but down 16% from 1992. The related costs and expenses of these operations were \$5.2 million, \$3.7 million and \$4.1 million for the three years ended June 30, 1994, 1993 and 1992, respectively. The gross profit margin was 19% in fiscal 1994, down from 34% in fiscal 1993 and 46% in fiscal 1992. The gross profit derived from these operations is a function of drilling activities in the period, costs of materials and supplies and the mix of operations between lower margin trucking operations versus higher margin labor oriented service operations. During fiscal 1994, activity increased due to a higher number of wells drilled, but revenues did not increase proportionately because of the company's higher retained working interest in wells being provided services. The company anticipates that revenues and costs in fiscal 1995 will increase over 1994 based on current drilling plans, although not

proportionately higher due to the company's higher retained working interests.

INTEREST AND OTHER Interest and other income for fiscal 1994 was \$981,000 which compares to \$880,000 in 1993 and \$542,000 for fiscal 1992. Changes in this revenue result from factors such as changes in interest rates, average cash balances and other factors.

Periodically the company enters into futures contracts to hedge a portion of its future oil or gas production. The costs and the market value changes of these contracts are recognized as gain or loss when the contracts are closed as Interest and Other.

PRODUCTION EXPENSES AND TAXES Production expenses and taxes, which include lifting costs and production and excise taxes, increased to \$3.6 million in fiscal 1994, as compared to \$2.9 million and \$2.1 million in fiscal 1993 and 1992, respectively. These increases on a year to year basis were the result of increased production. On an Mcfe production unit basis, production expenses and taxes decreased to \$.36 per Mcfe in fiscal 1994, as compared to \$.67 and \$.60 per unit in 1993 and 1992, respectively. The company expects that operating costs in fiscal 1995 will remain stable or decline slightly on a per unit basis absent a significant change in oil and gas prices upward which would increase production taxes, or a change in the composition of its property base.

DEPRECIATION, DEPLETION AND AMORTIZATION

Depreciation, depletion and amortization ("DD&A") of oil and gas properties for fiscal 1994 was \$8.1 million, \$3.9 million higher than fiscal 1993's expense of \$4.2 million, and \$5.2 million higher than fiscal 1992's expense of \$2.9 million. The average DD&A per Mcfe, which rate is a function of capitalized costs and related underlying reserves in the periods presented, decreased to \$.80 in fiscal 1994, from \$.97 and \$.83 in fiscal 1993 and 1992, respectively. Due to the significantly higher levels of production, DD&A expense increased in 1994 despite the 18% decrease in the per unit rate. The company's DD&A rate in the future will be a function of the results of future acquisition, exploration, development and production results. However, the company anticipates comparable DD&A rates for 1995.

DEPRECIATION AND AMORTIZATION OF OTHER ASSETS

Depreciation and amortization ("D&A") of other assets increased to \$1.9 million in fiscal 1994, compared to \$0.6 million and \$1.0 million in 1993 and 1992, respectively. This increase includes \$285,000 of nonrecurring

accelerated write-offs of loan costs incurred for debts that were paid in full prior to their respective scheduled payment dates with proceeds from the Senior Notes. Also contributing to the increase in D&A are increased investments in depreciable service properties, equipment and other, and increased amortization of debt issuance costs as a result of the issuance of the Senior Notes in fiscal 1994. The company anticipates D&A to increase in fiscal 1995 as a result of a full year of debt issuance cost amortization.

GENERAL AND ADMINISTRATIVE General and administrative ("G&A") expenses, which are net of capitalized internal payroll and non-payroll expense (see note 10 of notes to Consolidated Financial Statements) were \$3.1 million in fiscal 1994, down 13% from \$3.6 million in fiscal 1993, and down 5% from \$3.3 million in fiscal 1992. The decrease in fiscal 1994 from 1993 results primarily from a combination of reduced utilization of independent consultants and non-capitalized expenses related to the company's public offering in fiscal 1993 and to a lesser extent, an increase in capitalized general and administrative expenses related to the company's acquisition, exploration and development activities. The company anticipates that G&A costs for fiscal 1995 will increase by approximately 30% as a result of increased budgets for exploration and development activities, and increasing operations activities, and attendant personnel and overhead requirements.

PROVISION FOR LEGAL AND OTHER SETTLEMENTS During the fourth quarter of 1993, the company recorded a charge of \$1.3 million for legal and other settlements. This amount included provisions for the settlement of three class action suits filed in the third quarter of fiscal 1993, related expenses, and other matters. No provision has been made for a February 1993, \$2.5 million judgement entered against the company and Messrs. McClendon and Ward. The company has been indemnified by Messrs. McClendon and Ward against any liability for the judgment rendered therein and expenses for the appeal.

INTEREST AND OTHER Interest and other expense increased to \$2.7 million in fiscal 1994, as compared to \$2.3 million and \$2.6 million in fiscal 1993 and 1992. However, interest expense in the fourth quarter of fiscal 1994 was approximately \$1.4 million, reflecting the issuance of \$47.5 million of Senior Notes on March 31, 1994 bearing interest at 12% per annum. Additionally, amortization of original issue discount in the amount of \$138,000 was recorded in the fourth quarter of fiscal 1994 relating to the

issuance of the Senior Notes and Warrants. The company anticipates interest expense to increase significantly in fiscal 1995 as compared to 1994 as a result of the Senior Notes.

INCOME TAX EXPENSE (BENEFIT) The company recorded income tax expense of \$1.25 million in fiscal 1994, as compared to a benefit recorded in 1993 of \$99,000, and expense of \$1.3 million in 1992. All of the income tax expense in 1994 was deferred due to net operating loss carryovers and the company's active drilling, much of the costs of which are currently deductible for income tax purposes. The effective tax rate of approximately 24% in 1994 compares to a tax rate of 21% in 1993 and 49% in 1992. The unusually high relationship of tax burden to pre-tax income in fiscal 1992 results from partnership losses incurred by Chesapeake Exploration Company, a general partnership ("CEX"), prior to the formation of the company which are included in financial income but for which no tax benefit is available to the company. The company anticipates an effective tax rate of between 28% and 30% for fiscal 1995, all of which should be deferred expense, conditioned upon sustaining or increasing the current level of drilling activities.

LIQUIDITY AND CAPITAL RESOURCES

FINANCING ACTIVITIES

PRE-IPO FINANCING Until February 1993, the company financed its growth primarily with borrowings from Trust Company of the West ("TCW") and Belco, through joint participation arrangements with industry participants, and with credit extended by vendors.

IPO The IPO in February 1993 provided the company with net proceeds of \$25.2 million, which were used to reduce indebtedness to lenders and vendors and to provide working capital for the continued development of the company's proved undeveloped oil and gas assets.

CREDIT FACILITY In April 1993, the company entered into a \$15 million oil and gas reserve-based revolving credit facility with Union Bank and repaid its indebtedness to TCW. The credit agreement was amended in March 1994. The facility's terms include interest at Union Bank's reference rate (7.25% at June 30, 1994) plus 1.5%, payable monthly, semi-annual borrowing base reviews (or quarterly, at the company's option), commitment fees, covenants restricting the company's ability to incur debt above certain limits or to pay dividends on its common stock without the bank's permission and other provisions consistent with normal energy lending practices. The borrowing base,

which at June 30, 1993, was \$10.2 million and at June 30, 1994, was \$8.0 million, reduces monthly by an amount determined at each redetermination of the borrowing base. The company had requested the current borrowing base of \$8 million to reduce commitment fees, but believes a higher borrowing base of as much as \$15 million is available. The company is required to make principal payments equal to the amount by which the principal balance exceeds the borrowing base. The principal balance at June 30, 1994, was \$10,000, as compared with \$10.2 million at June 30, 1993.

SENIOR NOTES On March 31, 1994, the company issued \$47,500,000 of 12% Senior Notes due 2001, and 486,875 warrants convertible into 486,875 shares of the company's common stock at \$.01 each. The Indenture governing the Senior Notes provides for semi-annual interest payments commencing September 1, 1994, and mandatory redemption on each of March 1, 1998, March 1, 1999 and March 1, 2000 of \$11,875,000 of Notes. The Notes are redeemable at the option of the company at any time on or after March 1, 1998. The Indenture limits borrowings under the Union Bank facility to the greater of \$15 million or 15% of the company's adjusted consolidated net tangible assets as defined in the Indenture. The company calculates that as of June 30, 1994, the adjusted consolidated net tangible assets of the company were approximately \$156 million.

WORKING CAPITAL The company had working capital of approximately \$2.4 million at June 30, 1994, as compared to a working capital deficit of \$10 million at June 30, 1993. The increase in working capital is attributable to the Senior Note offering on March 31, 1994 and cash provided by operating activities of \$19.4 million in fiscal 1994. Additionally, the company has an unused line of credit available from Union Bank.

Absent a significant increase in the company's Giddings field drilling schedule, the company's internally generated cash flow and existing cash resources should be sufficient to meet its operating activities, fund existing capital commitments, and service its outstanding debt in fiscal 1995. The company's capital spending is largely discretionary. The company has budgeted approximately \$33 million to fund drilling and completion activities for proved undeveloped reserves, and expects to spend up to \$15 million on exploration drilling and leasehold acquisition net of partner reimbursement for fiscal 1995. The discretionary nature of a significant portion of the company's capital spending permits the company to make

adjustments to its budget based upon factors such as oil and gas pricing, exploration and development drilling results, and the availability of internally generated capital resources.

The company is in negotiations with several financial institutions to provide, initially, a \$5 million non-recourse production financing secured by the company's production in the Golden Trend Field. The company would expand its development drilling program in the Golden Trend Field with these funds and might seek to acquire strategically located producing assets in the field with additional advances, if available.

CASH FLOW ANALYSIS

Cash provided by operating activities was approximately \$19 million in fiscal 1994, as compared to cash used in operating activities of \$1 million in fiscal 1993, and cash provided of \$9 million in 1992. The \$21 million difference comparing 1994 to 1993 was primarily attributable to the \$11 million increase in net income and non-cash charges and to changes in current assets and liabilities from fiscal 1993 to 1994.

Significantly higher cash was used in fiscal 1994 for development, exploration and acquisition of oil and gas properties as compared to fiscal 1993. Approximately \$35 million was expended by the company in 1994, as compared to \$17 million in 1993, an increase of \$18 million, or approximately 106%. In fiscal 1992 the company expended \$31 million for development and exploration activities, which decreased in fiscal 1993 due to capital constraints. Net cash proceeds received by the company for sales of oil and gas equipment, leasehold and other increased to over \$7 million, as compared to about \$4 million in 1993. This increase reflects the increase in company drilling activity, and increased sales of leasehold to non-operating partners, primarily Belco.

Cash flows from financing activities reflect approximately \$25 million received by the company in fiscal 1993 from issuance of common stock in its initial public offering. In fiscal 1994, the company received proceeds from long-term borrowings of \$49 million, primarily from the issuance of \$47.5 million in Senior Notes. This compares to approximately \$20 million and \$17 million borrowed in fiscal 1993 and 1992, respectively. Payments on long-term borrowings of \$26 million in fiscal 1994 primarily after the issuance of the Senior Notes and \$24 million after the initial public offering reflect the use of proceeds from these offerings to pay in full TCW, Union Bank and certain vendors, among others.

REPORT OF INDEPENDENT ACCOUNTANTS

To the Board of Directors and Stockholders
of Chesapeake Energy Corporation

In our opinion, the consolidated financial statements listed in the accompanying index present fairly, in all material respects, the financial position of Chesapeake Energy Corporation and its subsidiaries (the "company") at June 30, 1994 and 1993, and the results of their operations and their cash flows for each of the three years in the period ended June 30, 1994, in conformity with generally accepted accounting principles. These financial statements are the responsibility of the company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with generally accepted auditing standards which require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for the opinion expressed above.

PRICE WATERHOUSE LLP
Oklahoma City, Oklahoma
September 16, 1994

CONSOLIDATED BALANCE SHEETS

	JUNE 30,	
	1994	1993
(\$ IN THOUSANDS)		
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 16,225	\$ 4,851
Accounts receivable:		
Oil and gas sales	3,427	901
Joint interest and other, net of allowance for doubtful accounts of \$350,000 and \$584,000	14,020	9,086
Related parties	1,671	1,580
Inventory	7,162	3,404
Other	1,274	548
Total current assets	43,779	20,370
Property and Equipment:		
Oil and gas properties, at cost based on full cost accounting:		
Evaluated oil and gas properties	83,170	56,181
Unevaluated properties	3,729	2,411
Less — accumulated depreciation and amortization	(16,417)	(8,276)
	70,482	50,316
Service properties, equipment, and other	10,697	9,152
Less — accumulated depreciation and amortization	(2,732)	(2,141)
	78,447	57,327
Other assets	3,464	1,010
Total assets	\$ 125,690	\$ 78,707
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Notes payable and current maturities of long-term debt	\$ 7,576	\$ 7,812
Accounts payable	17,460	9,663
Accrued liabilities and other	4,162	2,158
Revenues and royalties due others	12,074	10,506
Income taxes payable	116	225
Total current liabilities	41,388	30,364
Long-term debt	47,878	14,051
Revenues and royalties due others	2,951	1,897
Deferred income taxes	2,213	963
Contingencies and commitments (Note 4)		
Stockholders' equity:		
Preferred stock, \$.01 par value, 1,153,846 shares authorized; 0 and 576,923 shares issued and outstanding at June 30, 1994, and 1993, respectively	—	6
Common stock, \$.01 par value, 20,000,000 shares authorized; 5,108,000 shares issued and outstanding at June 30, 1994, and June 30, 1993	51	51
Common stock warrants, exercise price of \$.01 per share for 486,875 shares of common stock, issued and outstanding at June 30, 1994	5	—
Paid-in capital	28,243	32,704
Accumulated earnings (deficit)	2,961	(1,329)
Total stockholders' equity	31,260	31,432
Total liabilities and stockholders' equity	\$ 125,690	\$ 78,707

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

CONSOLIDATED STATEMENTS OF OPERATIONS

	1994	YEARS ENDED JUNE 30, 1993	1992
	(\$ IN THOUSANDS, EXCEPT PER SHARE DATA)		
REVENUES:			
Oil and gas sales	\$22,404	\$ 11,602	\$ 10,520
Oil and gas service operations	6,439	5,526	7,656
Interest and other	981	880	542
Total revenues	29,824	18,008	18,718
COSTS AND EXPENSES:			
Production expenses and taxes	3,647	2,890	2,103
Oil and gas service operations	5,199	3,653	4,113
Oil and gas depreciation, depletion and amortization	8,141	4,184	2,910
Depreciation and amortization of other assets	1,871	557	974
General and administrative	3,135	3,620	3,314
Provision for legal and other settlements	—	1,286	—
Interest and other	2,676	2,282	2,577
Total costs and expenses	24,669	18,472	15,991
Income (loss) before income taxes	5,155	(464)	2,727
Income tax expense (benefit)	1,250	(99)	1,337
Net income (loss)	\$ 3,905	\$ (365)	\$ 1,390
Earnings per common share computation:			
Net income (loss)	\$ 3,905	\$ (365)	\$ 1,390
Dividends on preferred stock	—	385	—
Net income (loss) available to common	\$ 3,905	\$ (750)	\$ 1,390
Net income (loss) per common share	\$.73	\$ (.20)	\$.45
Weighted average common shares outstanding	5,360	3,728	3,101

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

CONSOLIDATED STATEMENTS OF CASH FLOWS

	1994	YEARS ENDED JUNE 30, 1993	1992
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income (loss)	\$ 3,905	\$ (365)	\$ 1,390
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Depreciation, depletion and amortization	9,455	4,741	3,884
Deferred taxes	1,250	(99)	1,192
Amortization of loan costs	557	127	—
Amortization of bond discount	138	—	—
Bad debt expense	222	—	—
CHANGES IN CURRENT ASSETS AND LIABILITIES:			
(Increase) decrease in accounts receivable	(7,682)	401	(840)
(Increase) decrease in accounts receivable — related parties	(91)	(1,580)	2,503
(Increase) decrease in inventory	(304)	834	1,088
(Increase) decrease in other current assets	(726)	(247)	(156)
Increase (decrease) in accounts payable, accrued liabilities and other	10,186	(11,472)	273
Increase in current and non-current revenues and royalties due others	2,622	6,161	2,071
Increase (decrease) in income taxes payable	(109)	—	145
Cash provided by (used in) operating activities	19,423	(1,499)	11,550
CASH FLOWS FROM INVESTING ACTIVITIES:			
Exploration development and acquisition of oil and gas properties	(34,654)	(16,806)	(31,247)
Proceeds from sale of oil and gas equipment, leasehold and other	7,598	3,943	5,500
Other proceeds from sales	765	—	—
Other property and equipment additions	(2,920)	(2,279)	(1,240)
Cash used in investing activities	(29,211)	(15,142)	(26,987)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Proceeds from issuance of common stock	—	25,168	—
Proceeds from long-term borrowings	48,800	19,762	16,543
Payments on long-term borrowings	(25,738)	(23,487)	(3,774)
Placement fee on Senior Notes and Warrants	(1,900)	—	—
Other financing	—	(641)	—
Contributed capital	—	—	10
Cash provided by financing activities	21,162	20,802	12,779
Net increase (decrease) in cash and cash equivalents	11,374	4,161	(2,658)
Cash and cash equivalents, beginning of period	4,851	690	3,348
Cash and cash equivalents, end of period	\$ 16,225	\$ 4,851	\$ 690
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION			
CASH PAYMENTS FOR:			
Interest expense	\$ 1,467	\$ 2,520	\$ 2,166
Income taxes	\$ 109	\$ 56	\$ —

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

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

During the year ended June 30, 1992, accounts receivable in the amount of \$1,049,000 were settled by an acceptance of an assignment of a working interest in specified wells. The trade receivable due from the industry partner was reclassified to oil and gas properties.

During the year ended June 30, 1992, the company executed note agreements with several vendors to formalize payment terms on approximately \$3,700,000 of accounts payable.

During the year ended June 30, 1993, notes payable in the amount of \$7,500,000 were converted to preferred stock.

On June 30, 1994 and 1993, the company became the legal and beneficial owner of certain oil and gas equipment inventory. The total purchase price to be paid for the

equipment is \$5,952,000 and \$2,498,000, respectively. No cash consideration will be exchanged for the inventory until actual draws on the inventory are made.

On March 31, 1994, the company issued 8,000 units (see Note 2) to Trust Company of the West ("TCW") primarily in consideration for TCW's surrender of 576,923 shares of the company's 9% convertible preferred stock, including its rights to dividends (\$725,000 accrued but unpaid at December 31, 1993).

In February 1994, pending litigation against the company's subsidiary, Chesapeake Operating, Inc. ("COI"), was settled. The agreement requires COI to pay \$1.25 million, of which \$250,000 plus interest was paid in July 1994, and the balance of which will be payable over six years in equal quarterly installments with 7% interest.

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

CONSOLIDATED STATEMENTS OF
STOCKHOLDERS' EQUITY

	1994	YEARS ENDED JUNE 30,	
		1993	1992
	(\$ IN THOUSANDS)		
Preferred stock			
Balance, beginning of period	\$ 6	\$ —	\$ —
Exchange of 576,923 shares of preferred stock	(6)	—	—
Issuance of 576,923 shares of preferred stock	—	6	—
Balance, end of period	—	6	—
Common stock			
Balance, beginning of period	51	28	—
Issuance of 2,808,000 shares of common stock	—	—	28
Issuance of 2,300,000 shares of common stock	—	23	—
Balance, end of period	51	51	28
Common stock warrants			
Balance, beginning of period	—	—	—
Issuance of common stock warrants	5	—	—
Balance, end of period	5	—	—
Paid-in capital			
Balance, beginning of period	32,704	683	—
Exchange of preferred stock	(7,494)	—	—
Issuance of common stock warrants	3,033	—	—
Issuance of preferred stock	—	7,494	—
Issuance of common stock	—	25,668	683
Offering expenses and other	—	(1,141)	—
Balance, end of period	28,243	32,704	683
Contributed capital			
Balance, beginning of period	—	—	410
Capital contribution	—	—	301
Issuance of common stock	—	—	(711)
Balance, end of period	—	—	—
Accumulated earnings (deficit)			
Balance, beginning of period	(1,329)	(579)	(1,969)
Net income (loss)	3,905	(365)	1,390
Preferred dividends	(340)	(385)	—
Cancellation of preferred dividends	725	—	—
Balance, end of period	2,961	(1,329)	(579)
Total stockholders' equity	\$ 31,260	\$31,432	\$ 132

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

**NOTE 1. BASIS OF PRESENTATION AND
SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

Chesapeake Energy Corporation (the "company"), a Delaware corporation, was incorporated in December 1991 for the purpose of combining (the "Combination") certain of the oil and gas exploration, oil and gas production and oil field service operations previously conducted by Chesapeake Operating, Inc. ("COI"), Chesapeake Exploration Company ("CEX"), a general partnership, Lindsay Oil Field Supply, Inc. and subsidiaries of those entities, (collectively referred to as the "Combined Entities"), along with certain office buildings, interests in oil and gas properties and related debt associated with these assets, all of which were beneficially owned by Aubrey K. McClendon and Tom L. Ward. The Combination was effective January 1, 1992 and the company succeeded to all of the exploration and development operations and oil and gas assets of the Combined Entities. In addition, on May 1, 1991, interests in certain oil and gas properties owned by Chesapeake Investments ("CI"), which is wholly owned by Mr. McClendon and his family, and TLW Investments, Inc. ("TLW"), which is wholly owned by Mr. Ward, were transferred (the "Transfer") to CEX. CEX assumed certain liabilities related to such properties. The excess of historical net cost over the amounts then owed by CI and TLW relating to the assets transferred to CEX was recorded as a contribution from owners in the accompanying consolidated statements of stockholders' equity.

The Combination and Transfer were recorded on the basis of a reorganization of entities under common control at historical cost, in a manner similar to a pooling of interests. The accompanying consolidated financial statements give retroactive effect to the Combination and Transfer to reflect the historical results of operations of the assets that were acquired and liabilities assumed by the company. The net income from the interests in oil and gas properties prior to the Transfer is reflected in the accompanying consolidated statements of operations with the offset reflected as capital withdrawals in the accompanying consolidated statements of stockholders' equity.

PRINCIPLES OF CONSOLIDATION The accompanying consolidated financial statements include the accounts of the Combined Entities as described above. All significant intercompany accounts and transactions have been eliminated.

CASH EQUIVALENTS For purposes of the consolidated

financial statements, the company considers investments in all highly liquid debt instruments purchased with original maturities of three months or less to be cash equivalents.

INVENTORY Inventory consists primarily of tubular goods and other lease and well equipment which the company plans to utilize in its ongoing exploration and development activities and in its service operations and is carried at the lower of cost or market, on the specific identification method.

PROPERTY AND EQUIPMENT The company follows the full cost method of accounting under which all costs associated with property acquisition, exploration and development activities are capitalized. The company capitalizes internal costs that can be directly identified with its acquisition, exploration and development activities and do not include any costs related to production, general corporate overhead or similar activities (see Note 10). Capitalized costs are amortized on a composite unit-of-production method based on proved oil and gas reserves. The company's oil and gas reserves are estimated annually by independent petroleum engineers. The average composite rates used for depreciation, depletion and amortization were \$0.80, \$0.97 and \$0.83 per equivalent Mcf in 1994, 1993 and 1992, respectively. Proceeds from the sale of properties are accounted for as reductions to capitalized costs unless such sales involve a significant change in the relationship between costs and the value of proved reserves or the underlying value of unproved properties, in which case a gain or loss is recognized. Unamortized costs as reduced by related deferred taxes are subject to a ceiling which limits such amounts to the estimated present value of oil and gas reserves, reduced by operating expenses, future development costs and income taxes. The costs of unproved properties are excluded from amortization until the properties are evaluated.

OTHER PROPERTY AND EQUIPMENT Other property and equipment primarily consists of vehicles, oil and gas servicing equipment, office buildings and equipment, and software. Major renewals and betterments are capitalized while the costs of repairs and maintenance are charged to expense as incurred. The costs of assets retired or otherwise disposed of and the applicable accumulated depreciation are removed from the accounts, and the resulting gain or loss is reflected in operations. Other property and equipment costs are depreciated on both straight-line and

accelerated methods over the estimated useful lives of the assets, which range from 3 to 30 years.

LEASES The company leases certain office facilities under an operating lease expiring in August 1996. Included in service properties, equipment and other in the consolidated balance sheets is computer equipment, software, and certain other office equipment held under capital leases. Minimum lease payments under these operating and capital leases are as follows:

	CAPITAL LEASES	OPERATING LEASES
1995	\$ 76,573	\$ 54,150
1996	76,573	64,980
1997	69,444	10,830
1998	62,316	—
1999	15,233	—
Total minimum lease payments	\$ 300,139	\$ 129,960
Less: amount relating to interest	72,251	
Present value of minimum payments	\$ 227,888	

CAPITALIZED INTEREST During fiscal 1994, 1993 and 1992, interest of approximately \$356,000, \$192,000 and \$0 was capitalized on significant investments in unproved properties that are not being currently depreciated, depleted, or amortized and on which exploration or development activities are in progress.

SERVICE OPERATIONS Certain subsidiaries of the company perform contractual services on wells the company operates as well as for third parties. Oil and gas service operations revenues and costs and expenses reflected in the accompanying consolidated statements of operations include amounts derived from certain of the contractual services provided. The company's economic interest in its oil and gas properties is not affected by the performance of these contractual services and all intercompany profits have been eliminated.

CONCENTRATION OF CREDIT RISK The company operates exclusively in the oil and gas industry. The company's joint interest billings and oil and gas sales receivables represent substantially all of the balance included in trade accounts receivable in the accompanying balance sheets.

INCOME TAXES Except for CEX, the Combined Entities were C Corporations which filed separate income tax

returns prior to the Combination. CEX is a partnership and, accordingly, its taxable income or loss for periods prior to the Combination was allocated to its individual partners and reported in their income tax returns. Subsequent to the Combination, the company has filed a consolidated federal income tax return.

The company has adopted Statement of Financial Accounting Standards ("SFAS") No. 109, "Accounting for Income Taxes" (SFAS 109). SFAS 109 requires deferred tax liabilities or assets be recognized for the anticipated future tax effects of temporary differences that arise as a result of the differences in the carrying amounts and the tax bases of assets and liabilities.

NET INCOME PER SHARE Primary earnings per share for all periods have been computed based upon the weighted average number of shares outstanding after giving retroactive effect to the 1.8 for 1 stock split, the 2,808,000 common shares issued in the Combination, the 2,300,000 common shares issued in the initial public offering, the common stock equivalents arising from the warrants issued to TCW on July 2, 1992, the common stock equivalents from the warrants issued to Belco, common stock warrants issued in connection with the Senior Note Offering (see Note 2) on March 31, 1994, and the common stock equivalents arising from the employee stock options granted in fiscal 1994 and 1993. Computations of primary and fully diluted earnings per share have not given effect to common stock equivalents or other contingent issuances for any period in which their inclusion would have the effect of increasing the earnings per share amount or decreasing the loss per share amount otherwise computed. Dilutive options or warrants which are issued during a period or which expire or are cancelled during a period are reflected in both primary and fully diluted earnings per share computations for the time they were outstanding during the period being reported upon.

GAS IMBALANCES The company follows the "sales method" of accounting for its oil and gas revenue whereby the company recognizes sales revenue on all oil or gas sold to its purchasers, regardless of whether the sales are proportionate to the company's ownership in the property. A liability is recognized only to the extent that the company has a net imbalance in excess of the reserves on the underlying properties. The company's net imbalance positions at June 30, 1994 and 1993 were not material.

RECLASSIFICATIONS Certain reclassifications have been made to the consolidated financial statements for the years

ended June 30, 1992 and 1993 to conform to the presentation used for the June 30, 1994 consolidated financial statements.

ACCOUNTING FOR FUTURES CONTRACTS Periodically, the company enters into futures contracts to hedge a portion of its future oil and gas production. The market value changes of these contracts are recognized in revenues when the contracts are closed.

DEBT ISSUE COSTS Other assets relate primarily to debt issue costs associated with the issuance of Senior Notes (see Note 2) on March 31, 1994. The remaining unamortized costs at June 30, 1994 totaled \$2,448,000, and are being amortized over the life of the Senior Notes.

NOTE 2. SENIOR NOTES

On March 31, 1994, the company completed a private offering (the "Senior Note Offering") of 47,500 Units consisting of an aggregate of \$47,500,000 principal amount of 12% Senior Notes due 2001 ("Senior Notes") and 486,875 warrants ("Warrants") to purchase 486,875 shares of the company's common stock ("Warrant Shares") at an exercise price of \$.01 per Warrant Share. The Warrants expire on March 1, 1999. In exchange for 8,000 Units, the company acquired from TCW 576,923 shares of the company's 9% cumulative convertible preferred stock and all rights to dividends thereon, warrants to purchase 312,001 shares of the company's common stock and 50% of an outstanding overriding royalty interest held by TCW. In September 1994, the company offered to exchange the Senior Notes for 12% Senior Exchange Notes due 2001 ("Senior Exchange Notes") in a registered exchange offer. The Senior Notes and the Senior Exchange Notes have identical terms. The company also registered the Warrants and the Warrant Shares.

All subsidiaries of the company (the "Subsidiary Guarantors") have fully and unconditionally guaranteed

the company's obligations under the Notes on a joint and several basis. In addition, the securities of the Subsidiary Guarantors have been pledged to secure performance of such obligations. Each of the Subsidiary Guarantors is a direct or indirect wholly-owned subsidiary of the company. The only affiliate securities constituting a substantial portion of the collateral for the Notes are the general partner interests in CEX. The company is a holding company and owns no operating assets and has no significant operations independent of its subsidiaries. Separate financial statements of the Subsidiary Guarantors have not been provided because the company believes they are not material to investors.

CEX is a general partnership which is 90% owned by COI, a wholly-owned subsidiary of the company, and 10% owned directly by the company. CEX owns all of the company's producing properties. The CEX general partnership condensed financial statements were prepared on a separate entity basis as reflected in the company's books and records and include all material costs of doing business as if the partnership were on a stand-alone basis. No provision has been made for income taxes because the partnership is not a taxpaying entity.

The company's bank credit agreement prohibits any distributions by CEX to its partners (the company and COI) if the maturity of any obligations owing to the lender has been accelerated. The pledge agreement securing the company's obligations under the Notes requires that all dividends and distributions from Subsidiary Guarantors be paid to the collateral agent thereunder upon an event of default under the Indenture governing the Notes. There are no other restrictions on the payment of cash dividends by Subsidiary Guarantors.

Set forth below are condensed consolidating financial statements of CEX, the other Subsidiary Guarantors, all Subsidiary Guarantors combined and the company (parent).

CONDENSED CONSOLIDATING BALANCE SHEET

AS OF JUNE 30, 1994						
	SUBSIDIARY GUARANTORS			COMPANY (PARENT)	ELIMINATIONS	CONSOLIDATED
	CEX	ALL OTHERS	COMBINED			
ASSETS						
(\$ IN THOUSANDS)						
Current assets						
Cash and cash equivalents	\$ —	\$ 13,946	\$ 13,946	\$ 2,279	\$ —	\$ 16,225
Accounts receivable	8,686	10,432	19,118	—	—	19,118
Inventory	—	7,162	7,162	—	—	7,162
Other	—	1,274	1,274	—	—	1,274
Total current assets	8,686	32,814	41,500	2,279	—	43,779
Property and equipment						
Oil and gas properties	92,182	(5,284)	86,898	—	—	86,898
Other property and equipment	—	8,156	8,156	2,542	—	10,698
Less: accumulated depreciation, depletion and amortization	(16,417)	(2,568)	(18,985)	(164)	—	(19,149)
	75,765	304	76,069	2,378	—	78,447
Investments in subsidiaries and intercompany advances						
	(68,813)	1,621	(67,192)	67,192	—	—
Other assets	712	10	722	2,742	—	3,464
	\$ 16,350	\$ 34,749	\$ 51,099	\$ 74,591	\$ —	\$ 125,690
LIABILITIES AND STOCKHOLDERS' EQUITY						
Current liabilities						
Accounts payable and other	\$ —	\$ 32,587	\$ 32,587	\$ 1,225	\$ —	\$ 33,812
Notes payable	—	7,543	7,543	33	—	7,576
Total current liabilities	—	40,130	40,130	1,258	—	41,388
Long-term debt	10	2,550	2,560	45,318	—	47,878
Revenues payable	—	2,951	2,951	—	—	2,951
Deferred income taxes	—	2,363	2,363	(150)	—	2,213
Stockholders' equity						
Common stock	—	36	36	51	(36)	51
Common stock warrants	—	—	—	5	—	5
Preferred stock	—	9	9	—	(9)	—
Other	16,340	(13,290)	3,050	28,109	45	31,204
	16,340	(13,245)	3,095	28,165	—	31,260
	\$ 16,350	\$ 34,749	\$ 51,099	\$ 74,591	\$ —	\$ 125,690

CONDENSED CONSOLIDATING BALANCE SHEET

AS OF JUNE 30, 1993						
	SUBSIDIARY GUARANTORS			COMPANY (PARENT)	ELIMINATIONS	CONSOLIDATED
	CEX	ALL OTHERS	COMBINED			
ASSETS						
(\$ IN THOUSANDS)						
Current assets						
Cash and cash equivalents	\$ 177	\$ 4,136	\$ 4,313	\$ 538	\$ —	\$ 4,851
Accounts receivable	83	11,484	11,567	—	—	11,567
Inventory	—	3,404	3,404	—	—	3,404
Other	—	548	548	—	—	548
Total current assets	260	19,572	19,832	538	—	20,370
Property and equipment						
Oil and gas properties	57,528	1,063	58,591	—	—	58,591
Other property and equipment	—	6,747	6,747	2,405	—	9,152
Less: accumulated depreciation, depletion and amortization	(8,276)	(2,059)	(10,335)	(81)	—	(10,416)
	49,252	5,751	55,003	2,324	—	57,327
Investments in subsidiaries and intercompany advances						
	(32,580)	1,437	(31,143)	31,287	(144)	—
Other assets						
	861	149	1,010	—	—	1,010
	\$ 17,793	\$ 26,909	\$ 44,702	\$ 34,149	\$ (144)	\$ 78,707
LIABILITIES AND STOCKHOLDERS' EQUITY						
Current liabilities						
Accounts payable and other	\$ —	\$ 21,941	\$ 21,941	\$ 610	\$ —	\$ 22,551
Notes payable	—	7,813	7,813	—	—	7,813
Total current liabilities	—	29,754	29,754	610	—	30,364
Long-term debt						
	10,352	2,922	13,274	777	—	14,051
Revenues payable						
	—	1,897	1,897	—	—	1,897
Deferred income taxes						
	—	963	963	—	—	963
Stockholders' equity						
Common stock	—	135	135	51	(135)	51
Common stock warrants	—	—	—	—	—	—
Preferred stock	—	9	9	6	(9)	6
Other	7,441	(8,771)	(1,330)	32,705	—	31,375
	7,441	(8,627)	(1,186)	32,762	(144)	31,432
	\$ 17,793	\$ 26,909	\$ 44,702	\$ 34,149	\$ (144)	\$ 78,707

CONDENSED CONSOLIDATING STATEMENTS
OF OPERATIONS

	FOR THE YEAR ENDED JUNE 30, 1994					
	SUBSIDIARY GUARANTORS			COMPANY (PARENT)	ELIMINATIONS	CONSOLIDATED
	CEX	ALL OTHERS	COMBINED			
	(\$ IN THOUSANDS)					
REVENUES						
Oil and gas sales	\$ 22,404	\$ —	\$ 22,404	\$ —	\$ —	\$ 22,404
Oil and gas service operations	—	6,439	6,439	—	—	6,439
Interest and other	—	622	622	359	—	981
	22,404	7,061	29,465	359	—	29,824
COSTS AND EXPENSES						
Production expenses and taxes	3,647	—	3,647	—	—	3,647
Oil and gas service operations	—	5,199	5,199	—	—	5,199
Oil and gas depreciation	8,141	—	8,141	—	—	8,141
Other depreciation and amortization	—	1,707	1,707	164	—	1,871
General and administrative						
— Direct	10	2,982	2,992	143	—	3,135
— Allocated	246	(246)	—	—	—	—
Provision for legal settlements	—	—	—	—	—	—
Interest and other						
— Direct	507	538	1,045	1,631	—	2,676
— Allocated	954	—	954	(954)	—	—
	13,505	10,180	23,685	984	—	24,669
Income (loss) before income tax	8,899	(3,119)	5,780	(625)	—	5,155
Income tax expense (benefit)	—	1,400	1,400	(150)	—	1,250
Net Income (loss)	\$ 8,899	\$ (4,519)	\$ 4,380	\$ (475)	\$ —	\$ 3,905
FOR THE YEAR ENDED JUNE 30, 1993						
REVENUES						
Oil and gas sales	\$ 11,602	\$ —	\$ 11,602	\$ —	\$ —	\$ 11,602
Oil and gas service operations	—	5,526	5,526	—	—	5,526
Interest and other	6	842	848	32	—	880
	11,608	6,368	17,976	32	—	18,008
COSTS AND EXPENSES						
Production expenses and taxes	2,590	—	2,590	—	—	2,590
Oil and gas service operations	—	3,653	3,653	—	—	3,653
Oil and gas depreciation	4,184	—	4,184	—	—	4,184
Other depreciation and amortization	—	545	545	12	—	557
General and administrative						
— Direct	252	3,652	3,904	16	—	3,920
— Allocated	170	(170)	—	—	—	—
Provision for legal settlements	—	1,286	1,286	—	—	1,286
Interest and other						
— Direct	1,829	450	2,279	3	—	2,282
— Allocated	—	—	—	—	—	—
	9,025	9,416	18,441	31	—	18,472
Income (loss) before income tax	2,583	(3,048)	(465)	1	—	(464)
Income tax expense (benefit)	—	(99)	(99)	—	—	(99)
Net income (loss)	\$ 2,583	\$ (2,949)	\$ (366)	\$ 1	\$ —	\$ (365)

CONDENSED CONSOLIDATING STATEMENTS
OF OPERATIONS (continued)

FOR THE YEAR ENDED JUNE 30, 1992						
	SUBSIDIARY GUARANTORS			COMPANY (PARENT)	ELIMINATIONS	CONSOLIDATED
	CEX	ALL OTHERS	COMBINED			
(\$ IN THOUSANDS)						
REVENUES						
Oil and gas sales	\$10,520	\$ —	\$10,520	\$ —	\$ —	\$10,520
Oil and gas service operations	—	7,656	7,656	—	—	7,656
Other	5	537	542	—	—	542
	10,525	8,193	18,718	—	—	18,718
COSTS AND EXPENSES						
Production expenses and taxes	2,003	—	2,003	—	—	2,003
Oil and gas service operations	—	4,113	4,113	—	—	4,113
Oil and gas depreciation	2,910	—	2,910	—	—	2,910
Other depreciation and amortization	—	974	974	—	—	974
General and administrative						
— Direct	514	2,900	3,414	—	—	3,414
— Allocated	126	(126)	—	—	—	—
Provision for legal settlements	—	—	—	—	—	—
Interest and other						
— Direct	1,942	635	2,577	—	—	2,577
— Allocated	—	—	—	—	—	—
	7,495	8,496	15,991	—	—	15,991
Income (loss) before income tax	3,030	(303)	2,727	—	—	2,727
Income tax expense	—	1,337	1,337	—	—	1,337
Net income (loss)	\$ 3,030	\$(1,640)	\$ 1,390	\$ —	\$ —	\$ 1,390

CONDENSED CONSOLIDATING STATEMENTS
OF CASH FLOWS

	FOR THE YEAR ENDED JUNE 30, 1994					
	SUBSIDIARY GUARANTORS			COMPANY (PARENT)	ELIMINATIONS	CONSOLIDATED
	CEX	ALL OTHERS	COMBINED			
	(\$ IN THOUSANDS)					
CASH FLOWS FROM OPERATING ACTIVITIES	\$ 9,637	\$11,201	\$20,838	\$(1,415)	\$ —	\$ 19,423
CASH FLOWS FROM INVESTING ACTIVITIES						
Oil and gas properties	(34,654)	—	(34,654)	—	—	(34,654)
Proceeds from sales	—	8,363	8,363	—	—	8,363
Other additions	—	(1,941)	(1,941)	(979)	—	(2,920)
	(34,654)	6,422	(28,232)	(979)	—	(29,211)
CASH FLOWS FROM FINANCING ACTIVITIES						
Issuance of common stock	—	—	—	—	—	—
Proceeds from borrowings	—	8,800	8,800	40,000	—	48,800
Payments on borrowings	(10,201)	(15,537)	(25,738)	—	—	(25,738)
Intercompany advances, net	35,041	(1,076)	33,965	(33,965)	—	—
Other financing	—	—	—	(1,900)	—	(1,900)
	24,840	(7,813)	17,027	4,135	—	21,162
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(177)	9,810	9,633	1,741	—	11,374
Cash, beginning of period	177	4,136	4,313	538	—	4,851
Cash, end of period	\$ —	\$13,946	\$13,946	\$ 2,279	\$ —	\$ 16,225

FOR THE YEAR ENDED JUNE 30, 1993

CASH FLOWS FROM OPERATING ACTIVITIES	\$ 3,065	\$ (4,577)	\$ (1,512)	\$ 13	\$ —	\$ (1,499)
CASH FLOWS FROM INVESTING ACTIVITIES						
Oil and gas properties	(13,386)	(2,340)	(15,726)	—	—	(15,726)
Proceeds from sales	—	2,863	2,863	—	—	2,863
Other additions	—	(2,279)	(2,279)	—	—	(2,279)
	(13,386)	(1,756)	(15,142)	—	—	(15,142)
CASH FLOWS FROM FINANCING ACTIVITIES						
Issuance of common stock	—	—	—	25,168	—	25,168
Proceeds on borrowings	—	18,985	18,985	777	—	19,762
Payments on borrowings	(9,385)	(14,102)	(23,487)	—	—	(23,487)
Intercompany advances, net	19,875	4,904	24,779	(24,779)	—	—
Other financing	—	—	—	(641)	—	(641)
	10,490	9,787	20,277	525	—	20,802
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	169	3,454	3,623	538	—	4,161
Cash, beginning of period	8	682	690	—	—	690
Cash, end of period	\$ 177	\$ 4,136	\$ 4,313	\$ 538	\$ —	\$ 4,851

CONDENSED CONSOLIDATING STATEMENTS
OF CASH FLOWS (continued)

FOR THE YEAR ENDED JUNE 30, 1992						
	SUBSIDIARY GUARANTORS			COMPANY (PARENT)	ELIMINATIONS	CONSOLIDATED
	CEX	ALL OTHERS	COMBINED			
(\$ IN THOUSANDS)						
CASH FLOWS FROM OPERATING ACTIVITIES	\$ 6,657	\$ 4,893	\$11,550	\$ —	\$ —	\$11,550
CASH FLOWS FROM INVESTING ACTIVITIES						
Oil and gas properties	(28,565)	(2,682)	(31,247)	—	—	(31,247)
Proceeds from sales	—	5,500	5,500	—	—	5,500
Other additions	—	(1,240)	(1,240)	—	—	(1,240)
	(28,565)	1,578	(26,987)	—	—	(26,987)
CASH FLOWS FROM FINANCING ACTIVITIES						
Issuance of common stock	—	—	—	—	—	—
Proceeds on borrowings	11,737	4,806	16,543	—	—	16,543
Payments on borrowings	—	(3,774)	(3,774)	—	—	(3,774)
Intercompany advances, net	10,020	(10,020)	—	—	—	—
Other financing	—	10	10	—	—	10
	21,757	(8,978)	12,779	—	—	12,779
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(151)	(2,507)	(2,658)	—	—	(2,658)
Cash, beginning of period	159	3,189	3,348	—	—	3,348
Cash, end of period	\$ 8	\$ 682	\$ 690	\$ —	\$ —	\$ 690

NOTE 3. NOTES PAYABLE AND LONG-TERM DEBT

Notes payable and long-term debt consist of the following:

	JUNE 30,	
	1994	1993
	(\$ IN THOUSANDS)	
Senior Notes, interest at 12% per annum payable semi-annually on March 1 and September 1, mandatory redemption of \$11,875,000 on each of March 1, 1998, 1999 and 2000, with remaining principal due 2001	\$47,500	\$ —
Discount on Senior Notes	(2,900)	—
Note Payable to an individual and S.W. Energy, interest at 7% per annum, collateralized by producing oil and gas properties, \$250,000 payable in July 1994 and balance payable in 24 equal, quarterly installments commencing in June 1994	1,216	—
Term note payable to Union Bank, interest of 7.5% per annum, collateralized by producing oil and gas properties, payable in monthly installments through September 1994. Note was paid in full March 31, 1994	—	10,211
Term note payable to Union Bank, interest of 8.75% per annum, collateralized by producing oil and gas properties	10	—
Note payable to Belco Oil & Gas Corp., interest at 9% per annum, collateralized by non-producing leasehold, interest is due in quarterly installments from April 1993 through January 1998. Note was paid in full March 31, 1994	—	2,407
Note payable to a vendor, interest at 1% per annum, collateralized by oil and gas tubulars, payments are due 60 days from shipment of the tubulars	5,952	2,498
Note payable to a bank, interest at 7.75% per annum, collateralized by office buildings, payments due in monthly installments through May 1998	751	777
Notes payable to vendors participating in the vendor financing programs, interest at 7% per annum, collateralized by producing oil and gas properties, payable in monthly installments based on the production from certain oil and gas properties. Notes were paid in full in April 1994	—	1,620
Note payable to a vendor for oil field equipment, annual interest at 10% through January 1994, and 18% thereafter, payments due in monthly installments of principal plus interest. Note was paid in full in April 1994	—	2,084
Notes payable to various entities to acquire oil service equipment, interest varies from 6.5% to 18.4% per annum, collateralized by equipment, payments due in monthly installments through December 2000	2,357	2,082
Notes payable to various vendors to refinance trade accounts payable, interest varies from 0% to 12% per annum.	—	116
Other, secured	482	68
Other, unsecured	86	—
Total notes payable and long-term debt	55,454	21,863
Less — Current maturities	(7,576)	(7,812)
Notes payable and long-term debt, net of current maturities	\$47,878	\$14,051

The aggregate scheduled maturities of notes payable and long-term debt for the next five fiscal years ending June 30, 1999 and thereafter were as follows as of June 30, 1994 (in thousands of dollars):

1995	\$ 7,576
1996	974
1997	683
1998	10,952
1999	11,699
After 1999	23,570
	<hr/>
	\$55,454

March 31, 1994, the company completed a Senior Note Offering of \$47.5 million principal amount of Senior Notes and Warrants for 486,875 shares of the company's common stock (see Note 2). The Warrants were valued at \$3.04 million based on the market value of the company's common stock at the date of issue (\$6.25 per common share) and are recorded as common stock warrants and paid-in capital on the consolidated balance sheets. A bond discount was created as the difference between the combined value of the Senior Notes and Warrants and the face value of the Units. The principal amount of the Senior Notes, less the unamortized bond discount, is classified as long-term debt. As part of the Offering, the company issued 8,000 Units to TCW in exchange for preferred stock, common stock warrants and an overriding royalty interest.

In April 1993, the company's subsidiary, CEX, entered into a \$15 million oil and gas reserve-based reducing revolving credit facility (the "Credit Facility") with Union Bank of California. In conjunction with the consummation of the Senior Note Offering, the Credit Facility was amended and all but \$10,000 of the balance was paid. The maturity date is December 31, 1998. Outstanding borrowings under the Credit Facility bear interest at a rate equal to Union Bank's reference rate (7.25% at June 30, 1994) plus 1.5%. Borrowings are secured by a first priority lien on substantially all of the borrower's proved developed producing reserves, and are unconditionally guaranteed by the company. At June 30, 1994, there was a \$10,000 outstanding balance under the Credit Facility.

Semi-annually, Union Bank determines the borrowing base based upon its estimate of the value of the collateral, the company's debt service obligations, its trade payables and other factors affecting the company's solvency and liquidity. At the company's request, such borrowing base redetermination may be made at quarterly intervals.

Should the amount outstanding exceed the borrowing base, the company must either reduce the amount outstanding to an amount which does not exceed the borrowing base, or add sufficient additional collateral acceptable to Union Bank. Mandatory monthly commitment reductions are determined at each borrowing base redetermination. The company paid a facility fee of \$100,000 when the facility was amended in March 1994 and pays a commitment fee equal to 0.5% per annum calculated on the average daily amount of the unused portion of the facility availability, payable quarterly. In addition, the company pays an engineering fee of \$5,000 at each borrowing base redetermination, and an annual administrative fee of 0.35% of the borrowing base. The credit facility contains customary financial covenants, limitations on indebtedness and liabilities, liens, prepayments of other indebtedness (including the Notes), and loans, investments and guarantees by the company and prohibits the payment of dividends on the company's common stock.

In February 1994, pending litigation against the company's subsidiary, COI, was settled. The agreement requires COI to pay \$1.25 million, of which \$250,000 plus interest was paid in July 1994, and the balance of which will be payable over six years in equal quarterly installments with 7% interest. Payment of the \$1.25 million obligation is secured by mortgages on several of the company's producing oil and gas properties.

Effective December 31, 1992, the company entered into a loan agreement with Belco pursuant to which Belco loaned \$2.5 million to the company. The terms of the agreement included restrictions on future indebtedness, limitations on the company's right to pay dividends or redeem capital stock, and restrictions on the amount of general and administrative expenses that the company could incur. As part of this transaction, Belco received warrants to purchase up to 180,000 shares of common stock at an exercise price equal to \$9.60 per share (see Note 9). At June 30, 1993, the unpaid principal balance of the loan was \$2.4 million. On September 24, 1993, the company and Belco entered into the First Amendment to Loan Agreement ("First Amendment") which modified the mandatory payment terms of the original loan agreement, added mandatory prepayment terms on the loan in the event the company made any sale of equity securities or debt convertible into equity securities, and amended certain of its covenants including the ceiling on general and administrative expenses. The amendment to the mandatory prepayment provisions was effective as of January 1, 1994. The other provisions in the First

Amendment were effective June 30, 1993. In March 1994, the company paid the entire balance owed to Belco (\$2.3 million) under the Belco loan. The Belco loan provided for interest at 9% per annum.

At June 30, 1993 the company was in default under a promissory note with a vendor dated July 13, 1992, with a June 30, 1993, balance of \$2.08 million. In April 1993, the vendor commenced legal action to collect the balance of the note. In October 1993, the promissory note was modified to restructure the terms. The accompanying consolidated balance sheets reflect the modification of terms of this promissory note as of June 30, 1993. The outstanding balance of the note was paid in full in April 1994.

The company has agreements with certain of its vendors under which the vendors agreed to extend long-term credit for supplies, materials and services provided by such vendors to the company in connection with current and future drilling projects. At June 30, 1994 and 1993, \$0 and approximately \$1.6 million of credit was outstanding under these agreements.

NOTE 4. CONTINGENCIES AND COMMITMENTS

The company is currently involved in certain litigation and has included \$450,000 in accrued liabilities at June 30, 1994, for future settlement costs. While it is not possible to determine the ultimate disposition of these matters, management, after consultation with legal counsel, is of the opinion that the final resolution of all currently pending or threatened litigation is not likely to have a material adverse effect on the consolidated financial position or results of operations of the company when considering the aforementioned provision.

In February 1993, a \$2.15 million (plus costs and interest) judgment was entered against the company and its two principal shareholders. The company and the other defendants have appealed the judgment. The two principal shareholders have indemnified the company against any liability with respect to the judgment and the appeal.

The company, together with certain of its executive officers, its directors and others, are defendants in three class action suits based upon alleged misstatements in the company's February 1993 prospectus used in connection with the initial public offering of its common stock. A Memorandum of Understanding has been executed by the parties, fully settling the claims against the defendants subject to approval by the court of a definitive settlement agreement. The settlement, if approved by the court, would require a \$485,000 payment by the company and

indemnification of the company by its two principal shareholders for any liability resulting from the judgment described in the preceding paragraph and for post-judgment fees and expenses incurred by the company. As of June 30, 1994, the company has provided a reserve for its estimated cost of settlement.

In addition to the three class action suits described above, on November 26, 1993, a fourth purported class action suit was filed against the company and certain of its executive officers. The plaintiffs allege that certain statements in the company's Prospectus and certain press releases and other statements were materially misleading and omissive. The company intends to move to dismiss the complaint and to defend itself vigorously if mediation is not successful.

In February 1994, pending litigation against the company's subsidiary, COI, was settled. Pursuant to the terms of the settlement, the company paid plaintiff \$250,000 upon execution of the definitive settlement agreement, one farmout agreement was terminated and the other farmout agreement was amended and restated to provide for a two-year term covering approximately 4,700 acres in Utah. COI will be required to drill one well by February 1995 and, upon completion, will earn an interest in the well. COI will have the nonexclusive option to drill additional wells and will earn interests in the wells drilled. If COI elects not to drill the initial well by February 1995, COI will be required to pay the plaintiff liquidated damages in the amount of \$600,000 (see Note 3).

A subsidiary of the company, COI, sold fractional undivided working interests through fiscal 1992 in many of the wells it has drilled to oil and gas companies and individual investors. Offers and sales of such interests are generally subject to the registration and anti-fraud provisions of federal and state securities laws. None of the offers and sales of working interests made by COI were registered under the Securities Act or any state securities laws.

Various individuals and corporations who purchased fractional undivided working interests in specific oil and gas properties from COI and purchasers of interests from COI have asserted claims against the company. As of September 16, 1994, there were no suits pending against the company for securities violations arising out of such sales, although there can be no assurance that claims will not be asserted in the future.

The company has employment contracts with its two principal shareholders and its chief financial officer which provide for annual base salaries, bonus compensation and various benefits. The contracts provide for the

continuation of salary and benefits for the respective terms of the agreements in the event of termination of employment without cause. One agreement expires February 28, 1995, and the others expire June 30, 1995.

Due to the nature of the oil and gas business, the company and its subsidiaries are exposed to possible environmental risks. The company has implemented various policies and procedures to avoid environmental contamination and risks from environmental contamination. The company is not aware of any potential environmental issues or claims.

NOTE 5. INCOME TAXES

As discussed in Note 1, the company has adopted SFAS No. 109. The components of the income tax provision for each of the periods are as follows (in thousands of dollars):

YEARS ENDED JUNE 30,	1994	1993	1992
	(\$ IN THOUSANDS)		
Current	\$ —	\$ —	\$ 145
Deferred	1,250	(99)	1,192
Total	\$1,250	\$ (99)	\$1,337

The effective income tax rate differed from the computed "expected" federal income tax rate on earnings before income taxes for the following reasons:

YEARS ENDED JUNE 30,	1994	1993	1992
	(\$ IN THOUSANDS)		
Computed "expected" income tax provision (benefit)	\$1,753	\$(158)	\$ 927
Tax percentage depletion	(780)	—	—
Partnership operations prior to the Combination	—	—	299
Other	277	59	111
	\$1,250	\$(99)	\$1,337

Deferred income taxes are provided to reflect temporary differences in the basis of net assets for income tax and financial reporting purposes. The tax effected temporary differences and tax loss carryforwards which comprise deferred taxes are as follows:

YEARS ENDED JUNE 30,	1994	1993	1992
	(\$ IN THOUSANDS)		
Deferred tax liabilities:			
Acquisition, exploration and development costs and related depreciation, depletion and amortization	\$(15,872)	\$(6,295)	\$(2,449)
Deferred tax assets:			
Net operating loss carryforwards	12,879	5,332	1,387
Percentage depletion carryforward	780	—	—
	13,659	5,332	1,387
Total Noncurrent	\$ (2,213)	\$ (963)	\$(1,062)

At June 30, 1994, the company had net operating loss carryforwards of approximately \$36 million available to offset future federal income taxes payable to the extent regular income taxes payable exceeds alternative minimum taxes payable. These loss carryforward amounts will expire during the years 2007 through 2009. The company also had a percentage depletion carryforward of approximately \$2.3 million at June 30, 1994, which is available to offset future federal income taxes payable and has no expiration date.

NOTE 6. RELATED PARTY TRANSACTIONS

Certain directors, shareholders and employees of the company have acquired working interests in certain of the company's oil and gas properties. The owners of such working interests are required to pay their proportionate share of all costs. As of June 30, 1994, 1993 and 1992 the company had accounts receivable from these directors, shareholders and employees of \$1,671,000, \$1,580,000, and \$0, respectively. The aggregate average receivable balance due from these parties for the years ended June 30, 1994, 1993, and 1992 approximated \$1,331,000, \$1,153,000, and \$3,779,000, respectively.

During fiscal 1994, 1993, and 1992, the company incurred legal expenses of \$631,000, \$723,000, and \$507,000, respectively, for legal services provided by the law firm of which a director is a member.

From September 1993 to July 1994, the company owned a 40% interest in, and was represented on the operating committee of Wickford Energy Marketing, L.C. ("Wickford"), a limited liability company engaged in the

marketing of oil and gas production. The remaining interests were owned by other oil and gas producers and marketers. In January 1994, the company began to market a significant amount of its oil and gas production through Wickford. The company sold its interest in Wickford to the other owners in July 1994. For fiscal 1994, Wickford marketed 28%, or \$6.2 million, of the company's total oil and gas sales. Oil and gas sales receivables from Wickford were \$1.8 million at June 30, 1994, and are reflected as oil and gas receivables on the accompanying consolidated balance sheet. The company's investment in Wickford is accounted for using the equity method.

The company has assigned carried interests in oil and gas properties to certain of its employees and consultants. During the year ended June 30, 1992, the company ceased assigning such interests.

During the year ended June 30, 1992, CI and TLW were engaged as consultants to the company at a monthly fee of \$10,000 to both CI and TLW. The company recorded \$240,000 as general and administrative expense in the accompanying statement of operations for the year ended June 30, 1992, related to these consulting arrangements. The consulting engagement terminated on July 1, 1992.

During the year ended June 30, 1992, the company leased two of its office buildings from CI and TLW and recorded \$120,000 as general and administrative expense in the accompanying statements of operations related to these leases. These monthly charges ceased effective December 31, 1991, at which time CI and TLW transferred the buildings and certain furniture and fixtures to the company, as part of the Combination for a total consideration of approximately \$1,290,000 which included assumption of certain indebtedness as well as the assumption of two notes payable to a bank, which were collateralized by the buildings. During the year ended June 30, 1993, the notes were paid in full.

NOTE 7. EMPLOYEE BENEFIT PLANS

Effective October 1, 1989, the company established a 401(K) profit sharing plan (the "401(K) Plan"). On December 1, 1993, the company amended the plan and established the Chesapeake Energy Savings and Incentive Plan (the "Savings and Incentive Plan") with Massachusetts Mutual Life Insurance Company. Eligible employees may make voluntary contributions to the Savings and Incentive Plan which are matched by the company up to 2.5% of the employees' salary. The amount of employee contributions is limited as specified in the Savings and Incentive Plan. The company may, at its discretion, make additional

contributions to the Savings and Incentive Plan. The company contributed \$70,000, \$44,000 and \$17,000 to the Savings and Incentive Plan during the fiscal years ended June 30, 1994, 1993 and 1992, respectively.

NOTE 8. MAJOR CUSTOMERS

Sales to individual customers constituting 10% or more of total oil and gas sales were as follows:

YEAR	AMOUNT	PERCENT OF OIL AND GAS SALES
(\$ IN THOUSANDS)		
1994	Wickford Energy Marketing, L.C.	\$6,190 28%
	GPM Gas Corporation	\$6,105 27%
	Plains Marketing and Transportation, Inc.	\$2,659 12%
	Texaco Exploration & Production, Inc.	\$2,249 10%
1993	Plains Marketing and Transportation, Inc.	\$2,579 22%
	GPM Gas Corporation	\$2,039 18%
	Mobil Oil Corporation	\$1,775 15%
	Total Petroleum, Inc.	\$1,380 12%
	Texaco Exploration & Production, Inc.	\$1,368 12%
1992	Plains Marketing and Transportation, Inc.	\$4,937 47%

Management believes that the loss of any of the above customers would not have a material impact on the company's results of operations or its financial position.

NOTE 9. STOCKHOLDERS' EQUITY

On March 31, 1994, the company completed a Senior Note Offering of \$47.5 million principal amount of Senior Notes and Warrants for 486,875 shares of the company's common stock (see Notes 2 and 3). The Warrants were valued at \$3.04 million and are recorded as common stock warrants and paid-in capital on the consolidated balance sheets. As part of the Senior Note Offering, the company issued 8,000 Units to TCW in exchange for preferred stock, common stock warrants and an overriding royalty interest.

In February 1993, the company completed an initial public offering of 2,300,000 shares of its common stock at \$12 per share. The total proceeds were \$27.6 million with

total net proceeds of approximately \$25.2 million, of which \$12.8 million was used to reduce indebtedness, and the balance was used to fund operations and as working capital.

On December 4, 1992, the company issued to TCW 576,923 shares of its convertible preferred stock, in exchange for a \$7,500,000 reduction in the company's debt to TCW. Each share of the convertible preferred stock had a liquidation preference of \$13.00, accumulated dividends at an annual rate of \$1.17 per share cumulative from December 4, 1992, and was convertible at any time into a number of shares of common stock equal to the liquidation preference plus accumulated dividends of such share of convertible preferred stock surrendered for conversion divided by a conversion price of \$9.60. Commencing December 31, 1993, accumulated dividends in arrears, if any, accumulated additional dividends at a rate of 9% per annum. Pro forma per share data assuming full conversion of the convertible preferred stock to common shares is not provided herein as the results are anti-dilutive. The convertible preferred stock was acquired by the company in connection with the Senior Note Offering (see Note 2) and has been retired.

In connection with the July 2, 1992, amendment to the TCW Credit Agreement, the company issued to TCW a stock warrant granting TCW the right to purchase up to 312,001 shares of Common Stock at a price of \$4.17 per share. The warrant was acquired by the company in connection with the Senior Note Offering (see Note 2).

As discussed in Note 1, as part of the Combination, certain office buildings, interests in producing and nonproducing oil and gas properties, other property and related debt were contributed to the company effective January 1, 1992. These contributions had no effect on consolidated stockholders' equity since the property contributed was recorded at historical costs totaling approximately \$2,528,000 in exchange for \$2,207,000 of existing accounts receivable from CI and TLW and assumption of \$321,000 in long-term debt. Such transaction is not reflected in the consolidated statement of cash flows.

The Transfer was consummated as a series of contributions to the company and its subsidiaries. As a result, the Transfer was a taxable transaction to Messrs. McClendon and Ward to the extent the company assumed liabilities in excess of Messrs. McClendon and Ward's bases in the assets transferred to the company. The tax bases of assets acquired were adjusted to equal the liabilities

assumed which resulted in a reduction of deferred income tax liabilities and an increase in contributions from owners of \$291,000 as reflected in the accompanying consolidated statements of stockholders' equity.

As part of the loan transaction with Belco (see Note 3), Belco received warrants to purchase a maximum of 180,000 shares of common stock at an exercise price of \$9.60 per share. Belco also received certain registration rights for the shares issuable upon exercise of the warrants and the company has registered the shares issuable under the warrants.

A 1.8-for-1 stock split of the common stock during 1993 has been given retroactive effect in these financial statements.

STOCK OPTION PLANS

Under the company's 1992 Incentive Stock Option Plan (the "ISO Plan"), options to purchase common stock may be granted only to employees of the company and its subsidiaries. Subject to any adjustment as provided by the ISO Plan, the aggregate number of shares which may be issued and sold may not exceed 418,000 shares. The maximum period for exercise of an option shall not be more than ten years (or five years for an optionee who owns more than 10% of the common stock) from the date of grant, and the exercise price may not be less than the fair market value of the shares underlying options on the date of grant (or 110% of such value for an optionee who owns more than 10% of the common stock). Options granted become exercisable at dates determined by the Stock Option Committee of the Board of Directors. No options may be granted under the ISO Plan after December 10, 2002.

Under the company's 1992 Nonstatutory Stock Option Plan (the "NSO Plan"), options to purchase common stock may be granted only to directors and consultants of the company. Subject to any adjustment as provided by the NSO Plan, the aggregate number of shares which may be issued and sold may not exceed 290,000 shares. The maximum period for exercise of an option may not be more than ten years from the date of grant, and the exercise price may not be less than the fair market value of the shares underlying options on the date of grant. Options granted become exercisable at dates determined by the Stock Option Committee of the Board of Directors. No options may be granted under the NSO Plan after December 10, 2002.

	# OF OPTIONS	OPTION PRICES
Options outstanding at June 30, 1992	—	—
Options granted	286,300	\$9.60 - \$12.00
Options exercised	—	—
Options terminated	(1,080)	\$9.60
Options outstanding at June 30, 1993	285,220	\$9.60 - \$12.00
Options granted	309,500	\$5.00 - \$7.70
Options exercised	—	—
Options terminated	(41,100)	\$5.00 - \$9.60
Options outstanding at June 30, 1994	553,620	\$5.00 - \$12.00

NOTE 10. DISCLOSURES ABOUT OIL AND GAS PRODUCING ACTIVITIES

NET CAPITALIZED COSTS

Evaluated and unevaluated capitalized costs related to the company's oil and gas producing activities are summarized as follows:

YEARS ENDED JUNE 30,	1994	1993	1992
	(\$ IN THOUSANDS)		
Oil and gas properties:			
Proved	\$83,170	\$56,181	\$45,729
Unproved	3,729	2,411	—
Total	\$86,899	\$58,592	\$45,729
Less accumulated depreciation, depletion and amortization	(16,417)	(8,276)	(4,091)
Net capitalized costs	\$70,482	\$50,316	\$41,638

Unproved properties not subject to amortization at June 30, 1994 and 1993, consist mainly of lease acquisition costs. The company capitalized approximately \$356,000, \$192,000 and \$0 of interest during the years ended June 30, 1994, 1993, and 1992 on significant investments in unproved properties that are not being currently depreciated, depleted, or amortized and on which exploration or development activities are in progress. The company will continue to evaluate its unevaluated properties; however, the timing of the ultimate evaluation and disposition of the properties has not been determined.

COSTS INCURRED IN OIL AND GAS ACQUISITION, EXPLORATION AND DEVELOPMENT

Costs incurred in oil and gas property acquisition, exploration and development activities which have been capitalized are summarized as follows:

YEARS ENDED JUNE 30,	1994	1993	1992
	(\$ IN THOUSANDS)		
Development costs	\$21,812	\$12,263	\$27,841
Exploration costs	5,358	1,123	724
Acquisition costs:			
Unproved properties	3,305	1,364	—
Proved properties	3,320	976	2,233
Capitalized internal costs	2,110	1,080	449
Proceeds from sale of leasehold, equipment and other	(7,598)	(3,943)	(5,500)
Total	\$28,307	\$12,863	\$25,747

RESULTS OF OPERATIONS FROM OIL AND GAS PRODUCING ACTIVITIES (UNAUDITED)

The company's results of operations from oil and gas producing activities are presented below for the years ended June 30, 1994, 1993 and 1992, respectively. The following table includes revenues and expenses associated directly with the company's oil and gas producing activities. It does not include any allocation of the company's interest costs and, therefore, is not necessarily indicative of the contribution to consolidated net operating results of the company's oil and gas operations.

YEARS ENDED JUNE 30,	1994	1993	1992
	(\$ IN THOUSANDS)		
Oil and gas sales	\$22,404	\$11,602	\$10,520
Production costs (a)	(3,647)	(2,890)	(2,103)
Depletion and depreciation	(8,141)	(4,184)	(2,910)
Imputed income tax provision (b)	(3,610)	(1,540)	(1,872)
Results of operations from oil and gas producing activities	\$7,006	\$2,988	\$3,635

(a) Production costs include lease operating expenses and production taxes.

(b) The imputed income tax provision is hypothetical and determined without regard to the company's deduction for general and administrative expenses, interest costs and other income tax credits and deductions.

OIL AND GAS RESERVE QUANTITIES (UNAUDITED)

The reserve information presented below is based upon reports prepared by the independent petroleum engineering firm of Williamson Petroleum Consultants, Inc. ("Williamson") as of June 30, 1994, June 30, 1993, and October 1, 1992 (adjusted to June 30, 1992 by the company). The information is presented in accordance with regulations prescribed by the Securities and Exchange Commission. The company emphasizes that reserve estimates are inherently imprecise. The company's reserve estimates were generally based upon extrapolation of historical production trends, analogy to similar properties and volumetric calculations. Accordingly, these estimates

are expected to change, and such changes could be material, as future information becomes available.

Proved oil and gas reserves represent the estimated quantities of crude oil, natural gas, and natural gas liquids which geological and engineering data demonstrate with reasonable certainty to be recoverable in future years from known reservoirs under existing economic and operating conditions. Proved developed oil and gas reserves are those expected to be recovered through existing wells with existing equipment and operating methods.

Presented below is a summary of changes in estimated reserves of the company based upon the reports prepared by Williamson.

	JUNE 30, 1994		JUNE 30, 1993		JUNE 30, 1992	
	OIL (MBBL)	GAS (MMCF)	OIL (MBBL)	GAS (MMCF)	OIL (MBBL)	GAS (MMCF)
Proved reserves, beginning of year	9,622	79,763	11,147	68,618	3,212	17,334
Extensions, discoveries and other additions	2,335	82,965	1,576	15,078	10,140	60,745
Revisions of previous estimate	(868)	(5,523)	(2,427)	3,529	(1,746)	(5,504)
Production	(537)	(6,927)	(276)	(2,677)	(374)	(1,252)
Sale of reserves-in-place	(6,398)	(33,212)	(398)	(4,789)	(97)	(2,718)
Purchase of undeveloped reserves-in-place	—	—	—	4	12	13
Proved reserves, end of year	4,154	117,066	9,622	79,763	11,147	68,618
Proved developed reserves, end of year	1,313	30,445	830	11,893	1,049	11,492

On October 25, 1993, the company entered into a joint development agreement ("Joint Development Agreement") with Union Pacific Resources Company ("UPRC"), the oil and gas production subsidiary of Union Pacific Corporation, and privately held GeoSouthern Energy Corporation ("GeoSouthern"). UPRC and GeoSouthern have agreed to combine their leasehold position with the company's contractual rights in a 20,000 gross acre development area in the Fayette County portion of the Giddings Field in southern Texas. The company entered into the Joint Development Agreement with the objective of enhancing the rate of return on capital invested in this area by optimizing well spacing and applying recent advances in drilling technology. The company's estimated ownership interests in the proved undeveloped properties covered by the Joint Development Agreement are significantly less than those used in the June 30, 1993 reserve report. The impact of the reduced ownership percentages is reflected as sales of reserves in place in the preceding table.

The revisions in the company's estimated quantities of oil and gas are attributable to revised estimates by Williamson. For fiscal 1992, significant downward revisions were attributed to the company's interests in the First Shot Field in Texas. At the end of fiscal 1993, Williamson significantly reduced the estimated quantities of oil and significantly increased the estimated quantities of gas attributable to the company's interests in the Giddings Field in Texas to reflect the higher gas to oil production ratio experienced by the company in fiscal 1993.

STANDARDIZED MEASURE OF DISCOUNTED FUTURE NET CASH FLOWS (UNAUDITED)

SFAS No. 69 prescribes guidelines for computing a standardized measure of future net cash flows and changes therein relating to estimated proved reserves. The company has followed these guidelines which are briefly discussed below.

Future cash inflows and future production and development costs are determined by applying year-end

prices and costs to the estimated quantities of oil and gas to be produced. Estimates are made of quantities of proved reserves and the future periods during which they are expected to be produced based on year-end economic conditions. Estimated future income taxes are computed using current statutory income tax rates including consideration for the current tax basis of the properties and related carryforwards, giving effect to permanent differences and tax credits. The resulting future net cash flows are reduced to present value amounts by applying a 10% annual discount factor.

The assumptions used to compute the standardized measure are those prescribed by the Financial Accounting Standards Board and, as such, do not necessarily reflect the company's expectations of actual revenue to be derived from those reserves nor their present worth. The limitations inherent in the reserve quantity estimation process, as discussed previously, are equally applicable to the standardized measure computations since these estimates are the basis for the valuation process.

The following summary sets forth the company's future net cash flows relating to proved oil and gas reserves based on the standardized measure prescribed in SFAS No. 69:

YEARS ENDED JUNE 30,	1994	1993	1992
	(\$ IN THOUSANDS)		
Future cash inflows	\$307,600	\$374,190	\$396,709
Future production costs	(50,765)	(72,691)	(58,403)
Future development costs	(47,040)	(86,383)	(71,087)
Future income tax provision	(36,847)	(37,248)	(63,668)
Future net cash flows	172,948	177,868	203,551
Less effect of a 10% discount factor	(54,340)	(58,124)	(77,799)
Standardized measure of discounted future net cash flows	\$118,608	\$119,744	\$125,752

The principal sources of change in the standardized measure of discounted future net cash flows are as follows:

YEARS ENDED JUNE 30,	1994	1993	1992
	(\$ IN THOUSANDS)		
Standardized measure, beginning of year	\$119,744	\$125,752	\$22,054
Sales of oil and gas produced, net of production costs	(18,757)	(8,712)	(8,417)
Net changes in prices and production costs	(10,795)	(25,935)	8,394
Extensions and discoveries, net of production and development costs	99,175	21,579	151,296
Changes in future development costs	(2,855)	(4,154)	875
Development costs incurred during the period that reduced future development costs	9,855	7,233	11,115
Revisions of previous quantity estimates	(13,107)	(13,089)	(19,693)
Purchase of undeveloped reserves-in-place	0	(3)	103
Sales of reserves in-place	(66,372)	(10,114)	(4,067)
Accretion of discount	14,166	16,453	2,781
Net change in income taxes	(720)	16,556	(33,119)
Changes in production rates and other	(11,726)	(5,822)	(5,570)
Standardized measure, end of year	\$118,608	\$119,744	\$125,752

QUARTERLY FINANCIAL DATA

Summarized unaudited quarterly financial data for fiscal 1994 and 1993 are as follows:

	JUNE 30, 1994	QUARTERS ENDED MARCH 31, 1994	DECEMBER 31, 1993	SEPTEMBER 30, 1993
	(\$ IN THOUSANDS, EXCEPT PER SHARE DATA)			
Net sales	\$ 10,621	\$ 6,606	\$ 6,250	\$ 5,366
Gross profit	4,816	716	841	650
Net income	2,900	340	517	285
Income per share	\$.51	\$.07	\$.07	\$.02
	JUNE 30, 1993	QUARTERS ENDED MARCH 31, 1993	DECEMBER 31, 1992	SEPTEMBER 30, 1992
	(\$ IN THOUSANDS, EXCEPT PER SHARE DATA)			
Net sales	\$ 4,686	\$ 4,461	\$ 4,329	\$ 3,652
Gross profit	1,801	503	629	291
Net income (loss)	(368)	298	(69)	(225)
Income (loss) per share	\$ (.11)	\$.03	\$ (.04)	\$ (.07)

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