
CHESAPEAKE ENERGY CORPORATION
ANNUAL REPORT FISCAL 1997

JULY 1, 1996 - JUNE 30, 1997

DRILLING AHEAD



S E L E C T E D F I N A N C I A L D A T A

Year Ended June 30,	1997	1996	1995	1994	1993	1992
Income Data (<i>\$ in thousands, except per share data</i>)						
Oil and gas sales	\$ 192,920	\$ 110,849	\$ 56,983	\$ 22,404	\$ 11,602	\$ 10,520
Oil and gas marketing sales	76,172	28,428	-	-	-	-
Service operations and other	11,223	10,145	10,360	7,420	6,406	8,198
Total revenues	280,315	149,422	67,343	29,824	18,008	18,718
Production expenses and taxes	15,107	8,303	4,256	3,647	2,890	2,103
Oil and gas marketing expenses	75,140	27,452	-	-	-	-
Service operations	-	4,895	7,747	5,199	3,653	4,113
Impairment of oil and gas properties	236,000	-	-	-	-	-
Oil and gas depreciation, depletion and amortization	103,264	50,899	25,410	8,141	4,184	2,910
Other depreciation and amortization	3,782	3,157	1,765	1,871	557	974
General and administrative	8,802	4,828	3,578	3,135	4,906	3,314
Interest and other	18,550	13,679	6,627	2,676	2,282	2,577
Total expenses	460,645	113,213	49,383	24,669	18,472	15,991
Income (loss) before income taxes and extraordinary item	(180,330)	36,209	17,960	5,155	(464)	2,727
Income tax expense (benefit)	(3,573)	12,854	6,299	1,250	(99)	1,337
Income (loss) before extraordinary item	(176,757)	23,355	11,661	3,905	(365)	1,390
Extraordinary item, net of applicable income tax	(6,620)	-	-	-	-	-
Net income (loss)	\$ (183,377)	\$ 23,355	\$ 11,661	\$ 3,905	\$ (365)	\$ 1,390
Earnings (loss) per share	\$ (2.79)	\$ 0.40	\$ 0.21	\$ 0.08	\$ (0.02)	\$ 0.05
Weighted average shares outstanding	65,767	58,342	55,872	48,240	33,552	27,910
Property Data (<i>\$ in thousands</i>)						
Oil reserves (MBbbls)	17,373	12,258	5,116	4,154	9,622	11,147
Gas reserves (MMcf)	298,766	351,224	211,808	117,066	79,763	68,618
Reserves in equivalent thousand barrels	67,167	70,795	40,417	23,665	22,915	22,583
Reserves in equivalent million cubic feet	403,004	424,775	242,505	141,992	137,495	135,500
Future net revenues discounted at 10% (before tax)	\$ 437,386	\$ 547,016	\$ 188,137	\$ 141,249	\$ 141,665	\$ 162,713
Oil production (MBbbls)	2,770	1,413	1,139	537	276	374
Gas production (MMcf)	62,005	51,710	25,114	6,927	2,677	1,252
Production in equivalent thousand barrels	13,104	10,031	5,325	1,692	722	583
Production in equivalent million cubic feet	78,625	60,190	31,947	10,152	4,333	3,496
Average oil price (per Bbl)	\$ 20.93	\$ 17.85	\$ 17.36	\$ 15.09	\$ 20.20	\$ 21.85
Average gas price (per Mcf)	\$ 2.18	\$ 1.66	\$ 1.48	\$ 2.06	\$ 2.25	\$ 1.88
Average gas equivalent price (per Mcfe)	\$ 2.45	\$ 1.84	\$ 1.78	\$ 2.21	\$ 2.68	\$ 3.01

Chesapeake Energy Corporation is an independent oil and gas exploration company headquartered in Oklahoma City. The company utilizes advanced drilling and completion techniques to develop significant new oil and natural gas discoveries in major onshore producing areas of the United States. Chesapeake is traded on the New York Stock Exchange under the symbol CHK.

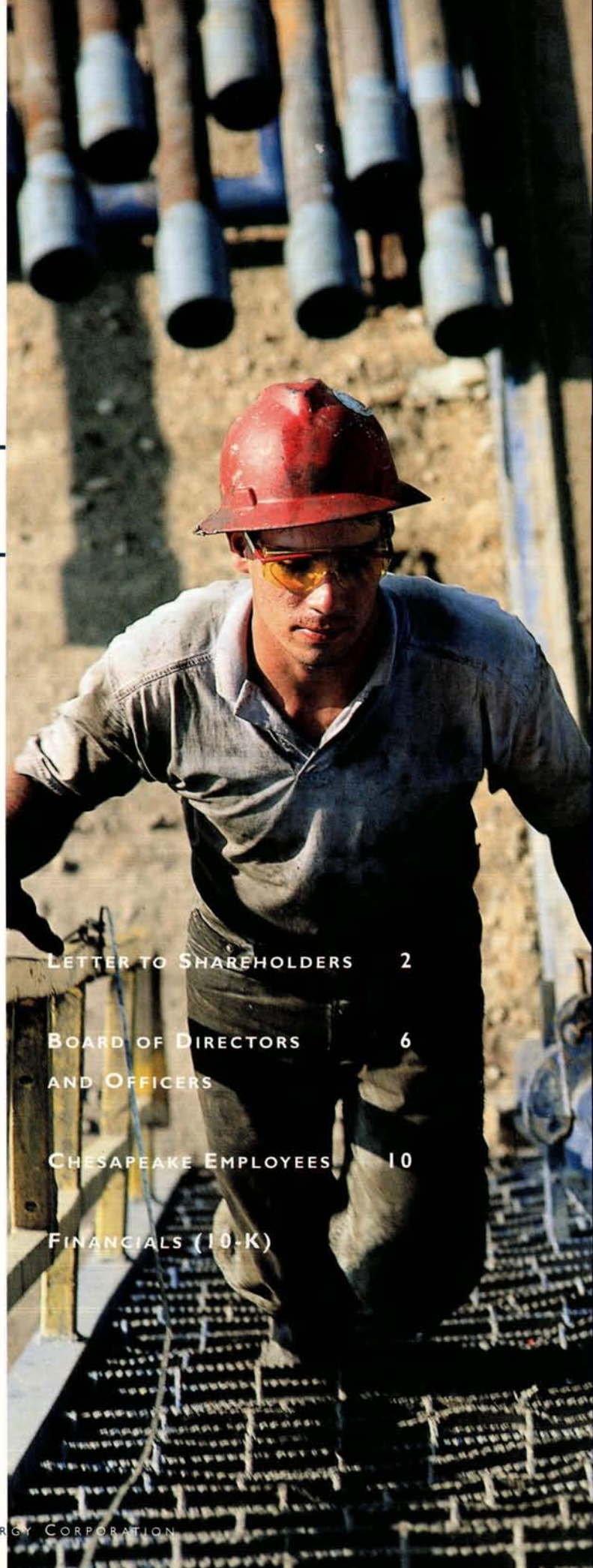
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FINANCIALS (10-K)



Masters Creek will be the centerpiece of Chesapeake's refocused Louisiana Trend drilling program in fiscal 1998.

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Dear Fellow Shareholders:

We began fiscal 1997 optimistic about the continued growth and prosperity of Chesapeake.

Unfortunately, the year ended with great disappointment as we wrote down the value of the company's assets by \$236 million and incurred an after-tax loss of \$183 million.

It was our first Louisiana well, the James 7, that generated substantial enthusiasm regarding the potential of extending

investment for our company. However, we believed the substantial benefit of building a multi-year inventory of future drillsites in what appeared to be the most attractive onshore exploration play of recent years justified the inherent risks.

Consistent with our commitment to the company's shareholders, Chesapeake initiated an aggressive exploration program across six Louisiana Trend prospect areas: South Brookeland, Leesville, Masters Creek, St. Landry, Baton Rouge, and Livingston. Unfortunately, this program yielded two

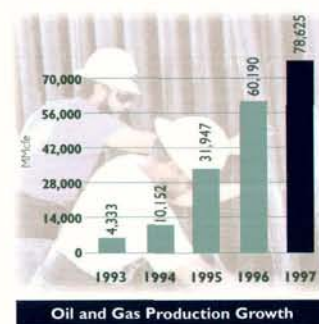
"...We are also modifying our historical approach of achieving growth exclusively through the drillbit by selectively acquiring underdeveloped producing properties and undercapitalized companies."

the Austin Chalk drilling program from the Giddings Field in Texas across the border into Louisiana. The well began producing on June 29, 1996 and during July 1997 averaged 2,000 barrels of oil and 8.5 million cubic feet of natural gas production per day. This well, other highly productive wells drilled by our competitors in the Masters Creek area, and the extensive 2-D seismic control and well log information obtained from over 500 prior penetrations of the Austin Chalk formation seemed to confirm that the Louisiana Austin Chalk Trend would prove productive across a large portion of central and southeastern Louisiana.

Other companies arrived at similar conclusions, resulting in one of the most competitive oil and gas lease acquisition efforts in the past fifteen years over a 200 mile-long trend in Louisiana. Chesapeake's geologists, geophysicists and landmen, along with scores of contract lease brokers, competed aggressively to increase our position in this highly regarded acreage. By the end of fiscal 1997, Chesapeake had invested over \$175 million acquiring more than one million acres - the dominant leasehold position in the Louisiana Trend - and greater than the collective ownership of our major competitors Union Pacific Resources, Sonat, Occidental, and Amoco. It was clearly a major

conclusion as fiscal 1997 drew to a close. First, the technological challenges and drilling costs in the Louisiana Trend were substantially greater than we had encountered previously. Second, the reservoir quality in the Louisiana Austin Chalk was not as consistently productive as the Austin Chalk in the Giddings Field in Texas.

Accordingly, in the last days of the fourth quarter of fiscal 1997, we determined that a significant portion of the company's Louisiana Trend leasehold had become evaluated under the full cost accounting method, which in combination with significant related drilling costs, caused us to exceed our full cost ceiling limitation and required a writedown of our assets. This writedown and the resulting loss for the year disappointed all Chesapeake shareholders, especially us. After all, we had personally purchased \$30 million of Chesapeake stock in February 1997, reflecting our confidence in the likely success of the company's Louisiana drilling program. Notwithstanding recent setbacks, we remain proud to own approximately 33% of



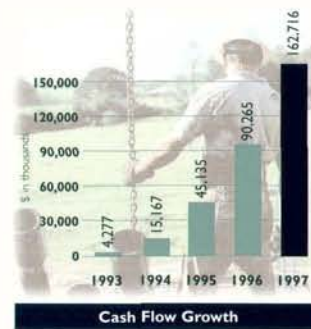
Chesapeake and believe future drilling successes will increase our company's value. Determined to prove that fiscal 1997's drilling results were an aberration, we have embarked on what the company believes is the appropriate road to recovery in fiscal 1998.

Road to Recovery

What is this road to recovery and why should shareholders have faith in management's ability to navigate this road? First,

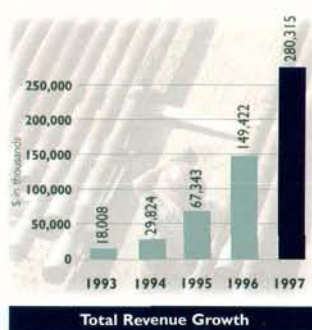
competitors establish the economic viability of a particular area. Our plan is then to begin developing the company's leasehold in the new area at a lower risk than if we had drilled the initial well.

We are also modifying our historical approach of achieving growth exclusively through



“...While the oil and gas industry remains a high-risk business with many short-term ups and downs, we believe the Chesapeake management team has made the necessary adjustments to achieve success for our company in the years ahead.”

the company continues to have substantial financial resources to develop its two million acre onshore U.S. leasehold inventory and to complete the 3-D seismic studies which will help high-grade our drilling efforts. Including the expected monetization during the second quarter of fiscal 1998 of our 30% investment in Bayard Drilling Technologies, Inc. (the fifth largest onshore drilling contractor in the U.S. and presently in registration for its IPO), we have more than \$200 million of cash and investments to conduct our future drilling programs. Additionally, we have structured our long-term debt so that it has an average



life of nine years with none of it scheduled to mature until 2002.

Second, we have reduced significantly the scope of our exploration program in Louisiana. Although this may reduce the potential for hitting

home runs with our drilling efforts, we hope to continue targeting production increases of 10-15% per year while incurring lower risk. We plan to achieve this lower risk profile by delaying our drilling activities outside of Masters Creek and letting our

the drillbit by selectively acquiring underdeveloped producing properties and undercapitalized companies. We believe the imposing and increasing costs of conducting 3-D seismic and horizontal drilling programs, combined with the limited number of people experienced in utilizing these technologies, will require a consolidation of the independent oil and gas industry. We believe this trend will create attractive acquisition opportunities for Chesapeake, especially given the quality, experience, and depth of our management and technical teams.

During the past five years, we have built Chesapeake into a drilling leader with some of the best engineering, geoscientific, land, and financial talent in the industry. Furthermore, with an almost 40% equity stake in the company, our management team and directors are clearly motivated to return Chesapeake to its historic performance level.

Many current shareholders may be aware that we experienced similar challenges in fiscal 1994 as investors lost confidence in our ability to make the transition from a small Oklahoma-based development company to a large multi-state exploration company. As many of you know, we made that transition and increased shareholder value significantly. While the oil and gas industry remains a high-risk business with many

short-term ups and downs, we believe the Chesapeake management team has made the necessary adjustments to achieve success for our company in the years ahead.

Chesapeake's Business Model

Since founding Chesapeake eight years ago, we have tried to develop a company with distinctive characteristics that could help us grow more quickly and profitably than our competitors. While we have not always achieved our ambitious growth objectives, we are proud that we have developed a reputation for clearly articulating the methods by which we seek to build shareholder value.

We remain committed to certain fundamental beliefs: increasing reserves and production through the drillbit, establishing dominant leasehold positions, using our technological leadership to achieve high rates of return on our investments, and maintaining an entrepreneurial culture inspired by one of the highest management equity positions in our industry. And to further broaden our business strategy in fiscal 1998, we will consider selective acquisitions to diversify and strengthen our reserve base.

Having learned important lessons during fiscal 1997 and having modified our fiscal 1998 growth strategy accordingly, we believe the keys to Chesapeake's recovery are in place. We are determined to effectively execute our fiscal 1998 strategy and look forward to sharing better results with you as we drill ahead.



Aubrey K. McClendon

Chairman of the Board and Chief Executive Officer



Tom L. Ward

President and Chief Operating Officer

October 15, 1997





Aubrey K. McClendon
Chairman of the Board, Chief Executive Officer and Director

Aubrey K. McClendon has served as Chairman of the Board and Chief Executive Officer and has been a director of the company since its inception. From 1982 to 1989, Mr. McClendon was an independent producer of oil and gas in affiliation with Mr. Tom L. Ward. Mr. McClendon is a member of the Board of Visitors of the Fuqua School of Business at Duke University, an Executive Committee member of the Texas Independent Producers and Royalty Owners Association, a Director of the Oklahoma Independent Petroleum Association, and a Director of the Louisiana Independent Oil and Gas Association. Mr. McClendon graduated from Duke University in 1981.

Tom L. Ward
President, Chief Operating Officer and Director

Tom L. Ward has served as President and Chief Operating Officer and has been a director of the company since its inception. From 1982 to 1989, Mr. Ward was an independent producer of oil and gas in affiliation with Mr. Aubrey K. McClendon. Mr. Ward



is a member of the Board of Trustees of Anderson University in Anderson, Indiana. Mr. Ward graduated from the University of Oklahoma in 1981.

E. F. Heizer, Jr.
Director

E. F. Heizer, Jr. has served as a director of the company since February 1993. He founded Heizer Corp. in 1969 and served as Chairman and Chief Executive Officer until 1986, when Heizer Corp. was reorganized into a number of public and private companies. Mr. Heizer was assistant treasurer of the Allstate Insurance Company from 1962 to 1969. He



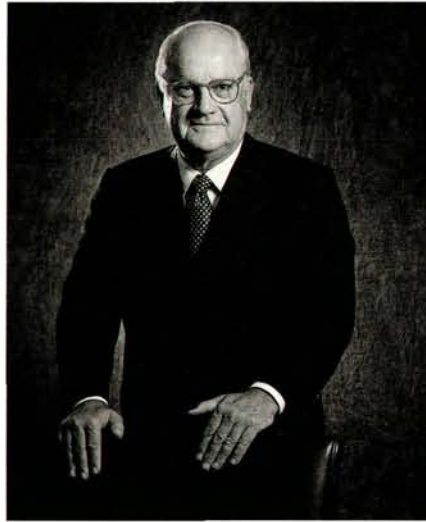
was employed by Booz, Allen and Hamilton from 1958 to 1962, Kidder, Peabody & Co. from 1956 to 1958 and Arthur Anderson & Co. from 1954 to 1956. He is chairman of the Heizer Center for Entrepreneurship at the Kellogg School of Management at Northwestern University and the Executive Committee of Yale Law School. Mr. Heizer graduated from Northwestern University in 1951 and received a Juris Doctorate from Yale in 1954.

Breene M. Kerr
Director

Breene M. Kerr has served as a director of the company since February 1993. In 1969, Mr. Kerr founded Kerr Consolidated, Inc., of which he is currently Chairman and President, and co-founded the Resource Analysis and Management Group. From 1967 to 1969, he was Vice President of Kerr-McGee Chemical Corporation and served as a director of Kerr-McGee Corporation from 1957 to 1981. Mr. Kerr has served as a chairman of the Investment Committee for the Massachusetts Institute of Technology



Law, in Oklahoma City, which he co-founded in 1991. Mr. Self was an associate and shareholder in the law firm of Hastie and Kirschner, Oklahoma City, from 1984 to 1991 and was employed by Arthur Young & Co. from 1979 to 1980. He graduated from the University of Oklahoma in 1979 and received a Juris Doctorate from Northwestern University in 1984.



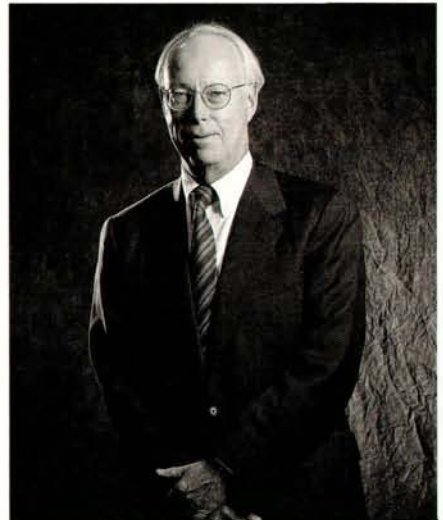
**Frederick B. Whittemore
Director**

Frederick B. Whittemore has served as a director of the company since February 1993. Mr. Whittemore has been an advisory director of Morgan Stanley & Co. since 1989 and was a managing director of Morgan Stanley & Co. from 1970 to 1989. He was Vice-Chairman of the American Stock Exchange from 1982 to 1984. Mr. Whittemore was a partner with Morgan Stanley & Co. from 1967 to 1970 and an associate from 1958 to 1967. He is a director of Integon Corporation in Winston-Salem, North Carolina, Partner Reinsurance Company, Ltd. in Bermuda, and

Southern Pacific Petroleum Corporation, an Australian oil and gas company. Mr. Whittemore graduated from Dartmouth College in 1953 and from Dartmouth's Amos Tuck School of Business Administration in 1954.

**Walter C. Wilson
Director**

Walter C. Wilson has served as a director of the company since February 1993. From 1963 to 1974 and from 1978 to the present, Mr. Wilson has been a general agent with Massachusetts Mutual Life Insurance Company. From 1974 to 1978, he was Senior Vice President of Massachusetts Mutual Life Insurance Company, and from 1958 to 1963, he was an agent with that company. Mr. Wilson is a member of



the Board of Trustees of Springfield College, Springfield, Massachusetts, and is a director of Earth Satellite Corporation, Rockville, Maryland, and Amerac Energy Corporation, Houston, Texas. Mr. Wilson graduated from Dartmouth College in 1958.

and is a life member on the Board of Trustees. Mr. Kerr is a trustee and serves on the Investment Committee of the Brookings Institute in Washington, D.C., and has been an associate director since 1987 of Aven Gas & Oil, Inc., located in Oklahoma City. Mr. Kerr graduated from the Massachusetts Institute of Technology in 1951.

**Shannon T. Self
Director**

Shannon T. Self has served as a director of the company since February 1993. Mr. Self is a shareholder of Self, Giddens & Lees, Inc., Attorneys at





Marcus C. Rowland
Sr. Vice President – Finance
and Chief Financial Officer

Marc Rowland has served as Sr. Vice President – Finance and Chief Financial Officer of the Company since 1993. From 1990 until he joined the Company, Mr. Rowland was Chief Operating Officer of Anglo-Suisse, L.P. assigned to the White Nights Russian Enterprise, a joint venture of Anglo-Suisse, L.P. and Phibro Energy Corporation, a major foreign operation which was granted the right to engage in oil and gas operations in Russia. Previously, Mr. Rowland owned and managed his own oil and gas company and prior to that was Chief Financial Officer of a private exploration company in Oklahoma City from 1981 to 1985. Mr. Rowland is a Certified Public Accountant and graduated from Wichita State University in 1975.



Steven C. Dixon
Sr. Vice President – Operations

Steve Dixon served as Vice President – Exploration from 1991 to 1995 and was appointed Senior Vice President – Operations in 1995. Mr. Dixon was a self-employed geological consultant in Wichita, Kansas, from 1983 through 1990. He was employed by Beren Corporation in Wichita, Kansas, from 1980 to 1983 as a geologist. Mr. Dixon graduated from the University of Kansas in 1980.



J. Mark Lester
Sr. Vice President –
Exploration

Mark Lester served as Vice President – Exploration from 1989 to 1995 and was appointed Senior Vice President – Exploration in 1995. From 1986 to 1989, Mark Lester was employed by Messrs. McClendon and Ward as a geologist. He was employed by various independent oil companies in Oklahoma City from 1980 to 1986, and was employed by Union Oil Company of California from 1977 to 1980 as a geophysicist. Mr. Lester graduated from Purdue University in 1975 and 1977.



Henry J. Hood
Sr. Vice President –
Land and Legal

Henry Hood has served as Sr. Vice President – Land and Legal since September 1997. Mr. Hood served as Vice President - Land and Legal from 1995 to 1997. Mr. Hood was retained as a consultant to the Company during the prior two years. He was associated with the law firm of Watson & McKensie from 1987 to 1992 and, from 1991 to 1992, Mr. Hood was of counsel to the law firm of White, Coffey, Galt & Fite. Mr. Hood is a member of the Oklahoma and Texas Bars. He graduated from Duke University in 1982 and from the University of Oklahoma College of Law in 1985.



Ronald A. Lefave
Controller and Chief
Accounting Officer

Ron Lefave has served as Controller and Chief Accounting Officer since

1993. From 1991 until his association with the Company, Mr. Lefaive was Controller for Phibro Energy Production, Inc., an international exploration and production subsidiary of Phibro Energy Corporation. From 1982 to 1991, Mr. Lefaive served as Assistant Controller, General Auditor, and Manager of Management Information Systems at Conquest Exploration Company in Houston, Texas. Previously, Mr. Lefaive held various financial staff and management positions with The Superior Oil Company and Shell Oil Company. Mr. Lefaive is a Certified Public Accountant and graduate of the University of Houston in 1975.

and by Arthur Andersen & Co. Ms. Burger is a Certified Public Accountant and graduated from the University of Central Oklahoma in 1982 and from Oklahoma City University in 1992.



Thomas S. Price, Jr.
Vice President – Corporate Development

Tom Price has served as Vice President – Corporate Development since 1992 and was a consultant to the Company during the prior two years. He was employed by Kerr-McGee Corporation, Oklahoma City, from 1988 to 1990 and by Flag-Redfern Oil Company from 1984 to 1988. Mr. Price graduated from the University of Central Oklahoma in 1983, from the University of Oklahoma in 1989, and from the American Graduate School of International Management in 1992.

Charles Imes has served as Director – Management Information Systems since 1993 and was appointed Vice President – Information Technology (Administration, Finance, and Land) in 1997. From 1983 to 1993, Mr. Imes owned Imes Software Systems and served as a consultant and supplier of software to the Company from 1990 to 1993. Mr. Imes graduated from the University of Oklahoma in 1969.



Terry L. Kite
Vice President – Information Technology (Operations)

Terry Kite has served as Vice President – Information Technology (Operations) since February 1997. From 1981 to 1996, Mr. Kite served in various positions in information technology at Amerada Hess Corporation, including Manager – Geoscience and Engineering Systems. Prior to joining Amerada Hess, Mr. Kite held information systems staff positions with Earth Science Programming from 1979 to 1980 and with Seismograph Corporation from 1976 to 1979. Mr. Kite graduated from the Colorado School of Mines in 1976.



Martha A. Burger
Treasurer and Human Resources Manager

Martha Burger has served as Treasurer since 1995 and as Treasurer and Human Resources Manager since 1996. From 1994 to 1995, she served in various accounting positions with the Company, including Assistant Controller – Operations. From 1989 to 1993, Ms. Burger was employed by Hadson Corporation as Assistant Treasurer and from 1994 to 1995, served as Vice President and Controller of Hadson. Prior to joining Hadson, Ms. Burger was employed by Phoenix Resource Companies, Inc. as Assistant Treasurer



Charles W. Imes
Vice President – Information Technology (Administration)



Although Chesapeake remains dedicated to our traditional strategy of growth through the drillbit, in fiscal 1998 we will also increase our reserves and production through selected acquisitions of underdeveloped properties and undercapitalized companies, principally in the Mid-Continent.

CHESAPEAKE EMPLOYEES

Joel Alberts <i>Geologist</i>	Randy Borlaug <i>Purchasing</i>	Ilan Cathey <i>Geology Technician</i>	Jason Davis <i>Production Facility Operator</i>	Amy Foreman <i>Receptionist</i>
Richey Albright <i>Pumper</i>	Dale Bossert <i>Vice President - Production</i>	Jay Chambers <i>IT Network Specialist</i>	Ted Davis <i>Pumper</i>	Pat Foster <i>Geology Technician</i>
Linda Allen <i>Legal Assistant</i>	Marion Bowen <i>Administrative Division - Order Analyst</i>	David Chesher <i>Landman</i>	Kevin Decker <i>Production Coordinator</i>	Rick Foster <i>Geology Technician</i>
Sam Allen <i>Landman</i>	James Brinkley <i>Welder</i>	Dale Clark <i>Sr. Drilling Engineer</i>	Casidy Denney <i>Administrative Assistant</i>	Barbara Frailey <i>Land Assistant</i>
Karla Allford <i>Engineering Technician</i>	Jim Brock <i>Sr. Division Order Analyst</i>	Darrell Clark <i>Production Facility Operator</i>	George Denny <i>Landman</i>	Joy Franklin <i>Production Assistant</i>
Sandra Alvarado <i>Lease Analysis Supervisor</i>	Leslie Bross <i>Land Technician</i>	Ivajeon Clark <i>Tax Accountant</i>	Tim Denny <i>Administrative Services Coordinator</i>	Sherry Freeman <i>Accounting Assistant</i>
Eduardo Alvarez-Salazar <i>Roustabout</i>	Janice Brown <i>Lease Technician</i>	Steve Cody <i>Geology Technician</i>	David DeSalvo <i>Production Foreman</i>	Linda Gardner <i>Executive Assistant</i>
Heather Anderson <i>Lease Analyst</i>	Pamela Brown <i>Sr. Title Analyst</i>	Kimberly Coffman <i>Operations Accounting Supervisor</i>	Alton Dickey <i>Pumper</i>	Steve Gaskins <i>Pumper</i>
Colley Andrews <i>District Manager- Louisiana</i>	Keri Bruegger <i>Administrative Assistant</i>	Michael Coles <i>Production Foreman</i>	Lynn Diel <i>Division Order Assistant</i>	Eric Gearhart <i>Lease Records Assistant</i>
Judy Arias-Sanchez <i>Accounting Assistant</i>	Martha Burger <i>Treasurer/Human Resources Director</i>	Gary Collings <i>Sr. Division Order Analyst</i>	Steve Dixon <i>Sr. Vice President- Operations</i>	Robert Gilkes <i>Revenue Accountant</i>
Paula Asher <i>Drilling Secretary</i>	Jeff Burling <i>Geologist</i>	Mike Collis <i>Production Foreman</i>	Janice Dobbs <i>Compliance Manager</i>	Kim Ginter <i>Division Order Assistant</i>
Eric Ashmore <i>Drilling Superintendent</i>	Steve Burns <i>Geologist</i>	Maria Constantino <i>Accounting Assistant</i>	Justin Dodson <i>Roustabout</i>	Charlene Glover <i>Landman</i>
David Ault <i>Sr. Drilling Engineer</i>	Shelli Butler <i>Accounting Assistant</i>	Kristine Conway <i>Accounting Assistant</i>	Mandy Duane <i>Land Technician</i>	Robin Glynn <i>Drilling Engineer</i>
Jack Austin <i>Geologist</i>	Sara Caldwell <i>Title Assistant</i>	Dale Cook <i>Audit Supervisor</i>	Michael Dubea <i>Production Facility Operator</i>	Randy Goben <i>Operations Accounting Manager</i>
Sonya Baker <i>Engineering Technician</i>	Mike Cameron <i>Geologist</i>	Stacey Costa <i>Drilling Technician</i>	Gary Dunlap <i>Land Manager</i>	Ron Goff <i>Sr. Drilling Engineer</i>
Barbara Bale <i>Regulatory Analyst</i>	Patti Carlisle <i>Executive Assistant</i>	Rose-Marie Coulter <i>Lease Technician</i>	Julie Eck <i>Assistant Treasurer</i>	Jim Gomez <i>Graphics Lease Analyst</i>
Marilyn Ball <i>JIB Coordinator</i>	Leonardo Carmona <i>Pusher</i>	Lorrie Cove <i>Land Assistant</i>	Laurie Eck <i>Accounting Coordinator</i>	Traci Gonzales <i>Tax Manager</i>
Ralph Ball <i>Network Coordinator</i>	Ramon Carmona <i>Roustabout</i>	Marie Cox <i>Accounting Assistant</i>	Heidi Einspahr <i>Financial Accountant</i>	Pat Goode <i>Land Manager</i>
René Beard <i>Accounting Coordinator</i>	Martin Carmona-Cruz <i>Roustabout</i>	Tiffany Cruce <i>Production Assistant</i>	Kyle Essmiller <i>Financial Accounting Supervisor</i>	Jennifer Grigsby <i>Revenue Accounting Supervisor</i>
Michaela Benners <i>Contract Administration Manager</i>	John Carsrud <i>Drilling Superintendent</i>	Michelle Cullen <i>Division Order Tech</i>	Brian Gross <i>Production Engineer</i>	Melissa Gruenewald <i>Revenue Accountant</i>
Rodney Beverly <i>Production Foreman</i>	Jamie Carter <i>Sr. Division Order Analyst</i>	Ronald Curry <i>Production Facility Operator</i>	Brian Guire <i>IT Programmer</i>	James Gulde <i>Production Facility Operator</i>
Calvin Bodin <i>Production</i>	James Castalano <i>Production Facility Operator</i>	Elaine Darby <i>Operations Technician</i>	Amy Fell <i>Production Technician</i>	Cheryl Hamilton <i>Accounting Coordinator</i>
Bill Bond <i>Accountant</i>	Belinda Cathey <i>Division Order Assistant</i>	Ken Davidson <i>District Manager- Oklahoma</i>	David Ferguson <i>Landman</i>	

C H E S A P E A K E E M P L O Y E E S

Shane Hamilton <i>Administrative Services</i>	Jan Howard <i>Accounting Assistant</i>	Terry Kite <i>Vice President-Information Technology</i>	Charles Long <i>Production Facility Operator</i>	Sondra McNeiland <i>Executive Assistant</i>
Cliff Hanoch <i>Geophysicist</i>	David Hudnall <i>Production Facility Operator</i>	Darvin Knapp <i>Lead Drilling Superintendent</i>	Kimberly Louthan <i>Lease Analyst</i>	Dorina Meihls <i>Accounting Assistant</i>
Kathy Harrell <i>Sr. Land Technician</i>	Pamela Huggins <i>Engineering Assistant</i>	Mack Knapp <i>Production Facility Operator</i>	Kinney Louthan <i>Landman</i>	Ricky Mercer <i>Production Facility Operator</i>
Gayle Harris <i>Division Order Supervisor</i>	Fred Hughes <i>Graphics Lease Analyst</i>	Greg Knight <i>Engineering Technician</i>	Heath Lovinggood <i>Revenue Accountant</i>	Steve Miller <i>Vice President-Drilling</i>
Jim Harrison <i>Drilling Superintendent</i>	Jean Hughes <i>Production Technician</i>	Ted Krigbaum <i>Landman</i>	Janet Lowrey <i>Administrative Division - Order Analyst</i>	Laura Minter <i>Lease Records Assistant</i>
Gaylon Havel <i>Field Representative</i>	Rick Hughes <i>Production Foreman</i>	Wesley Kruckenberg <i>Production Foreman</i>	Larry Lunardi <i>Geophysicist</i>	Linda Mollman <i>Land Technician</i>
Jimmy Hayes <i>Pumper</i>	Brian Imes <i>Administrative Services</i>	Sandi Lagaly <i>Revenue Coordinator</i>	Troy Mahan <i>Pumper</i>	Tommy Morphew <i>Pumper</i>
Garve Hays <i>IT Supervisor</i>	Charles Imes <i>Vice President-Information Technology</i>	Steve Lane <i>Geologist</i>	Felipe Maldonado <i>Pusher</i>	James Morton <i>Pumper</i>
Julie Hays <i>Lease Analyst</i>	Kimberly Imes <i>Treasury Assistant</i>	Gwen Lang <i>Administrative Assistant</i>	Liz Mallett <i>Executive Assistant</i>	Eric Murray <i>Equipment Operator</i>
Mike Hazlip <i>Landman</i>	Lorrie Jacobs <i>Human Resources Administrator</i>	Jesse Langford <i>Landman</i>	John Marks <i>IT Programmer</i>	Leland Murray <i>Pumper</i>
Duane Heckelsberg <i>Geologist</i>	Doug Johnson <i>Geologist</i>	Barry Langham <i>Production Engineer</i>	Tim Marnich <i>Lead Production Operator</i>	Elizabeth Muskrat <i>Title Analyst</i>
Robert Hefner, IV <i>Geologist</i>	Jim Johnson <i>Vice President-Contract Administration</i>	Kim Laughlin <i>Land Assistant</i>	Ben Mathis <i>Drilling Engineer</i>	Tara Nash <i>Lease Technician</i>
Steve Henley <i>Production Superintendent</i>	Michael Johnson <i>Assistant Controller</i>	Cindy LeBlanc <i>Land Assistant</i>	Sandra Mathis <i>Executive Assistant</i>	Bob Neely <i>IT User Support</i>
David Higgins <i>Production Foreman</i>	Rusty Johnson <i>Roustabout</i>	Mike Lebsack <i>Graphics Lease Analyst</i>	Kresson Mays <i>Land File Coordinator</i>	Dennis Neill <i>Production Facility Operator</i>
Kristi Hitz <i>Production Assistant</i>	Mike Johnston <i>Pumper</i>	Dan LeDonne <i>Administrative Services Supervisor</i>	Sam McCaskill <i>Drilling Superintendent</i>	Mickey Nemecek <i>Lease Payments Supervisor</i>
Joanna Ho <i>Accounts Payable Coordinator</i>	David Jones <i>Auditor Analyst</i>	Ron Lefaive <i>Controller and Chief Accounting Officer</i>	Rich McClanahan <i>Production Engineer</i>	Buddy Novak <i>Drilling Engineer</i>
Carol Holden <i>Division Order Supervisor</i>	Frank Jordan <i>Vice President-Drilling</i>	Scotty LePretre <i>Production Facility Operator</i>	Aubrey McClendon <i>Chairman of the Board and Chief Executive Officer</i>	Mary Jane Nunley <i>Division Order Analyst</i>
Larry Holladay <i>Drilling Superintendent</i>	Susan Keller <i>Engineering Assistant</i>	Steven LePretre <i>Production Facility Operator</i>	Joe McClendon <i>Special Projects</i>	Gerda Oliver <i>Cashier</i>
Henry Hood <i>Sr. Vice President-Land and Legal</i>	Taylor Kemp <i>Administrative Services</i>	Mark Lester <i>Sr. Vice President-Exploration</i>	Carrol McCoy <i>Sr. Lease Analyst</i>	John O'Quinn <i>Production Facility Operator</i>
Marilyn Hooser <i>Sr. Title Analyst</i>	Phyllis Kimray <i>Land Technician</i>	Kirsten Lewellen <i>Operations Accounting Coordinator</i>	Frank McGee <i>Roustabout</i>	Lisa Owens <i>Gas Controller</i>
Kenneth Hopkins <i>Production Facility Operator</i>			Scott McMurran <i>Operations Accounting Supervisor</i>	Alan Page <i>Revenue Accounting Coordinator</i>
Michael Horn <i>Associate Geophysicist</i>			Janelle McNeely <i>Title Supervisor</i>	Carol Passick <i>IT Programmer</i>
Jan Horton <i>Landman</i>				Greg Pearce <i>Field Representative</i>

C H E S A P E A K E E M P L O Y E E S

Michelle Peery <i>Payroll Administrator</i>	Deborah Richardson <i>Executive Assistant</i>	Jolene Schur <i>Administrative Division - Order Analyst</i>	Jenny Thompson <i>Contract Analyst</i>	Chris Webb <i>Land Technician</i>
Ursula Perry <i>Receptionist</i>	Mark Richeson <i>Production Engineer</i>	Ricky Scruggs <i>Pumper</i>	Mike Thompson <i>Pumper</i>	Keith Weekly <i>Production Facility Operator</i>
Linda Peterburs <i>Accounting Coordinator</i>	Christie Rickey <i>Accounting Assistant</i>	Cheryl Self <i>Land Technician</i>	Steve Tipton <i>Sr. Drilling Engineer</i>	Janet Weeks <i>Engineering Technician</i>
Dale Petty <i>Accounting Coordinator</i>	Tammy Rideau <i>Land Technician</i>	Terry Sensat <i>Production Facility Operator</i>	Bill Totty <i>Gas Marketing Coordinator</i>	Greg Weinschenk <i>Pumper</i>
Randy Pierce <i>Purchasing Manager</i>	Mark Robins <i>Audit Coordinator</i>	Stephanic Shedden <i>Lease Analyst</i>	Lynda Townsend <i>Landman</i>	Lu Ann Wernli <i>Safety Administrator</i>
Marion Poindexter <i>Sr. Lease Analyst</i>	Carole Robinson <i>Operations Accountant</i>	Ellen Short <i>Administrative Assistant</i>	Ken Turner <i>Drilling Superintendent</i>	Colene Whitaker <i>Sr. Land Technician</i>
Pat Pope <i>Operations Accounting Coordinator</i>	Connie Robles <i>Land Administration Manager</i>	Arlene Shuman <i>Sr. Lease Analyst</i>	Guy Unger <i>Roustabout</i>	Craig White <i>IT Systems Coordinator</i>
Bobby Portillo <i>Pusher</i>	Les Rodman <i>Landman</i>	Maria Sinclair <i>Land Assistant</i>	Amy VanBrunt <i>Accounts Payable Supervisor</i>	Shelly White <i>Title Analyst</i>
Fernando Portillo <i>Pumper</i>	Randy Rodrigue <i>Field Representative</i>	Charles Smith <i>Attorney</i>	Joe Vaughan <i>Landman</i>	Tim Wiemers <i>Production Engineer</i>
Robert Potts <i>Geology Technician</i>	Lawrence Rogers <i>Production Foreman</i>	Jason Smith <i>Production Facility Operator</i>	Melissa Verett <i>Tax Accountant</i>	Angela Wiley-Lair <i>Land Technician</i>
Robert Powell, Jr. <i>Assistant Production Foreman</i>	Pat Rolla <i>Geologist</i>	Vivian Smith <i>Executive Assistant</i>	Peggy Vosika <i>Sr. Lease Analyst</i>	Ken Will <i>Drilling Superintendent</i>
Shannon Presley <i>Production Facility Operator</i>	Janna Rothwell <i>Operations Accountant</i>	Jan Solinski <i>Sr. Division Order Analyst</i>	Elizabeth Raskin <i>Contract Administrator</i>	Cindi Williams <i>Engineering Technician</i>
Heather Preston <i>Sr. Lease Analyst</i>	Ray Roush <i>Attorney</i>	Kevin Soter <i>Production Engineer</i>	Brent Voto <i>Operations Accountant</i>	Jeff Williams <i>Landman</i>
Ron Prewitt <i>Geophysicist</i>	Marc Rowland <i>Sr. Vice President - Finance and Chief Financial Officer</i>	Antonio Soto <i>Roustabout</i>	Conway Waak <i>Drilling Engineer</i>	Thomas Williams <i>Drilling Engineer</i>
Tom Price, Jr. <i>Vice President - Corporate Development</i>	Beth Russ <i>G&A Accountant</i>	Davina Spillers <i>Accounting Assistant</i>	Bill Wagner <i>Sr. Division Order Analyst</i>	Durell Willoughby <i>IT System Administrator</i>
Carlin Price <i>Title Analyst</i>	Danny Rutledge <i>Production Foreman</i>	Krysta Starkey <i>Treasury Analyst</i>	Charles Waldroup <i>Pumper</i>	Brian Winter <i>Geologist</i>
Wayne Psencik <i>District Manager - Texas</i>	Bryan Sagebiel <i>IT Supervisor</i>	Larry Stephens <i>Geologist</i>	Ronnie Walker <i>Production Facility Operator</i>	David Wittman <i>Production Superintendent</i>
Thomas Putz <i>Roustabout</i>	Tony Say <i>Vice President - Marketing</i>	Donna Stewart <i>Accounting Assistant</i>	Ronnie Ward <i>Land Manager</i>	Walter Wolff <i>Production Facility Operator</i>
John Qualls <i>Pumper</i>	Hank Scheel <i>Assistant Controller</i>	Stan Stinnett <i>Pumper</i>	Tom Ward <i>President and Chief Operating Officer</i>	Jimmy Wright <i>Production Foreman</i>
Lori Ray <i>Sr. Land Technician</i>	Patti Schlegel <i>Land Systems Coordinator</i>	Brenda Stremble <i>Title Analyst</i>	Julie Washam <i>Investor Relations</i>	Anthony Yandell <i>IT User Support</i>
Deborah Reichert <i>Revenue Accountant</i>	Charles Scholz <i>Pumper</i>	John Striplin <i>Field Representative</i>	Patsy Watters <i>Sr. Division Order Analyst</i>	Gerald Zgabay <i>Production Foreman</i>
Aaron Reyna <i>Reservoir Engineer</i>	Bonnie Schomp <i>Landman</i>	Randy Summers <i>Production Superintendent</i>	Clarence Watts <i>Production Foreman</i>	
Jackie Rhoads <i>Office Administrator</i>	Kurt Schrantz <i>Geophysicist</i>	Wesley Tayrien <i>Pumper</i>	Melanie Weaver <i>Sr. Title Analyst</i>	
	Terri Thomas <i>Accounting Assistant</i>			

Chesapeake's two million acres of domestic leasehold should provide a multi-year inventory of drilling opportunities.

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SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K*

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

For the Fiscal Year ended June 30, 1997

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

Commission File No. 1-13726

Chesapeake Energy Corporation

(Exact Name of Registrant as Specified in Its Charter)

Oklahoma
(State or other jurisdiction of
incorporation or organization)

73-1395733
(I.R.S. Employer
Identification No.)

6100 North Western Avenue
Oklahoma City, Oklahoma
(Address of principal executive offices)

73118
(Zip Code)

(405) 848-8000

Registrant's telephone number, including area code

Securities registered pursuant to Section 12(b) of the Act:

<u>Title of Each Class</u>	<u>Name of Each Exchange on Which Registered</u>
Common Stock, par value \$.01	New York Stock Exchange
9.125% Senior Notes due 2006	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act:

None

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

The aggregate market value of Common Stock held by non-affiliates on October 27, 1997 was \$423,923,486. At such date, there were 70,429,017 shares of Common Stock issued and outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

None

* As amended on October 31, 1997.

PART I

ITEM 1. *Business*

Overview

Chesapeake Energy Corporation (“Chesapeake” or the “Company”) is an independent energy company which utilizes advanced drilling and completion technologies to explore for and produce oil and natural gas. The Company has traditionally been among the most active drillers of new wells in the United States.

From inception in 1989 through June 30, 1997, Chesapeake drilled and participated in a total of 736 gross (294 net) wells, of which 691 gross (276 net) wells were completed. From its first full fiscal year of operation ended June 30, 1990 to the fiscal year ended June 30, 1997, the Company’s estimated proved reserves increased to 403 Bcfe from 11 Bcfe, annual production increased to 79 Bcfe from 0.2 Bcfe, total revenue increased to \$280 million from \$0.6 million, and total assets increased to \$949 million from \$8 million. Despite this overall favorable record of growth, in fiscal 1997 the Company incurred a net loss of \$183 million primarily as a result of a \$236 million impairment of its oil and gas properties. The impairment was the result of its capitalized costs of oil and gas properties exceeding the estimated present value of future net revenues from the Company’s proved reserves at June 30, 1997.

In response to the fiscal 1997 loss, Chesapeake has revised its fiscal 1998 business strategy. These revisions include slowing its exploration pace in the Louisiana Austin Chalk Trend (“Louisiana Trend”) and concentrating its Louisiana Trend drilling activities in Masters Creek; utilizing more extensive use of 3-D seismic prior to conducting drilling operations; reducing the acquisition of additional unproven leasehold; and selectively acquiring proved reserves as a complement to its primary strategy of developing reserves through the drillbit.

Reference is made to the “Glossary” that appears at the end of this Item 1 for definitions of certain terms used in this Form 10-K.

Description of Business

Since its inception, Chesapeake’s primary business strategy has been growth through the drillbit. Using this strategy, the Company has expanded its reserves and production through the acquisition and subsequent development of large blocks of acreage.

From inception through fiscal 1994, the Company concentrated its undeveloped leasehold acquisitions and associated drilling in the Giddings Field of southern Texas and the Golden Trend Field of southern Oklahoma. Beginning in fiscal 1995, Chesapeake initiated development of new project areas that were either extensions of the Company’s historical focus in the Giddings and Golden Trend Fields or new areas in which the Company believed had similar characteristics. These additional project areas included the Knox Field in southern Oklahoma, the Sholem Alechem Field in southern Oklahoma, the Louisiana Trend, the Arkoma Basin in southeastern Oklahoma, the Lovington area in eastern New Mexico, and the Williston Basin in eastern Montana and western North Dakota. In fiscal 1997, the Company also added a large exploration project in Wharton County, Texas.

The Company invested approximately \$179 million, including capitalized interest, to acquire over one million acres of leasehold in the Louisiana Trend from fiscal 1995 through fiscal 1997, and an additional \$163 million in drilling to explore this leasehold in fiscal 1996 and 1997. Of the Company’s six project areas identified in the Louisiana Trend, only in the Masters Creek area has the Company consistently found commercial quantities of oil and gas in the Austin Chalk formation.

As of June 30, 1997 the Company owned over two million net undeveloped acres in its leasehold inventory. The Company expects that its inventory of proved and unproved drilling locations will continue to be an important source of new reserves, production and cash flow over the next few years. The Louisiana Trend continues to be a key element of this existing inventory.

The following table sets forth the Company's estimated proved reserves (net of interests of other working and royalty interest owners and others entitled to share in production), estimated capital expenditures and the number of potential net drilling locations required to develop the Company's proved undeveloped reserves at June 30, 1997:

<u>Areas</u>	<u>Oil (MBbl)</u>	<u>Gas (MMcf)</u>	<u>Gas Equivalent</u>	<u>Percent of Proved Reserves</u>	<u>Estimated Capital Expenditures Required to Develop PUD's (\$ in 000's)</u>	<u>Number of Net Proved Undeveloped Locations</u>
Louisiana Trend	7,673	36,418	82,456	20%	54,529	16
Oklahoma	4,483	123,393	150,291	37%	48,741	37
Giddings.....	1,990	128,992	140,932	35%	33,825	26
Williston Basin	872	551	5,783	2%	2,669	3
Other Areas	2,355	9,412	23,542	6%	7,204	9
Total	<u>17,373</u>	<u>298,766</u>	<u>403,004</u>	<u>100%</u>	<u>146,968</u>	<u>91</u>

Primary Operating Areas

The Company's activities are concentrated in three primary operating areas: (i) the Louisiana Trend, (ii) the Knox, Sholem Alechem, Golden Trend, and Arkoma Basin areas of Oklahoma, and (iii) the Navasota River and Independence areas of the downdip Giddings Field in southern Texas.

Louisiana Austin Chalk Trend. The Louisiana Trend is the newest of the Company's three primary operating areas and is budgeted to represent approximately 50% of the Company's exploration and development activities in fiscal 1998. In late 1994, Occidental Petroleum Corporation ("Occidental") completed a horizontal Austin Chalk discovery well in the Masters Creek area of central Louisiana. Occidental's well was drilled 200 miles east of the Company's activity in the downdip Giddings Field and 60 miles east of the nearest previous commercial multi-well horizontal Austin Chalk production in the Brookeland Field of southeast Texas.

Following the announcement of Occidental's discovery well, the Company extensively reviewed and analyzed vertical drilling reports, electric logs, mud logs, seismic data and vertical Austin Chalk production records to arrive at a geological conclusion that the Austin Chalk could be productive across a large portion of central and southeastern Louisiana. Accordingly, and in competition with Union Pacific Resources Company, Sonat, Inc., Occidental, Amoco Production Company, Helmerich & Payne, Inc., Belco Oil & Gas Corporation and others, Chesapeake invested approximately \$179 million from fiscal 1995 through fiscal 1997 to acquire over one million acres of leasehold in the Louisiana Trend. Beginning in fiscal 1996 and accelerating substantially by the end of fiscal 1997, Chesapeake expended an additional \$163 million to initiate drilling efforts on 56 gross (34 net) wells to evaluate this leasehold position.

From December 1996 through April 1997, the Company initiated drilling efforts on 15 new operated wells in the Louisiana Trend. Between April 1997 and July 1997, the Company completed operations on ten exploratory wells in areas of the Louisiana Trend outside of Masters Creek. Of these wells, one was completed on April 15, 1997, one on May 3, 1997 and eight were completed after June 1, 1997. Based upon the results from these wells, which primarily became known to the Company in late June 1997, the Company made the determination that a significant amount of leasehold previously classified as unevaluated had become evaluated. This determination, in combination with development in the Masters Creek area, resulted in a transfer of approximately \$91 million of previously unevaluated leasehold costs to the full cost pool which, and in conjunction with disappointing drilling results and the related costs thereof and lower oil and gas prices, was the primary cause of the full cost ceiling writedown.

The Company believes that some portion of the Louisiana Trend outside of the Masters Creek area, and specifically certain areas of East Baton Rouge and Point Coupee Parishes that are prospective for the Tuscaloosa formation, may ultimately be successfully exploited. It is the Company's intent to focus its

Louisiana drilling in fiscal 1998 primarily in the Masters Creek area and to allow others to lead the continued exploration of areas outside of Masters Creek.

The Masters Creek area, where as of September 30, 1997 the Company and the Company's competitors have completed approximately 36 out of 40 wells as commercially productive with approximately 25 additional wells currently drilling, has generally been much more successful than the other areas within the Louisiana Trend. As of September 30, 1997, the Company had eight rigs operating in this area and is participating in more than 10 non-operated wells. For fiscal 1998, the Company has budgeted \$125 million to drill approximately 25 net wells targeting the Austin Chalk formation and \$13 million to drill two net wells targeting the Tuscaloosa formation. These planned expenditures, in combination with anticipated seismic costs, represent approximately 50% of the Company's planned exploration and development capital expenditures for all areas. There can be no assurance that the Louisiana Trend drilling will yield substantial economic returns. Failure of the wells to produce significant quantities of economically attractive reserves and production could have a material adverse impact on the Company's future financial condition and results of operations, and could result in a future ceiling limitation under rules of the Securities and Exchange Commission.

Oklahoma. Chesapeake's largest concentration of proved reserves is located in Oklahoma and is comprised of the Knox, Golden Trend, Sholem Alechem, and Arkoma Basin areas. These areas are generally characterized by relatively long lived production from multiple pay zones. The Company has conducted and is evaluating 3-D seismic surveys over significant portions of its Oklahoma leasehold in an effort to enhance its future drilling efforts. In fiscal 1997, the Company invested approximately \$68 million to drill 51 gross (32 net) wells in Oklahoma. The Company has budgeted approximately \$28 million in fiscal 1998 to drill 36 gross (21 net) wells in Oklahoma.

Giddings Field. Chesapeake's second largest concentration of proved reserves and its highest concentration of present value is located in the Giddings Field, Texas. The primary producing formation in Giddings is the Austin Chalk formation, a fractured carbonate reservoir found at depths ranging from 7,000 feet to 17,000 feet along a 15,000 square mile trend in southeastern Texas and central Louisiana. Chesapeake has concentrated its drilling efforts in the gas prone downdip portion of the Giddings Field, where the Austin Chalk is located at depths below 11,000 feet.

The Giddings Field contributed approximately 44.6 Bcfe, or 57% of the Company's total production in fiscal 1997, compared to 47.2 Bcfe or 78% in 1996. The Company expects production to decline in this relatively mature area in fiscal 1998. In fiscal 1997, the Company invested approximately \$57 million to drill 36 gross (19 net) wells in Giddings. The Company has budgeted approximately \$17 million to drill 18 gross (eight net) wells in Giddings during fiscal 1998.

Other Operating Areas

Williston Basin. During fiscal 1996, Chesapeake began acquiring leasehold in the Williston Basin, located in eastern Montana and western North Dakota, and as of June 30, 1997 owned more than 700,000 gross (500,000 net) acres. During fiscal 1997, the Company drilled and successfully completed four vertical wells targeting the Red River formation on the northern portion of its leasehold. On the southern portion of its leasehold, the Company was unsuccessful in an attempt to establish horizontally drilled Red River production. Also during fiscal 1997, the Company tested a third large area of its Williston acreage with a successful horizontal Nesson well. Currently, the Company is focusing its Williston efforts on continuing to develop the Nesson formation. The Company has budgeted \$6 million to drill six gross and net wells during fiscal 1998 in the Williston Basin.

Permian Basin. In fiscal 1995, the Company initiated activity in the Permian Basin in the Lovington area of Lea County, New Mexico. In this project, the Company is utilizing 3-D seismic technology to search for algal reef buildups that management believes have been overlooked in this portion of the Permian Basin because of inconclusive results provided by traditional 2-D seismic technology.

During fiscal 1997 the Company initiated eight wells in this project area, seven of which were successfully completed. The Company has budgeted approximately \$14 million to drill 14 gross and net wells in this area during fiscal 1998.

Wharton County, Texas. During fiscal 1997 the Company acquired approximately 25,000 net acres at a cost of approximately \$29 million in Wharton County, Texas. This exploration project is seeking gas production from the shallower Frio and Yegua sands and from the Deep Wilcox at depths of up to 19,000 feet. The Company intends to participate with a 55% interest in a 55,000 acre 3-D seismic program with Coastal Oil & Gas Corporation, Seagull Energy Corporation and other industry partners during fiscal 1998 to delineate potential future drillsites in the vicinity of Coastal's recently completed Zeidman Trust #2 well.

Strategic Investments

During fiscal 1997, the Company invested in a number of oil and gas related businesses and projects. The most significant of these was the Company's May 1997 initial investment in Bayard Drilling Technologies, Inc. ("Bayard"), consisting of an \$18 million subordinated loan and the purchase of \$7 million of common stock. In August 1997, the Company agreed to invest up to an additional \$9 million and convert certain options, warrants and note amounts that will facilitate a potential initial public offering by Bayard. On August 27, 1997 Bayard filed a registration statement for an initial public offering of its common stock. Chesapeake, subsequent to the completion of the transaction noted above, will own 4,194,000 shares of Bayard common stock (30.4% of the common stock outstanding) and anticipates selling substantially all of its ownership in Bayard in the IPO (assuming the over-allotment option is exercised) and receiving repayment of the subordinated loan. If successful, assuming the sale of all of the Company's Bayard stock and based on the initial filing price of Bayard at \$15 per share, the Company would receive total proceeds of approximately \$74 million (net of offering costs) and realize a pre-tax gain of approximately \$40 million. No assurance can be given, however, that Bayard will successfully complete the initial public offering of its common stock, at what price, or that the net proceeds or pre-tax gain discussed above will be realized by the Company.

Also during fiscal 1997 the Company invested approximately \$12 million for its 50% interest in the Louisiana Austin Chalk Gathering System (a joint venture with Mitchell Energy and Development Corporation) and \$5 million for its 15.5% interest in the Masters Creek Gas Plant (a joint venture among Union Pacific, Sonat, Helmerich & Payne, and OXY). The Company has budgeted \$4 million for its share of the expansion of these assets during fiscal 1998. The Company considers these mid-stream gas assets to be non-core and therefore may seek to sell them in fiscal 1998.

Drilling Activity

The following table sets forth the wells drilled by the Company during the periods indicated. In the table, "gross" refers to the total wells in which the Company has a working interest and "net" refers to gross wells multiplied by the Company's working interest therein.

	Year Ended June 30,					
	1997		1996		1995	
	Gross	Net	Gross	Net	Gross	Net
Development:						
Productive	90	55.0	111	49.5	133	42.6
Non-productive	2	.2	4	1.6	5	2.8
Total	<u>92</u>	<u>55.2</u>	<u>115</u>	<u>51.1</u>	<u>138</u>	<u>45.4</u>
Exploratory:						
Productive	71	46.1	29	16.5	11	5.3
Non-productive	8	5.7	4	1.4	1	.7
Total	<u>79</u>	<u>51.8</u>	<u>33</u>	<u>17.9</u>	<u>12</u>	<u>6.0</u>

At June 30, 1997, the Company was drilling 25 gross (19.8 net) exploratory or development wells, of which 11 gross (8.1 net) wells have been successfully completed and 12 gross (9.7 net) wells are still being

drilled or tested. The Company was also participating with minority interests in 13 non-operated wells being drilled at that date.

1998 3-D Seismic Survey Program

The Company has increased its emphasis on the use of 3-D seismic surveys to evaluate and define potential drilling locations. During fiscal 1998 the Company has budgeted approximately \$25 million for seismic acquisition and evaluation and intends to conduct or participate in seismic surveys covering the following areas:

<u>Approximate Gross Acreage</u>	<u>Area</u>	<u>Target Formations</u>
85,000	Baton Rouge, LA	Tuscaloosa; Austin Chalk
55,000	Wharton County, TX	Deep Wilcox; Frio and Yegua
35,000	Golden Trend, OK	Multiple sand and carbonates
90,000	Lovington, NM	Strawn
50,000	Williston, MT	Red River
50,000	Allen Parish, LA	Wilcox; Austin Chalk

Well Data

At June 30, 1997, the Company had interests in approximately 593 (270.1 net) producing wells, of which 129 (55.4 net) were classified as primarily oil producing wells and 464 (214.7 net) were classified as primarily gas producing wells.

Volumes, Revenue, Prices and Production Costs

The following table sets forth certain information regarding the production volumes, revenue, average prices received and average production costs associated with the Company's sale of oil and gas for the periods indicated:

	<u>Year Ended June 30,</u>		
	<u>1997</u>	<u>1996</u>	<u>1995</u>
Net production:			
Oil (MBbl)	2,770	1,413	1,139
Gas (MMcf)	62,005	51,710	25,114
Gas equivalent (MMcfe)	78,625	60,190	31,947
Oil and gas sales (\$ in 000's):			
Oil	\$ 57,974	\$ 25,224	\$19,784
Gas	<u>134,946</u>	<u>85,625</u>	<u>37,199</u>
Total oil and gas sales	<u>\$192,920</u>	<u>\$110,849</u>	<u>\$56,983</u>
Average sales price:			
Oil (\$ per Bbl)	\$ 20.93	\$ 17.85	\$ 17.36
Gas (\$ per Mcf)	\$ 2.18	\$ 1.66	\$ 1.48
Gas equivalent (\$ per Mcfe)	\$ 2.45	\$ 1.84	\$ 1.78
Oil and gas costs (\$ per Mcfe):			
Production expenses and taxes	\$.19	\$.14	\$.13
General and administrative	\$.11	\$.08	\$.11
Depreciation, depletion and amortization of oil and gas properties	\$ 1.31	\$.85	\$.80

Development, Exploration and Acquisition Expenditures

The following table sets forth certain information regarding the costs incurred by the Company in its development, exploration and acquisition activities during the periods indicated:

	Year Ended June 30,		
	1997	1996	1995
	(\$ in thousands)		
Development costs	\$187,736	\$138,188	\$ 78,679
Exploration costs	136,473	39,410	14,129
Acquisition costs:			
Unproved properties	140,348	138,188	24,437
Proved properties	—	24,560	—
Capitalized internal costs	3,905	1,699	586
Proceeds from sale of leasehold, equipment and other ...	(3,095)	(6,167)	(11,953)
Total	<u>\$465,367</u>	<u>\$335,878</u>	<u>\$105,878</u>

Acreage

The following table sets forth as of June 30, 1997 the gross and net acres of both developed and undeveloped oil and gas leases which the Company holds. "Gross" acres are the total number of acres in which the Company owns a working interest. "Net" acres refer to gross acres multiplied by the Company's fractional working interest. Acreage numbers are stated in thousands.

	Developed		Undeveloped		Total Developed and Undeveloped	
	Gross	Net	Gross	Net	Gross	Net
Louisiana Trend	41	40	1,154(1)	1,003(1)	1,195	1,043
Oklahoma	85	34	297	134	382	168
Giddings	121	58	186	133	307	191
Williston Basin	3	2	732	498	735	500
Other Areas	27	19	331	250	358	269
Total	<u>277</u>	<u>153</u>	<u>2,700</u>	<u>2,018</u>	<u>2,977</u>	<u>2,171</u>

(1) Does not include options for additional leasehold held by the Company but not yet exercised.

Marketing

The Company's oil production is sold under market sensitive or spot price contracts. The Company's natural gas production is sold to purchasers under varying percentage-of-proceeds and percentage-of-index contracts. By the terms of these contracts, the Company receives a percentage of the resale price received by the purchaser for sales of residue gas and natural gas liquids recovered after gathering and processing the Company's gas. The residue gas and natural gas liquids sold by these purchasers are sold primarily based on spot market prices. The revenue received by the Company from the sale of natural gas liquids is included in natural gas sales. During fiscal 1997, the following three customers individually accounted for 10% or more of the Company's total oil and gas sales:

	Amount (\$ in thousands)	Percent of Oil and Gas Sales
Aquila Southwest Pipeline Corporation	53,885	28%
Koch Oil Company	29,580	15%
GPM Gas Corporation	27,682	14%

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

Chesapeake Energy Marketing, Inc., (“CEMI”) a wholly-owned subsidiary, provides oil and natural gas marketing services including commodity price structuring, contract administration and nomination services for the Company, its partners and other oil and natural gas producers in the geographical areas in which the Company is active.

Hedging Activities

Periodically the Company utilizes hedging strategies to hedge the price of a portion of its future oil and gas production. These strategies include (1) swap arrangements that establish an index-related price above which the Company pays the counterparty and below which the Company is paid by the counterparty, (2) the purchase of index-related puts that provide for a “floor” price below which the counterparty pays the Company the amount by which the price of the Commodity is below the contracted floor, (3) the sale of index-related calls that provide for a “ceiling” price above which the Company pays the counterparty the amount by which the price of the commodity is above the contracted ceiling, and (4) basis protection swaps. Results from hedging transactions are reflected in oil and gas sales to the extent related to the Company’s oil and gas production. The Company has not entered into hedging transactions unrelated to the Company’s oil and gas production or physical purchase or sale commitments.

As of June 30, 1997, the Company had the following oil swap arrangements for periods after June 1997:

<u>Month</u>	<u>Volume (Bbls)</u>	<u>NYMEX-Index Strike Price (per Bbl)</u>
July 1997	31,000	\$ 18.60
August 1997.....	31,000	\$ 18.43
September 1997.....	30,000	\$ 18.30
October 1997.....	31,000	\$ 18.19
November 1997.....	30,000	\$ 18.13
December 1997.....	31,000	\$ 18.08
January through June 1998	724,000	\$ 19.82

The Company entered into oil swap arrangements to cancel the effect of the above swaps for the months of August through December at an average price of \$21.07 per Bbl.

As of June 30, 1997, the Company had the following gas swap arrangements for periods after June 1997:

<u>Months</u>	<u>Volume (MMBtu)</u>	<u>Houston Ship Channel Index Strike Price (per MMBtu)</u>
July 1997	1,240,000	\$2.313
August 1997	1,240,000	\$2.301
September 1997	1,200,000	\$2.285
October 1997	1,240,000	\$2.300

The Company entered into gas swap arrangements to cancel the effect of the swaps for the months of July through October at an average price of \$2.133 per MMBtu.

The Company entered into a curve lock for approximately 4.9 Bcf of gas which allows the Company the option to hedge April 1999 through November 1999 gas based upon a negative \$0.285 differential to December 1998 gas any time between the strike date and December 1998.

The Company estimates that had all of the crude oil and natural gas swap agreements in effect for production periods beginning July 1, 1997 terminated on June 30, 1997, based on the closing prices for NYMEX futures contracts as of that date, the Company would have paid the various counterparties a net amount of approximately \$185,000, which would have represented the “fair value” at that date. These agreements were not terminated.

Periodically, CEMI enters into various hedging transactions designed to hedge against physical purchase commitments made by CEMI. Gains or losses on these transactions are recorded as adjustments to Oil and Gas Marketing Sales in the consolidated statements of operations and are not considered by management to be material.

Competition

The oil and gas industry is highly competitive. The Company competes with major and independent oil and gas companies for the acquisition of leasehold, proven oil and gas properties, as well as for the services and labor required to explore, develop and produce such properties. Many of these competitors have financial, technical and other resources substantially greater than those of the Company.

Seasonal Nature of Business

Historically the demand for natural gas decreases during the summer months and increases during the winter months. However, pipelines, utilities, local distribution companies and industrial users may more effectively utilize natural gas storage capacity by purchasing some of the winter load in the summer at reduced prices.

Regulation

General

Numerous departments and agencies, federal, state and local, issue rules and regulations binding on the oil and gas industry, some of which carry substantial penalties for failure to comply. The regulatory burden on the oil and gas industry increases the Company's cost of doing business and, consequently, affects its profitability.

Exploration and Production

The Company's operations are subject to various types of regulation at the federal, state and local levels. Such regulation includes requiring permits for the drilling of wells, maintaining bonding requirements in order to drill or operate wells and regulating the location of wells, the method of drilling and casing wells, the surface use and restoration of properties upon which wells are drilled, the plugging and abandoning of wells and the disposal of fluids used or obtained in connection with operations. The Company's operations are also subject to various conservation regulations. These include the regulation of the size of drilling and spacing units and the density of wells which may be drilled and the unitization or pooling of oil and gas properties. In this regard, some states (such as Oklahoma) allow the forced pooling or integration of tracts to facilitate exploration while other states (such as Texas) rely on voluntary pooling of lands and leases. In areas where pooling is voluntary, it may be more difficult to form units and, therefore, more difficult to develop a prospect if the operator owns less than 100% of the leasehold. In addition, state conservation laws establish maximum rates of production from oil and gas wells, generally prohibit the venting or flaring of gas and impose certain requirements regarding the ratable production. The effect of these regulations is to limit the amount of oil and gas the Company can produce from its wells and to limit the number of wells or the locations at which the Company can drill. The extent of any impact on the Company of such restrictions cannot be predicted.

Environmental and Occupational Regulation

General. The Company's activities are subject to existing federal, state and local laws and regulations governing environmental quality and pollution control. It is anticipated that, absent the occurrence of an extraordinary event, compliance with existing federal, state and local laws, rules and regulations concerning the protection of the environment and human health will not have a material effect upon the operations, capital expenditures, earnings or the competitive position of the Company. The Company cannot predict what effect additional regulation or legislation, enforcement policies thereunder and claims for damages for injuries to property, employees, other persons and the environment resulting from the Company's operations could have on its activities.

Activities of the Company with respect to the exploration, development and production of oil and natural gas are subject to stringent environmental regulation by state and federal authorities including the United States Environmental Protection Agency ("EPA"). Such regulation has increased the cost of planning, designing, drilling, operating and in some instances, abandoning wells. In most instances, the regulatory requirements relate to the handling and disposal of drilling and production waste products and waste created by water and air pollution control procedures. Although the Company believes that compliance with environmental regulations will not have a material adverse effect on operations or earnings, risks of substantial costs and liabilities are inherent in oil and gas operations, and there can be no assurance that significant costs and liabilities, including criminal penalties, will not be incurred. Moreover, it is possible that other developments, such as stricter environmental laws and regulations, and claims for damages for injuries to property or persons resulting from the Company's operations could result in substantial costs and liabilities.

Waste Disposal. The Company currently owns or leases, and has in the past owned or leased, numerous properties that for many years have been used for the exploration and production of oil and gas. Although the Company has utilized operating and disposal practices that were standard in the industry at the time, hydrocarbons or other wastes may have been disposed of or released on or under the properties owned or leased by the Company or on or under other locations where such wastes have been taken for disposal. In addition, many of these properties have been operated by third parties whose treatment and disposal or release of hydrocarbons or other wastes was not under the Company's control. State and federal laws applicable to oil and natural gas wastes and properties have gradually become more strict. Under such laws, the Company could be required to remove or remediate previously disposed wastes (including wastes disposed of or released by prior owners or operators) or property contamination (including groundwater contamination) or to perform remedial plugging operations to prevent future contamination.

The Company generates wastes, including hazardous wastes, that are subject to the federal Resource Conservation and Recovery Act ("RCRA") and comparable state statutes. The EPA and various state agencies have limited the disposal options for certain hazardous and nonhazardous wastes and are considering the adoption of stricter disposal standards for nonhazardous wastes. Furthermore, certain wastes generated by the Company's oil and natural gas operations that are currently exempt from treatment as hazardous wastes may in the future be designated as hazardous wastes, and therefore be subject to considerably more rigorous and costly operating and disposal requirements.

Superfund. The Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA"), also known as the "Superfund" law, imposes liability, without regard to fault or the legality of the original conduct, on certain classes of persons with respect to the release of a "hazardous substance" into the environment. These persons include the owner and operator of a site and persons that disposed of or arranged for the disposal of the hazardous substances found at a site. CERCLA also authorizes the EPA and, in some cases, third parties to take actions in response to threats to the public health or the environment and to seek to recover from responsible classes of persons the costs of such action. In the course of its operations, the Company may have generated and may generate wastes that fall within CERCLA's definition of "hazardous substances." The Company may also be or have been an owner of sites on which "hazardous substances" have been released. The Company may be responsible under CERCLA for all or part of the costs to clean up sites at which such wastes have been released. To date, however, neither the Company nor, to its knowledge, its predecessors or successors have been named a potentially responsible party under CERCLA or similar state superfund laws affecting property owned or leased by the Company.

Air Emissions. The operations of the Company are subject to local, state and federal regulations for the control of emissions of air pollution. Legal and regulatory requirements in this area are increasing, and there can be no assurance that significant costs and liabilities will not be incurred in the future as a result of new regulatory developments. In particular, regulations promulgated under the Clean Air Act Amendments of 1990 may impose additional compliance requirements that could affect the Company's operations. However, it is impossible to predict accurately the effect, if any, of the Clean Air Act Amendments on the Company at this time. The Company may in the future be subject to civil or administrative enforcement actions for failure to comply strictly with air regulations or permits. These enforcement actions are generally resolved by

payment of monetary fines and correction of any identified deficiencies. Alternatively, regulatory agencies could require the Company to forego construction or operation of certain air emission sources.

OSHA. The Company is subject to the requirements of the federal Occupational Safety and Health Act (“OSHA”) and comparable state statutes. The OSHA hazard communication standard, the EPA community right-to-know regulations under Title III of the federal Superfund Amendment and Reauthorization Act and similar state statutes require the Company to organize information about hazardous materials used, released or produced in its operations. Certain of this information must be provided to employees, state and local governmental authorities and local citizens. The Company is also subject to the requirements and reporting set forth in OSHA workplace standards. The Company provides safety training and personal protective equipment to its employees.

OPA and Clean Water Act. Federal regulations require certain owners or operators of facilities that store or otherwise handle oil, such as the Company, to prepare and implement spill prevention control plans, countermeasure plans and facilities response plans relating to the possible discharge of oil into surface waters. The Oil Pollution Act of 1990 (“OPA”) amends certain provisions of the federal Water Pollution Control Act of 1972, commonly referred to as the Clean Water Act (“CWA”), and other statutes as they pertain to the prevention of and response to oil spills into navigable waters. The OPA subjects owners of facilities to strict joint and several liability for all containment and cleanup costs and certain other damages arising from a spill, including, but not limited to, the costs of responding to a release of oil to surface waters. The CWA provides penalties for any discharges of petroleum product in reportable quantities and imposes substantial liability for the costs of removing a spill. State laws for the control of water pollution also provide varying civil and criminal penalties and liabilities in the case of releases of petroleum or its derivatives into surface waters or into the ground. Regulations are currently being developed under OPA and state laws concerning oil pollution prevention and other matters that may impose additional regulatory burdens on the Company. In addition, the CWA and analogous state laws require permits to be obtained to authorize discharges into surface waters or to construct facilities in wetland areas. With respect to certain of its operations, the Company is required to maintain such permits or meet general permit requirements. The EPA recently adopted regulations concerning discharges of storm water runoff. This program requires covered facilities to obtain individual permits, participate in a group permit or seek coverage under an EPA general permit. The Company believes that it will be able to obtain, or be included under, such permits, where necessary, with minor modifications to existing facilities and operations that would not have a material effect on the Company.

NORM. Oil and gas exploration and production activities have been identified as generators of concentrations of low-level naturally-occurring radioactive materials (“NORM”). NORM regulations have recently been adopted in several states. The Company is unable to estimate the effect of these regulations, although based upon the Company’s preliminary analysis to date, the Company does not believe that its compliance with such regulations will have a material adverse effect on its operations or financial condition.

Safe Drinking Water Act. The Company’s operations involve the disposal of produced saltwater and other nonhazardous oil-field wastes by reinjection into the subsurface. Under the Safe Drinking Water Act (“SDWA”), oil and gas operators, such as the Company, must obtain a permit for the construction and operation of underground Class II injection wells. To protect against contamination of drinking water, periodic mechanical integrity tests are often required to be performed by the well operator. The Company has obtained such permits for the Class II wells it operates. The Company also has disposed of wastes in facilities other than those owned by the Company (commercial Class II injection wells).

Toxic Substances Control Act. The Toxic Substances Control Act (“TSCA”) was enacted to control the adverse effects of newly manufactured and existing chemical substances. Under the TSCA, the EPA has issued specific rules and regulations governing the use, labeling, maintenance, removal from service and disposal of PCB items, such as transformers and capacitors used by oil and gas companies. The Company may own such PCB items but does not believe compliance with TSCA has or will have a material adverse effect on the Company’s operations or financial condition.

Title to Properties

Title to properties is subject to royalty, overriding royalty, carried, net profits, working and other similar interests and contractual arrangements customary in the oil and gas industry, to liens for current taxes not yet due and to other encumbrances. As is customary in the industry in the case of undeveloped properties, little investigation of record title is made at the time of acquisition (other than a preliminary review of local records). Drilling title opinions are always prepared before commencement of drilling operations. From time to time the Company's title to oil and gas properties is challenged through legal proceedings. The Company is routinely involved in litigation involving title to certain of its oil and gas properties, none of which management believes will be materially adverse to the Company, individually or in the aggregate.

Operating Hazards and Insurance

The oil and gas business involves a variety of operating risks, including the risk of fire, explosions, blow-outs, pipe failure, abnormally pressured formations and environmental hazards such as oil spills, gas leaks, ruptures or discharges of toxic gases, the occurrence of any of which could result in substantial losses to the Company due to injury or loss of life, severe damage to or destruction of property, natural resources and equipment, pollution or other environmental damage, clean-up responsibilities, regulatory investigation and penalties and suspension of operations. The Company's horizontal drilling activities involve greater risk of mechanical problems than conventional vertical drilling operations.

The Company maintains a \$50 million oil and gas lease operator policy that insures the Company against certain sudden and accidental risks associated with drilling, completing and operating its wells. There can be no assurance that this insurance will be adequate to cover any losses or exposure to liability. The Company also carries comprehensive general liability policies and a \$60 million umbrella policy. The Company and its subsidiaries carry workers' compensation insurance in all states in which they operate and a \$35 million employment practice liability policy. While the Company believes these policies are customary in the industry, they do not provide complete coverage against all operating risks.

Employees

The Company had 362 full-time employees as of June 30, 1997. No employees are represented by organized labor unions. The Company considers its employee relations to be good.

Facilities

The Company owns 12 buildings totaling approximately 80,000 square feet in an office complex in Oklahoma City that comprise its headquarters' offices and also owns a field office in Lindsay, Oklahoma. The Company leases field office space in College Station and Navasota, Texas, Lafayette, Louisiana and Calgary, Canada.

Reincorporation

On December 31, 1996, the Company changed its state of incorporation from Delaware to Oklahoma by the merger of Chesapeake Energy Corporation, a Delaware corporation, with and into its newly formed wholly-owned subsidiary, Chesapeake Oklahoma Corporation. The surviving corporation changed its name to Chesapeake Energy Corporation. Each outstanding share of Common Stock, par value \$.10, of the merged Delaware corporation was converted into one share of Common Stock, par value \$.01, of the surviving corporation. As a result of the merger, the surviving corporation succeeded to all of the assets and is responsible for all of the liabilities of the merged Delaware corporation. On matters of corporate governance, the rights of the Company's security holders are now governed by Oklahoma law, which is similar to the corporate law of Delaware.

Glossary

The terms defined in this section are used throughout this Form 10-K.

Bcf. Billion cubic feet.

Bcfe. Billion cubic feet of gas equivalent.

Bbl. One stock tank barrel, or 42 U.S. gallons liquid volume, used herein in reference to crude oil or other liquid hydrocarbons.

Btu. British thermal unit, which is the heat required to raise the temperature of a one-pound mass of water from 58.5 to 59.5 degrees Fahrenheit.

Commercial Well; Commercially Productive Well. An oil and gas well which produces oil and gas in sufficient quantities such that proceeds from the sale of such production exceed production expenses and taxes.

Developed Acreage. The number of acres which are allocated or assignable to producing wells or wells capable of production.

Development Well. A well drilled within the proved area of an oil or gas reservoir to the depth of a stratigraphic horizon known to be productive.

Dry Hole; Dry Well. A well found to be incapable of producing either oil or gas in sufficient quantities to justify completion as an oil or gas well.

Exploratory Well. A well drilled to find and produce oil or gas in an unproved area, to find a new reservoir in a field previously found to be productive of oil or gas in another reservoir or to extend a known reservoir.

Farmout. An assignment of an interest in a drilling location and related acreage conditional upon the drilling of a well on that location.

Formation. A succession of sedimentary beds that were deposited under the same general geologic conditions.

Gross Acres or Gross Wells. The total acres or wells, as the case may be, in which a working interest is owned.

Horizontal Wells. Wells which are drilled at angles greater than 70 from vertical.

MBbl. One thousand barrels of crude oil or other liquid hydrocarbons.

MBtu. One thousand Btus.

Mcf. One thousand cubic feet.

Mcfe. One thousand cubic feet of gas equivalent.

MMBbl. One million barrels of crude oil or other liquid hydrocarbons.

MMBtu. One million Btus.

MMcf. One million cubic feet.

MMcfe. One million cubic feet of gas equivalent.

Net Acres or Net Wells. The sum of the fractional working interest owned in gross acres or gross wells.

Present Value. When used with respect to oil and gas reserves, present value means the estimated future gross revenue to be generated from the production of proved reserves, net of estimated production and future development costs, using prices and costs in effect at the determination date, without giving effect to non-property related expenses such as general and administrative expenses, debt service and future income tax expense or to depreciation, depletion and amortization, discounted using an annual discount rate of 10%.

Productive Well. A well that is producing oil or gas or that is capable of production.

Proved Developed Reserves. Reserves that can be expected to be recovered through existing wells with existing equipment and operating methods.

Proved Reserves. 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 Undeveloped Location. A site on which a development well can be drilled consistent with spacing rules for purposes of recovering proved undeveloped reserves.

Proved Undeveloped Reserves. Reserves that are expected to be recovered from new wells drilled to known reservoir on undrilled acreage or from existing wells where a relatively major expenditure is required for recompletion.

Royalty Interest. An interest in an oil and gas property entitling the owner to a share of oil or gas production free of costs of production.

Tcf. One trillion cubic feet.

Tcfe. One trillion cubic feet of gas equivalent.

Undeveloped Acreage. Lease acreage on which wells have not been drilled or completed to a point that would permit the production of commercial quantities of oil and gas regardless of whether such acreage contains proved reserves.

Working Interest. The operating interest which gives the owner the right to drill, produce and conduct operating activities on the property and a share of production.

ITEM 2. Properties

Oil and Gas Reserves

The tables below set forth information as of June 30, 1997 with respect to the Company's estimated net proved reserves, the estimated future net revenue therefrom and the present value thereof at such date. Williamson Petroleum Consultants, Inc. ("Williamson") evaluated most of the Company's Texas oil and gas reserves and all of its Louisiana oil and gas reserves, together representing approximately 50% of the Company's total proved reserves. The Company internally evaluated the remaining reserves, which were subsequently evaluated by Williamson with a variance of approximately 4% of total proved reserves. The estimates were prepared based upon a review of production histories and other geologic, economic, ownership and engineering data developed by the Company. The present value of estimated future net revenue shown is not intended to represent the current market value of the estimated oil and gas reserves owned by the Company.

<u>Estimated Proved Reserves as of June 30, 1997</u>	<u>Oil (MBbl)</u>	<u>Gas (MMcf)</u>	<u>Total</u>
Proved developed	7,324	151,879	195,823
Proved undeveloped	10,049	146,887	207,181
Total proved.....	17,373	298,766	403,004
<u>Estimated Future Net Revenue as of June 30, 1997 (a)</u>	<u>Proved Developed</u>	<u>Proved Undeveloped</u>	<u>Total Proved</u>
		(\$ in thousands)	
Estimated future net revenue	\$336,417	\$275,537	\$611,954
Present value of future net revenue	\$248,765	\$188,621	\$437,386

(a) Estimated future net revenue represents estimated future gross revenue to be generated from the production of proved reserves, net of estimated production and future development costs, using prices and

costs in effect at June 30, 1997. The amounts shown do not give effect to non-property related expenses, such as general and administrative expenses, debt service and future income tax expense or to depreciation, depletion and amortization. The prices used in the Williamson and internal reports yield average prices of \$18.38 per barrel of oil and \$2.12 per Mcf of gas.

The future net revenue attributable to the Company's estimated proved undeveloped reserves of \$275.5 million at June 30, 1997, and the \$188.6 million present value thereof, have been calculated assuming that the Company will expend approximately \$146.9 million to develop these reserves through June 30, 2000. The amount and timing of these expenditures will depend on a number of factors, including actual drilling results, product prices and the availability of capital.

No estimates of proved reserves comparable to those included herein have been included in reports to any federal agency other than the Securities and Exchange Commission.

The Company's interest used in calculating proved reserves and the estimated future net revenue therefrom was determined after giving effect to the assumed maximum participation by other parties to the Company's farmout and participation agreements. The prices used in calculating the estimated future net revenue attributable to proved reserves do not reflect market prices for oil and gas production sold subsequent to June 30, 1997. There can be no assurance that all of the estimated proved reserves will be produced and sold at the assumed prices or that existing contracts will be honored or judicially enforced.

There are numerous uncertainties inherent in estimating quantities of proved reserves and in projecting future rates of production and timing of development expenditures, including many factors beyond the control of the producer. The reserve data set forth herein represent only estimates. Reserve engineering is a subjective process of estimating underground accumulations of oil and gas that cannot be measured in an exact way, and the accuracy of any reserve estimate is a function of the quality of available data and of engineering and geological interpretation and judgment. As a result, estimates made by different engineers often vary. In addition, results of drilling, testing and production subsequent to the date of an estimate may justify revision of such estimates, and such revisions may be material. Accordingly, reserve estimates are often different from the actual quantities of oil and gas that are ultimately recovered. Furthermore, the estimated future net revenue from proved reserves and the present value thereof are based upon certain assumptions, including prices, future production levels and cost, that may not prove correct. Predictions about prices and future production levels are subject to great uncertainty, and this is particularly true as to proved undeveloped reserves, which are inherently less certain than proved developed reserves and which comprise a significant portion of the Company's proved reserves. In fiscal 1997, such uncertainties resulted in a \$236 million impairment of the Company's oil and gas properties. (See "Results of Operations — Impairment of Oil and Gas Properties" in Item 7).

See Item 1 and Note 11 of Notes to Consolidated Financial Statements included in Item 8 for a description of the Company's primary and other operating areas, production and other information regarding its oil and gas properties.

ITEM 3. *Legal Proceedings*

The following purported class actions alleging violations of Sections 10b-5 and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder have been filed against the Company and certain of its officers and directors:

Joseph Friedman, as attorney-in-fact for Chana Wolowitz v. Chesapeake Energy Corporation, Aubrey K. McClendon, Thomas L. Ward, Marcus C. Rowland, Shannon T. Self, Walter C. Wilson, Henry J. Hood, Steven C. Dixon, and J. Mark Lester, filed in the U.S. District Court for the Western District of Oklahoma on August 21, 1997.

Albion Financial LLC v. Chesapeake Energy Corporation, Aubrey K. McClendon, Marcus C. Rowland, Shannon T. Self, and Walter Wilson ("Albion"), filed in the U.S. District Court for the Southern District of Texas, Houston Division, on August 29, 1997.

Frank M. Zacco v. Chesapeake Energy Corporation, Aubrey K. McClendon, Thomas L. Ward, Marcus C. Rowland, Shannon T. Self, Walter C. Wilson, Henry J. Hood, Steven C. Dixon, and J. Mark Lester, filed in the U.S. District Court for the Western District of Oklahoma on September 5, 1997.

Jeff Lezak v. Chesapeake Energy Corporation, Aubrey K. McClendon, Thomas L. Ward, Marcus C. Rowland, Shannon T. Self, Walter C. Wilson, Henry J. Hood, Steven C. Dixon, and J. Mark Lester, filed in the U.S. District Court for the Western District of Oklahoma on September 9, 1997.

Lisabeth Dolwig v. Chesapeake Energy Corporation, Aubrey K. McClendon, Marcus C. Rowland, Shannon T. Self, Walter Wilson, Ronald Lefaive, and J. Mark Lester, filed in the U.S. District Court for the Western District of Oklahoma on September 11, 1997.

Leslie Joseph Klein IRA v. Chesapeake Energy Corporation, Aubrey K. McClendon, Thomas L. Ward, Marcus C. Rowland, Shannon T. Self, Walter C. Wilson, Henry J. Hood, Steven C. Dixon, and J. Mark Lester, filed in the U.S. District Court for the Western District of Oklahoma on September 15, 1997.

Elmo G. Hubble v. Chesapeake Energy Corporation, Aubrey K. McClendon, Marcus C. Rowland, Shannon T. Self and Walter Wilson, filed in the U.S. District Court for the Southern District of Texas, Houston Division, on September 17, 1997.

Jamie Gottlieb, et al. v. Chesapeake Energy Corporation, Aubrey K. McClendon, Thomas L. Ward, Marcus C. Rowland, Shannon T. Self, Walter C. Wilson, Henry J. Hood, Steven C. Dixon, and J. Mark Lester, filed in the U.S. District Court for the Western District of Oklahoma on September 18, 1997.

David S. Winston v. Chesapeake Energy Corporation, Aubrey K. McClendon, Thomas L. Ward, Marcus C. Rowland, Shannon T. Self, Walter C. Wilson, Henry J. Hood, Steven C. Dixon, and J. Mark Lester, filed in the U.S. District Court for the Western District of Oklahoma on September 23, 1997.

Michael Spindle, et al. v. Chesapeake Energy Corporation, Aubrey K. McClendon, Marcus C. Rowland, Shannon T. Self, Walter Wilson, Ronald Lefaive and J. Mark Lester, filed in the U.S. District Court for the Western District of Oklahoma on September 24, 1997.

Robert Markewich v. Chesapeake Energy Corporation, Aubrey K. McClendon, Thomas L. Ward, Marcus C. Rowland, Shannon T. Self, Walter C. Wilson, Henry J. Hood, Steven C. Dixon, and J. Mark Lester, filed in the U.S. District Court for the Western District of Oklahoma on September 25, 1997.

The plaintiffs assert that the defendants made materially false and misleading statements and failed to disclose material facts about the success of the Company's exploration efforts, principally in the Louisiana Trend. As a result, the complaints allege, the price of the Company's common stock was artificially inflated during periods beginning as early as January 25, 1996 and ending on June 27, 1997, when the Company issued a press release announcing disappointing drilling results in the Louisiana Trend and a full-cost ceiling writedown to be reflected in its June 30, 1997 financial statements. The plaintiffs further allege that certain of the named individual defendants sold common stock during the class period when they knew or should have known adverse nonpublic information. Each case seeks a determination that the suit is a proper class action, certification of the plaintiff as a class representative and damages in an unspecified amount, together with costs of litigation, including attorneys' fees. The Company and the individual defendants believe that these actions are without merit, and intend to defend against them vigorously.

On October 15, 1996, Union Pacific Resources Company ("UPRC") filed suit against the Company in the U.S. District Court for the Northern District of Texas, Fort Worth Division alleging (a) infringement and inducing infringement of UPRC's claim to a patent (the "UPRC Patent") for an invention involving a method of maintaining a borehole in a stratigraphic zone during drilling, and (b) tortious interference with certain business relations between UPRC and certain of its former employees. UPRC's claims against the Company are based on services provided by a third party vendor to the Company. UPRC is seeking injunctive relief, damages of an unspecified amount, including actual, enhanced, consequential and punitive damages, interest, costs and attorneys' fees. The Company believes that it has meritorious defenses to UPRC's

allegations and has requested the court to declare the UPRC Patent invalid. The Company has also filed a motion to limit the scope of UPRC's claims and for summary judgment. No prediction can be made as to the outcome of the matter.

ITEM 4. *Submission of Matters to a Vote of Security Holders*

No matters were submitted to a vote of the Company's security holders during the fourth quarter of the Company's fiscal year ended June 30, 1997.

PART II

ITEM 5. *Market for Registrant's Common Equity and Related Stockholder Matters*

Price Range of Common Stock

The Common Stock has been trading on the New York Stock Exchange under the symbol "CHK" since April 28, 1995. The following table sets forth, for the periods indicated, the high and low sales prices per share (adjusted for 3-for-2 stock splits on December 15, 1995 and June 28, 1996 and a 2-for-1 stock split on December 31, 1996) of the Common Stock as reported by the New York Stock Exchange:

	<u>Common Stock</u>	
	<u>High</u>	<u>Low</u>
Fiscal year ended June 30, 1996:		
First Quarter	\$ 7.28	\$ 4.53
Second Quarter	11.08	6.20
Third Quarter	16.50	10.67
Fourth Quarter	30.38	15.50
Fiscal year ended June 30, 1997:		
First Quarter	34.00	21.00
Second Quarter	34.13	25.69
Third Quarter	31.50	19.88
Fourth Quarter	22.38	9.25

At September 30, 1997 there were 500 holders of record of Common Stock and approximately 18,000 beneficial owners.

Dividends

The Company initiated a quarterly dividend with the payment of \$0.02 per common share on July 15, 1997. The payment of future cash dividends, if any, will be reviewed periodically by the Board of Directors and will depend upon, among other things, the Company's financial condition, funds from operations, the level of its capital and development expenditures, its future business prospects and any contractual restrictions.

Certain of the Indentures governing the Company's outstanding Senior Notes contain certain restrictions on the Company's ability to declare and pay dividends. Under the Indentures, the Company may not pay any cash dividends in respect of its Common Stock if (i) a default or an event of default has occurred and is continuing at the time of or immediately after giving effect to the dividend payment, (ii) the Company would not be able to incur at least \$1 of additional indebtedness under the terms of the Indentures, or (iii) immediately after giving effect to the dividend payment, the aggregate of all Restricted Payments (as defined) declared or made after the respective issue dates of the notes exceeds the sum of specified income, proceeds from the issuance of stock and debt by the Company and other amounts from the quarter in which the respective note issuances occurred to the quarter immediately preceding the date of the dividend payment.

Stock Repurchase Authorization

In August 1997, the Company's Board of Directors authorized the Company to expend up to \$50 million in connection with purchases of the Company's outstanding common stock from time to time through open market transactions, block or privately negotiated purchases, or otherwise. To date, the Company has not repurchased any shares under the Board authorization.

ITEM 6. 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, 1997. The data is derived from the Consolidated Financial Statements of the Company, including the Notes thereto, appearing elsewhere in this report. 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, including the Notes thereto included elsewhere in this report. On June 13, 1997 the Company declared a dividend of \$0.02 per common share which was paid on July 15, 1997.

	Year Ended June 30,				
	1997	1996	1995	1994	1993
	(\$ in thousands, except per share data)				
Statement of Operations Data:					
Revenues:					
Oil and gas sales	\$ 192,920	\$ 110,849	\$ 56,983	\$ 22,404	\$ 11,602
Oil and gas marketing sales	76,172	28,428	—	—	—
Oil and gas service operations	—	6,314	8,836	6,439	5,526
Interest and other	11,223	3,831	1,524	981	880
Total revenues	<u>280,315</u>	<u>149,422</u>	<u>67,343</u>	<u>29,824</u>	<u>18,008</u>
Costs and expenses:					
Production expenses and taxes	15,107	8,303	4,256	3,647	2,890
Oil and gas marketing expenses	75,140	27,452	—	—	—
Oil and gas service operations	—	4,895	7,747	5,199	3,653
Impairment of oil and gas properties	236,000	—	—	—	—
Oil and gas depreciation, depletion and amortization	103,264	50,899	25,410	8,141	4,184
Depreciation and amortization of other assets	3,782	3,157	1,765	1,871	557
General and administrative	8,802	4,828	3,578	3,135	3,620
Provision for legal and other settlements	—	—	—	—	1,286
Interest and other	18,550	13,679	6,627	2,676	2,282
Total costs and expenses	<u>460,645</u>	<u>113,213</u>	<u>49,383</u>	<u>24,669</u>	<u>18,472</u>
Income (loss) before income taxes and extraordinary item	(180,330)	36,209	17,960	5,155	(464)
Provision (benefit) for income taxes	(3,573)	12,854	6,299	1,250	(99)
Income (loss) before extraordinary item	(176,757)	23,355	11,661	3,905	(365)
Extraordinary item:					
Loss on early extinguishment of debt, net of applicable income taxes of \$3,804	(6,620)	—	—	—	—
Net income (loss)	<u>\$ (183,377)</u>	<u>\$ 23,355</u>	<u>\$ 11,661</u>	<u>\$ 3,905</u>	<u>\$ (365)</u>
Earnings (loss) per common and common equivalent share:					
Income (loss) before extraordinary item	\$ (2.69)	\$ 0.40	\$ 0.21	\$ 0.08	\$ (0.02)
Extraordinary item	(0.10)	—	—	—	—
Net income (loss)	<u>\$ (2.79)</u>	<u>\$ 0.40</u>	<u>\$ 0.21</u>	<u>\$ 0.08</u>	<u>\$ (0.02)</u>
Cash Flow Data:					
Cash provided by (used in) operating activities	\$ 84,089	\$ 120,972	\$ 54,731	\$ 19,423	\$ (1,499)
Cash used in investing activities	523,854	344,389	112,703	29,211	15,142
Cash provided by financing activities	512,144	219,520	97,282	21,162	20,802
Balance Sheet Data: (at end of period)					
Total assets	\$ 949,068	\$ 572,335	\$ 276,693	\$ 125,690	\$ 78,707
Long-term debt, net of current maturities	508,950	268,431	145,754	47,878	14,051
Stockholders' equity	286,889	177,767	44,975	31,260	31,432

ITEM 7. *Management's Discussion and Analysis of Financial Condition and Results of Operations*

Overview

Chesapeake's revenue, operating cash flow (exclusive of changes in working capital) and production reached record levels in fiscal 1997. However, significant expenditures for acreage acquisition and drilling costs followed by unfavorable exploration and production results, together with increases in drilling and equipment costs and declines in oil and gas prices as of June 30, 1997, resulted in downward revisions in estimates of the Company's proved oil and gas reserves and the present value of the estimated future net revenues from these reserves. Such excess caused the Company to record a \$236 million asset writedown during the fourth quarter of the year and caused the Company to report a net loss of \$183 million for the year.

Chesapeake's strategy during fiscal 1997, and particularly in the third and fourth quarters of the year, was to identify the potential of the various areas of the Louisiana Trend by exploratory drilling. In several large areas outside of the Masters Creek portion of the Louisiana Trend, this exploration program was unsuccessful. In these areas significant leasehold and drilling costs were added to the evaluated oil and gas property pool while insignificant quantities of oil and gas reserves were added to the Company's proved reserve base.

During fiscal 1997, the Company participated in 171 gross (107 net) wells, of which 129 wells were operated by the Company. A summary of the Company's drilling activities and capital expenditures by primary operating area is as follows (\$ in thousands):

	Gross Wells	Net Wells	Capital Expenditures		
			Drilling	Leasehold	Total
Louisiana Trend	50	28.7	\$141,581	\$ 81,287	\$222,868
Oklahoma	51	31.8	67,689	4,556	72,245
Texas	51	31.7	64,514	41,112	105,626
Other	19	14.8	51,237	13,391	64,628
Total	171	107.0	\$325,021	\$140,346	\$465,367

The Company's proved reserves decreased 5% to an estimated 403 Bcfe at June 30, 1997, down 22 Bcfe from 425 Bcfe of estimated proved reserves at June 30, 1996 (see Note 11 of Notes to Consolidated Financial Statements in Item 8 and "Results of Operations — Impairment of Oil and Gas Properties"). Due to the numerous uncertainties inherent in estimating quantities of proved reserves and in projecting future rates of production and timing of development expenditures, including many factors beyond the control of the Company, there can be no assurance that the Company's estimated proved reserves will not decrease in the future.

The Company's business strategy in fiscal 1997 continued to emphasize the acquisition of large prospective leasehold positions which potentially provide a multi-year inventory of drilling locations. As of June 30, 1997, the Company had approximately 277,000 gross acres of developed leasehold and 2.7 million gross acres of undeveloped leasehold. The fiscal 1997 drilling program, particularly in Louisiana, consisted of more exploratory drilling than in previous years. The Company's strategy for fiscal 1998 is to reduce its capital expenditure program to approximately \$250-\$275 million, concentrate its Louisiana Trend drilling activities in Masters Creek, utilize more 3-D seismic prior to conducting drilling operations, reduce the acquisition of additional unproven leasehold, and selectively acquire proved reserves. This strategy will likely have the effect of reducing the Company's anticipated production growth rate from exploration and development drilling to between 10% and 15% per year.

To assist the Company in reducing exploratory risks and increasing economic returns the Company has increased its use of 3-D seismic. The Company has conducted, participated in, or is actively pursuing more than 25 3-D seismic programs to more fully evaluate the Company's acreage inventory.

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

	Year Ended June 30,		
	1997	1996	1995
Net Production Data:			
Oil (MBbl)	2,770	1,413	1,139
Gas (MMcf)	62,005	51,710	25,114
Gas equivalent (MMcfe)	78,625	60,190	31,947
Oil and Gas Sales (\$ in 000's):			
Oil	\$ 57,974	\$ 25,224	\$19,784
Gas	134,946	85,625	37,199
Total oil and gas sales	<u>\$192,920</u>	<u>\$110,849</u>	<u>\$56,983</u>
Average Sales Price:			
Oil (\$ per Bbl)	\$ 20.93	\$ 17.85	\$ 17.36
Gas (\$ per Mcf)	\$ 2.18	\$ 1.66	\$ 1.48
Gas equivalent (\$ per Mcfe)	\$ 2.45	\$ 1.84	\$ 1.78
Oil and Gas Costs (\$ per Mcfe):			
Production expenses and taxes	\$.19	\$.14	\$.13
General and administrative	\$.11	\$.08	\$.11
Depreciation, depletion and amortization	\$ 1.31	\$.85	\$.80
Net Wells Drilled:			
Horizontal wells	75.7	42.0	28.5
Vertical wells	31.3	27.0	23.0
Net Wells at End of Period	270.1	187.0	96.4

The Company completed an offering of 8,972,000 shares of common stock in December 1996 resulting in net proceeds to the Company of approximately \$288.1 million. Additionally, the Company issued \$300 million in Senior Notes in March 1997. The Company used the net proceeds from these offerings, along with cash flow from operations, to fund its net capital expenditures of \$524 million, repay all amounts outstanding under its commercial bank credit facilities, and retire \$47.5 million of Senior Notes.

Results of Operations

General. For the fiscal year ended June 30, 1997, the Company realized a net loss of \$183.4 million, or a loss of \$2.79 per common share, on total revenues of \$280.3 million. This compares to net income of \$23.4 million, or \$0.40 per common share, on total revenues of \$149.4 million in 1996, and net income of \$11.7 million, or \$0.21 per common share, on total revenues of \$67.3 million in fiscal 1995. The loss in fiscal 1997 as compared to significantly higher earnings in fiscal 1996 and fiscal 1995 was largely the result of a \$236 million asset writedown recorded in the fourth quarter under the full cost method of accounting. (See "Results of Operations — Impairment of Oil and Gas Properties").

Oil and Gas Sales. During fiscal 1997, oil and gas sales increased 74% to \$192.9 million versus \$110.8 million for fiscal 1996 and 238% from the fiscal 1995 amount of \$57 million. The increase in oil and gas sales resulted primarily from strong growth in production volumes and significantly higher average oil and gas prices. For fiscal 1997, the Company produced 78.6 Bcfe, at a weighted average price of \$2.45 per Mcfe, compared to 60.2 Bcfe produced in fiscal 1996 at a weighted average price of \$1.84 per Mcfe, and 31.9 Bcfe produced in fiscal 1995 at a weighted average price of \$1.78 per Mcfe. This represents production growth of 31% for fiscal 1997 compared to fiscal 1996 and 146% compared to fiscal 1995.

The following table shows the Company's production by major field area for fiscal 1997 and fiscal 1996:

	For the Year Ended June 30,			
	1997		1996	
	Production (MMcfe)	Percent	Production (MMcfe)	Percent
Texas	47,398	61%	49,347	82%
Oklahoma	17,370	22	10,420	17
Louisiana Trend	12,785	16	69	—
All Other Fields	1,072	1	354	1
Total Production	<u>78,625</u>	<u>100%</u>	<u>60,190</u>	<u>100%</u>

The Company's gas production represented approximately 79% of the Company's total production volume on an equivalent basis in fiscal 1997. This compares to 86% in fiscal 1996 and 79% in fiscal 1995. This decrease in gas production as a percentage of total production in fiscal 1997 was the result of drilling in the Louisiana Trend, which tends to produce more oil than gas.

For fiscal 1997, the Company realized an average price per barrel of oil of \$20.93, compared to \$17.85 in fiscal 1996 and \$17.36 in fiscal 1995. The Company markets its oil on monthly average equivalent spot price contracts and typically receives a premium to the price posted for West Texas Intermediate crude oil.

Gas price realizations increased from fiscal 1996 to 1997 from \$1.66 per Mcf to \$2.18 per Mcf, or 31%, generally as the result of market conditions. Gas prices in fiscal 1995 averaged \$1.48 per Mcf. The Company's gas price realizations in fiscal 1997 were also higher due to the increase in Louisiana Trend gas production, which generally receives premium prices at least equivalent to Henry Hub indexes due to the high Btu content and favorable market location of the production.

The Company's hedging activities resulted in decreases in oil and gas revenues of \$7.4 million, \$5.9 million, and none in fiscal 1997, 1996 and 1995, respectively.

Oil and Gas Marketing Sales. In December 1995, the Company entered into the oil and gas marketing business by establishing a subsidiary to provide primarily natural gas marketing services including commodity price structuring, contract administration and nomination services for the Company, its partners and other oil and natural gas producers in the geographical areas in which the Company is active. The Company realized \$76.2 million in oil and gas marketing sales for third parties in fiscal 1997, with corresponding oil and gas marketing expenses of \$75.1 million, resulting in a gross margin of \$1.1 million. This compares to sales of \$28.4 million, expenses of \$27.5 million, and a margin of \$0.9 million in fiscal 1996. There were no comparable marketing activities in fiscal 1995.

Oil and Gas Service Operations. On June 30, 1996, Peak USA Energy Services, Ltd., a limited partnership ("Peak"), was formed by Peak Oilfield Services Company (a joint venture between Cook Inlet Region, Inc. and Nabors Industries, Inc.) and Chesapeake for the purpose of purchasing the Company's oilfield service assets and providing rig moving, transportation and related site construction services to the Company and others in the industry. The Company sold its service company assets to Peak for \$6.4 million, and simultaneously invested \$2.5 million in exchange for a 33.3% partnership interest in Peak. This transaction resulted in recognition of a \$1.8 million pre-tax gain during the fourth fiscal quarter of 1996 (reported in Interest and other revenues). A deferred gain from the sale of service company assets of \$0.9 million was recorded as a reduction in the Company's investment in Peak and is being amortized to income over the estimated useful lives of the Peak assets. The Company's investment in Peak is accounted for using the equity method, and resulted in \$0.5 million of income being included in Interest and other revenues in fiscal 1997.

Revenues from oil and gas service operations were \$6.3 million in fiscal 1996, down 28% from \$8.8 million in fiscal 1995. The related costs and expenses of these operations were \$4.9 million and \$7.7 million for the two years ended June 30, 1996 and 1995 respectively. The gross profit margin of 22% in fiscal 1996 was up from the 12% margin in fiscal 1995. The gross profit margin 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.

Interest and Other. Interest and other revenues for fiscal 1997 were \$11.2 million which compares to \$3.8 million in fiscal 1996 and \$1.5 million in fiscal 1995. During fiscal 1997, the Company realized \$8.7 million in interest, \$1.6 million of other investment income, \$0.5 million from its investment in Peak, and \$0.4 million in other income. During fiscal 1996, the Company realized \$3.7 million of interest and other investment income, and a \$1.8 million gain related to the sale of certain service company assets, offset by a \$1.7 million loss due to natural gas basis changes in April 1996 as a result of the Company's hedging activities. During 1995, the Company did not incur any such gains on sale of assets or basis losses.

Production Expenses and Taxes. Production expenses and taxes, which include lifting costs and production and excise taxes, increased to \$15.1 million in fiscal 1997, as compared to \$8.3 million in fiscal 1996 and \$4.3 million in fiscal 1995. These increases on a year-to-year basis were primarily the result of increased production. On an Mcfe production unit basis, production expenses and taxes increased to \$0.19 per Mcfe as compared to \$0.14 per Mcfe in fiscal 1996 and \$0.13 per Mcfe in fiscal 1995. During fiscal 1996 and 1995, a high proportion of the Company's production was from the Giddings Field, much of which qualified for Texas severance tax exemptions. The Company expects that operating costs per Mcfe will continue to increase in fiscal 1998 based on the Company's expected production mix and drilling activities in oil prone areas which generally have higher operating costs than gas prone areas and because a higher percentage of the Company's production will not qualify for severance tax exemptions as compared to the past.

Impairment of Oil and Gas Properties. The Company utilizes the full cost method to account for its investment in oil and gas properties. Under this method, all costs of acquisition, exploration and development of oil and gas reserves (including such costs as leasehold acquisition costs, geological and geophysical expenditures, certain capitalized internal costs, dry hole costs and tangible and intangible development costs) are capitalized as incurred. These oil and gas property costs along with the estimated future capital expenditures to develop proved undeveloped reserves are depleted and charged to operations using the unit-of-production method based on the ratio of current production to proved oil and gas reserves as estimated by the Company's independent engineering consultants and Company engineers. Costs directly associated with the acquisition and evaluation of unproved properties are excluded from the amortization computation until it is determined whether or not proved reserves can be assigned to the property or whether impairment has occurred. To the extent that capitalized costs of oil and gas properties, net of accumulated depreciation, depletion and amortization and related deferred income taxes, exceed the discounted future net revenues of proved oil and gas properties, such excess costs are charged to operations.

Prior to January 1997, the Company completed operations on one exploratory well in each of three separate areas outside Masters Creek in the Louisiana Trend. Between April 1997 and July 1997, the Company completed operations on ten Company operated exploratory wells located outside Masters Creek in the Louisiana Trend that resulted in the addition of only 0.5 Bcfe of proved reserves. Cumulative well costs on these non-Masters Creek properties were approximately \$43 million as of June 30, 1997. Of the 10 wells, one was completed on April 15, 1997, one on May 3, 1997 and eight after June 1, 1997. Based upon this information and similar data which had become available from outside operated properties in these non-Masters Creek areas of the Louisiana Trend in late June 1997, management determined that a significant portion of its leasehold in the Louisiana Trend outside of Masters Creek was impaired. During the quarters ended March 31, 1997 and June 30, 1997 the Company transferred \$7.6 million and \$86.3 million, respectively, of non-Masters Creek Louisiana Trend leasehold costs to the amortization base of the full cost pool.

Oil and gas prices declined from \$20.90 per Bbl and \$2.41 per Mcf at June 30, 1996 to \$18.38 per Bbl and \$2.12 per Mcf at June 30, 1997. Drilling and equipment costs escalated rapidly in the fourth quarter of fiscal 1997 due primarily to higher day-rates for drilling rigs, thus increasing the estimated future capital expenditures to be incurred to develop the Company's proved undeveloped reserves. The oil and gas price declines and the increased costs to drill and equip wells caused the Company to eliminate 35 gross proved undeveloped locations in the Knox Field which contained an estimated 45 net Bcfe of proved undeveloped

reserves. Similar factors combined with unfavorable drilling and production results eliminated approximately 93 Bcfe of proved reserves in the Giddings, and Louisiana Trend areas.

In the Independence area of the Giddings Field of Texas, a single well completed in late March 1997 which the Company had estimated to contain 15.7 Bcfe of Company reserves at March 31, 1997, was significantly and adversely affected by another operator's offset well which damaged the reservoir and reduced the Company's estimated ultimate recovery to 8.0 Bcfe of reserves.

In late June 1997, management reviewed its March 31, 1997 internal estimates of proved reserves and related estimated discounted future net revenues from its proved reserves, and giving effect to fourth quarter 1997 drilling and production results, oil and gas prices, higher drilling and completion costs, and additional leasehold acquisition costs and delay rentals incurred in areas subsequently determined to have less reserve potential than had previously been estimated. After considering all of these factors, management estimated that at June 30, 1997 it would have capitalized costs of oil and gas properties which would exceed its full cost ceiling by approximately \$150 million to \$200 million and on June 27, 1997, issued a press release which included this estimate. Subsequently, based on the Company's final year-end estimates of its proved reserves and related estimated future net revenues, which took into account additional drilling and production results, management determined that as of June 30, 1997, its capitalized costs exceeded its full cost ceiling by approximately \$236 million.

No such writedown was experienced by the Company in fiscal 1996 or fiscal 1995.

Oil and Gas Depreciation, Depletion and Amortization. Depreciation, depletion and amortization ("DD&A") of oil and gas properties for fiscal 1997 was \$103.3 million, \$52.4 million higher than fiscal 1996's expense of \$50.9 million, and \$77.9 million higher than fiscal 1995's expense of \$25.4 million. The expense in fiscal 1997 excluded the effects of the asset writedown. The average DD&A rate per Mcfe, which is a function of capitalized costs, future development costs, and the related underlying reserves in the periods presented, increased to \$1.31 in fiscal 1997 compared to \$0.85 in fiscal 1996 and \$0.80 in fiscal 1995. The Company's DD&A rate in the future will be a function of the results of future acquisition, exploration, development and production results, but the Company's rate is expected to trend upward in fiscal 1998 based on projected higher finding costs for the Louisiana Trend and higher drilling, completing, and equipping expenses throughout the oil and gas industry.

Depreciation and Amortization of Other Assets. Depreciation and amortization ("D&A") of other assets increased to \$3.8 million in fiscal 1997, compared to \$3.2 million in fiscal 1996, and \$1.8 million in fiscal 1995. This increase in fiscal 1997 was caused by an increase in D&A as a result of increased investments in depreciable buildings and equipment, and increased amortization of debt issuance costs as a result of the issuance of Senior Notes in May 1995, April 1996 and March 1997. The Company anticipates an increase in D&A in fiscal 1998 as a result of a full year of debt issuance cost amortization on the Senior Notes issued in March 1997 and higher building depreciation expense on the Company's corporate offices.

General and Administrative. General and administrative ("G&A") expenses, which are net of capitalized internal payroll and non-payroll expenses (see Note 11 of Notes to Consolidated Financial Statements), were \$8.8 million in fiscal 1997, up 83% from \$4.8 million in fiscal 1996, and up from \$3.6 million in fiscal 1995. The increases in fiscal 1997 as compared to fiscal 1996 and 1995 result primarily from increased personnel expenses required by the Company's growth and industry wage inflation. The Company capitalized \$3.9 million of internal costs in fiscal 1997 directly related to the Company's oil and gas exploration and development efforts, as compared to \$1.7 million in 1996 and \$0.6 million in 1995. The Company anticipates that G&A costs for fiscal 1998 will continue to increase as the result of wage inflation in the oil and gas industry and legal fees associated with the UPRC and shareholder litigation.

Interest and Other. Interest and other expense increased to \$18.6 million in fiscal 1997 as compared to \$13.7 million in 1996 and \$6.6 million in fiscal 1995. Interest expense in the fourth quarter of fiscal 1997 was \$8.7 million, reflecting the issuance of the 7.875% Senior Notes and the 8.5% Senior Notes in March 1997. In addition to the interest expense reported, the Company capitalized \$12.9 million of interest during fiscal 1997, as compared to \$6.4 million capitalized in fiscal 1996 and \$1.6 million in fiscal 1995. Interest expense will

increase significantly in fiscal 1998 as compared to fiscal 1997 as a result of the \$300 million Senior Notes issued in March 1997 and reduced levels of capitalized interest expected in fiscal 1998.

Provision (Benefit) for Income Taxes. The Company recorded an income tax benefit of \$3.6 million for fiscal 1997, before consideration of the \$3.8 million tax benefit associated with the extraordinary loss from the early extinguishment of debt, as compared to income tax expense of \$12.9 million in 1996 and \$6.3 million in 1995. All of the income tax expense in 1996 and 1995 was deferred due to tax net operating losses and carryovers resulting from the Company's drilling program.

The Company's loss before income taxes and extraordinary item of \$180.3 million created a tax benefit for financial reporting purposes of \$67.7 million. However, due to limitations on the recognition of deferred tax assets, the total tax benefit was reduced to \$3.6 million.

At June 30, 1997 the Company had a net operating loss carryforward of approximately \$300 million for regular federal income taxes which will expire in future years beginning in 2007. Management believes that it cannot be demonstrated at this time that it is more likely than not that the deferred income tax assets, comprised primarily of the net operating loss carryforward, will be realizable in future years, and therefore a valuation allowance of \$64.1 million has been recorded in fiscal 1997. A deferred tax benefit related to the exercise of employee stock options of approximately \$4.8 million was allocated directly to additional paid-in capital in 1997, compared to \$7.9 million in 1996 and \$1.2 million in fiscal 1995.

The Company does not expect to record any net income tax expense in fiscal 1998 based on information available at this time.

Hedging. Periodically the Company utilizes hedging strategies to hedge the price of a portion of its future oil and gas production. These strategies include (1) swap arrangements that establish an index-related price above which the Company pays the counterparty and below which the Company is paid by the counterparty, (2) the purchase of index-related puts that provide for a "floor" price below which the counterparty pays the Company the amount by which the price of the commodity is below the contracted floor, (3) the sale of index-related calls that provide for a "ceiling" price above which the Company pays the counterparty the amount by which the price of the commodity is above the contracted ceiling, and (4) basis protection swaps. Results from hedging transactions are reflected in oil and gas sales to the extent related to the Company's oil and gas production. entered into hedging transactions unrelated to the Company's oil and gas production or physical purchase or sale commitments.

As of June 30, 1997, the Company had the following oil swap arrangements for periods after June 1997:

<u>Month</u>	<u>Volume (Bbls)</u>	<u>NYMEX-Index Strike Price (per Bbl)</u>
July 1997	31,000	\$ 18.60
August 1997	31,000	\$ 18.43
September 1997	30,000	\$ 18.30
October 1997	31,000	\$ 18.19
November 1997	30,000	\$ 18.13
December 1997	31,000	\$ 18.08
January through June 1998	724,000	\$ 19.82

The Company entered into oil swap arrangements to cancel the effect of the swaps for the months of August through December at an average price of \$21.07 per Bbl.

As of June 30, 1997, the Company had the following gas swap arrangements for periods after June 1997:

<u>Month</u>	<u>Volume (MMBtu)</u>	<u>Houston Ship Channel Index Strike Price (per Bbl)</u>
July 1997.....	1,240,000	\$2.313
August 1997.....	1,240,000	\$2.301
September 1997.....	1,200,000	\$2.285
October 1997.....	1,240,000	\$2.300

The Company had entered into gas swap arrangements to cancel the effect of the swaps for the months of July through October at an average price of \$2.133 per MMBtu.

The Company has entered into a curve lock for 4.9 Bcf of gas which allows the Company the option to hedge April 1999 through November 1999 gas based upon a negative \$0.285 differential to December 1998 gas any time between the strike date and December 1998.

Gains or losses on the crude oil and natural gas hedging transactions are recognized as price adjustments in the month of related production. The Company estimates that had all of the crude oil and natural gas swap agreements in effect for production periods beginning July 1, 1997 terminated on June 30, 1997, based on the closing prices for NYMEX futures contracts as of that date, the Company would have paid the counterparty approximately \$185,000, which would have represented the "fair value" at that date. These agreements were not terminated.

Periodically, the Company's oil and gas marketing subsidiary CEMI enters into various hedging transactions designed to hedge against physical purchase commitments made by CEMI. Gains or losses on these transactions are recorded as adjustments to Oil and Gas Marketing Sales in the consolidated statements of operations and are not considered by management to be material.

Liquidity and Capital Resources

Cash Flows from Operating Activities. Cash provided by operating activities (inclusive of changes in components of working capital) decreased to \$84.1 million in fiscal 1997, as compared to \$121.0 million in fiscal 1996 and \$54.7 million in fiscal 1995. The primary reason for the decrease from fiscal 1996 to 1997 was significant changes in the components of current assets and liabilities, specifically \$102.8 million of short-term investments at June 30, 1997. Cash provided by operating activities is expected to be a significant source for meeting forecasted cash requirements for fiscal 1998.

Cash Flows from Investing Activities. Significantly higher cash was used in fiscal 1997 for development, exploration and acquisition of oil and gas properties as compared to fiscal 1996 and 1995. Approximately \$524 million was expended by the Company in fiscal 1997 (net of proceeds from sale of leasehold, equipment and other), as compared to \$344 million in fiscal 1996, an increase of \$180 million, or approximately 52%. In fiscal 1995 the Company expended \$113 million (net of proceeds from sale of leasehold, equipment and other). Net cash proceeds received by the Company for sales of oil and gas equipment, leasehold and other decreased to approximately \$3.1 million in fiscal 1997 as compared to \$6.2 million in fiscal 1996 and \$12.0 million in fiscal 1995. In fiscal 1997, other property and equipment additions were \$34 million primarily as a result of its \$16.8 million investment in the Louisiana Chalk Gathering System and Masters Creek Gas Plant as well as the purchase of additional office buildings, improvements and related equipment in Oklahoma City.

Cash Flows from Financing Activities. On December 2, 1996, the Company completed a public offering of 8,972,000 shares of Common Stock at a price of \$33.63 per share resulting in net proceeds to the Company of approximately \$288.1 million. Approximately \$55.0 million of the proceeds was used to defease the Company's \$47.5 million Senior Notes due 2001, and \$11.2 million of the proceeds was used to retire all amounts outstanding under the Company's commercial bank credit facilities.

On March 17, 1997, the Company concluded the sale of \$150 million of 7.875% Senior Notes due 2004 (the "7.875% Senior Notes"), and \$150 million of 8.5% Senior Notes due 2012 (the "8.5% Senior Notes"), which offering resulted in net proceeds to the Company of approximately \$292.6 million. The 7.875% Senior Notes were issued at 99.92% of par and the 8.5% Senior Notes were issued at 99.414% of par. The 7.875% Senior Notes and the 8.5% Senior Notes are redeemable at the option of the Company at any time at the redemption or make-whole prices set forth in the respective Indentures. In April 1997 the Company terminated its commercial bank facilities.

In fiscal 1996, cash flows from financing activities were \$219.5 million, largely as the result of the issuance of 5,989,500 shares of Common Stock (net proceeds to the Company of approximately \$99.4 million) and \$120 million of 9.125% Senior Notes due 2006 (the "9.125% Senior Notes"). The Company may, at its option, redeem prior to April 15, 1999 up to \$42 million principal amount of the 9.125% Senior Notes at 109.125% of the principal amount thereof from equity offering proceeds. The 9.125% Senior Notes are redeemable at the option of the Company at any time at the redemption or make-whole prices set forth in the Indenture.

Financial Flexibility and Liquidity. The Company had working capital of approximately \$151.3 million at June 30, 1997. During fiscal 1997, the Company invested in a number of oil and gas related businesses and projects. The most significant of these was the Company's initial investment made in Bayard, consisting of an \$18 million subordinated note and \$7 million of common stock. In August 1997, the Company entered into an agreement with Bayard to invest up to an additional \$9 million and convert certain options, warrants and note amounts that will facilitate a potential initial public offering by Bayard. On August 27, 1997 Bayard filed a registration statement for an initial public offering of its common stock. Chesapeake, subsequent to the completion of the transaction noted above, will own 4,194,000 shares of Bayard common stock (30.4% of the common stock outstanding) and anticipates selling substantially all of its ownership in Bayard in the IPO (assuming the over-allotment option is exercised) and receiving repayment of the subordinated note. If successful, assuming the sale of all of the Company's Bayard stock, and based on the initial filing price of Bayard at \$15 per share, the Company would receive total proceeds of approximately \$74 million (net of offering costs) and realize a pre-tax gain of approximately \$40 million. No assurance can be given, however, that Bayard will successfully complete the initial public offering of its common stock, at what price, or that the net proceeds or pre-tax gain discussed above will be realized by the Company.

The Company also made investments in Louisiana Trend gas gathering and processing facilities which it may sell during fiscal 1998. These investments include a 50% interest in the Louisiana Austin Chalk Gathering System, and a 15.5% interest in the Masters Creek Gas Plant. If the Company decides to sell these investments, the Company expects that the proceeds should exceed the Company's cost basis of \$16.8 million as of June 30, 1997.

The Company currently maintains no commercial bank credit facilities because of its substantial working capital position, anticipated proceeds from the sale of the investments described above, and expected cash flows from operations as compared to the fiscal 1998 capital expenditure budget. Although the Senior Note Indentures contain various restrictions on additional indebtedness, based on asset values as of June 30, 1997, the Company estimates it could borrow up to approximately \$100 million of commercial bank debt within these restrictions.

Debt ratings for the Senior Notes are Ba3 by Moody's Investors Service and BB- by Standard & Poor's Corporation as of September 30, 1997. The Company's long-term debt represented approximately 64% of total capital at June 30, 1997. There are no scheduled principal payments required on any of the Senior Notes until June 2002. The Company's goal is to achieve an equity to capital ratio of at least 50% and to increase its credit ratings, ultimately achieving an investment grade debt rating.

Forward Looking Statements

The information contained in this Form 10-K includes certain forward-looking statements. When used in this document, the words budget, budgeted, anticipate, expects, estimates, believes, goals or projects and similar expressions are intended to identify forward-looking statements. It is important to note that

Chesapeake's actual results could differ materially from those projected by such forward-looking statements. Important factors that could cause actual results to differ materially from those projected in the forward-looking statements include, but are not limited to, the following: production variances from expectations, volatility of oil and gas prices, the need to develop and replace its reserves, the substantial capital expenditures required to fund its operations, environmental risks, drilling and operating risks, risks related to exploration and development drilling, the uncertainty inherent in estimating future oil and gas production or reserves, competition, government regulation, and the ability of the Company to implement its business strategy.

ITEM 7A. *Quantitative and Qualitative Disclosures About Market Risk*

— *Not applicable*

ITEM 8. *Financial Statements and Supplementary Data*

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REPORT OF INDEPENDENT ACCOUNTANTS

To the Board of Directors and Stockholders
of Chesapeake Energy Corporation

We have audited the accompanying consolidated balance sheets of Chesapeake Energy Corporation and its subsidiaries as of June 30, 1997 and 1996, and the related consolidated statements of operations, stockholders' equity and cash flows for the years then ended. 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 in accordance with generally accepted auditing standards. Those standards 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. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Chesapeake Energy Corporation and its subsidiaries as of June 30, 1997 and 1996, and the consolidated results of their operations and their cash flows for the years then ended in conformity with generally accepted accounting principles.

COOPERS & LYBRAND L.L.P.

Oklahoma City, Oklahoma
September 30, 1997

REPORT OF INDEPENDENT ACCOUNTANTS

To the Board of Directors and Stockholders
of Chesapeake Energy Corporation

In our opinion, the consolidated statements of operations, of cash flows and of stockholders' equity for the year ended June 30, 1995 present fairly, in all material respects, the results of operations and cash flows of Chesapeake Energy Corporation and its subsidiaries for the year ended June 30, 1995, 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 audit. We conducted our audit of these statements in accordance with generally accepted auditing standards which require that we plan and perform the audit 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 audit provides a reasonable basis for the opinion expressed above. We have not audited the consolidated financial statements of Chesapeake Energy Corporation and its subsidiaries for any period subsequent to June 30, 1995.

PRICE WATERHOUSE LLP

Houston, Texas

September 20, 1995, except for the third paragraph of Note 9
which is as of October 9, 1997

CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

ASSETS

	June 30,	
	1997	1996
	(\$ in thousands)	
CURRENT ASSETS:		
Cash and cash equivalents	\$ 124,017	\$ 51,638
Short-term investments	104,485	—
Accounts receivable:		
Oil and gas sales	10,906	12,687
Oil and gas marketing sales	19,939	6,982
Joint interest and other, net of allowances of \$387,000 and \$340,000, respectively	25,311	27,661
Related parties	7,401	2,884
Inventory	4,854	5,163
Other	692	2,158
Total Current Assets	<u>297,605</u>	<u>109,173</u>
PROPERTY AND EQUIPMENT:		
Oil and gas properties, at cost based on full cost accounting:		
Evaluated oil and gas properties	865,516	363,213
Unevaluated properties	128,505	165,441
Less: accumulated depreciation, depletion and amortization	<u>(431,983)</u>	<u>(92,720)</u>
	562,038	435,934
Other property and equipment	50,379	18,162
Less: accumulated depreciation and amortization	<u>(5,051)</u>	<u>(2,922)</u>
Total Property and Equipment	<u>607,366</u>	<u>451,174</u>
OTHER ASSETS	<u>44,097</u>	<u>11,988</u>
TOTAL ASSETS	<u>\$ 949,068</u>	<u>\$ 572,335</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Notes payable and current maturities of long-term debt	\$ 1,380	\$ 6,755
Accounts payable	86,817	54,514
Accrued liabilities and other	28,701	14,062
Revenues and royalties due others	29,428	33,503
Total Current Liabilities	<u>146,326</u>	<u>108,834</u>
LONG-TERM DEBT, NET	<u>508,950</u>	<u>268,431</u>
REVENUES AND ROYALTIES DUE OTHERS	<u>6,903</u>	<u>5,118</u>
DEFERRED INCOME TAXES	<u>—</u>	<u>12,185</u>
CONTINGENCIES AND COMMITMENTS (Note 4)	<u>—</u>	<u>—</u>
STOCKHOLDERS' EQUITY:		
Preferred Stock, \$.01 par value, 10,000,000 shares authorized; none issued	—	—
Common Stock, 100,000,000 shares authorized; par value of \$.01 and \$.05 at June 30, 1997 and 1996, respectively; 70,276,975 and 60,159,826 shares issued and outstanding at June 30, 1997 and 1996, respectively	703	3,008
Paid-in capital	432,991	136,782
Accumulated earnings (deficit)	<u>(146,805)</u>	<u>37,977</u>
Total Stockholders' Equity	<u>286,889</u>	<u>177,767</u>
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	<u>\$ 949,068</u>	<u>\$ 572,335</u>

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

CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS

	Year Ended June 30,		
	1997	1996	1995
	(\$ in thousands, except per share data)		
REVENUES:			
Oil and gas sales	\$ 192,920	\$ 110,849	\$ 56,983
Oil and gas marketing sales	76,172	28,428	—
Oil and gas service operations	—	6,314	8,836
Interest and other	11,223	3,831	1,524
Total Revenues	<u>280,315</u>	<u>149,422</u>	<u>67,343</u>
COSTS AND EXPENSES:			
Production expenses and taxes	15,107	8,303	4,256
Oil and gas marketing expenses	75,140	27,452	—
Oil and gas service operations	—	4,895	7,747
Impairment of oil and gas properties	236,000	—	—
Oil and gas depreciation, depletion and amortization	103,264	50,899	25,410
Depreciation and amortization of other assets	3,782	3,157	1,765
General and administrative	8,802	4,828	3,578
Interest and other	18,550	13,679	6,627
Total Costs and Expenses	<u>460,645</u>	<u>113,213</u>	<u>49,383</u>
INCOME (LOSS) BEFORE INCOME TAXES AND EXTRAORDINARY ITEM	(180,330)	36,209	17,960
PROVISION (BENEFIT) FOR INCOME TAXES	(3,573)	12,854	6,299
INCOME (LOSS) BEFORE EXTRAORDINARY ITEM	(176,757)	23,355	11,661
EXTRAORDINARY ITEM:			
Loss on early extinguishment of debt, net of applicable income tax of \$3,804	(6,620)	—	—
NET INCOME (LOSS)	<u>\$ (183,377)</u>	<u>\$ 23,355</u>	<u>\$ 11,661</u>
EARNINGS (LOSS) PER COMMON SHARE:			
EARNINGS (LOSS) PER COMMON AND COMMON EQUIVALENT SHARE-PRIMARY			
Income (loss) before extraordinary item	\$ (2.69)	\$ 0.40	\$ 0.21
Extraordinary item	(0.10)	—	—
Net income (loss)	<u>\$ (2.79)</u>	<u>\$ 0.40</u>	<u>\$ 0.21</u>
EARNINGS (LOSS) PER COMMON AND COMMON EQUIVALENT SHARE-FULLY DILUTED			
Income (loss) before extraordinary item	\$ (2.69)	\$ 0.40	\$ 0.21
Extraordinary item	(0.10)	—	—
Net income (loss)	<u>\$ (2.79)</u>	<u>\$ 0.40</u>	<u>\$ 0.21</u>
WEIGHTED AVERAGE COMMON AND COMMON EQUIVALENT SHARES OUTSTANDING (in 000's)			
Primary	<u>65,767</u>	<u>58,342</u>	<u>55,872</u>
Fully-diluted	<u>65,767</u>	<u>58,922</u>	<u>56,606</u>

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

CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended June 30,		
	1997	1996	1995
	(\$ in thousands)		
CASH FLOWS FROM OPERATING ACTIVITIES:			
NET INCOME (LOSS)	\$(183,377)	\$ 23,355	\$ 11,661
ADJUSTMENTS TO RECONCILE NET INCOME (LOSS) TO NET CASH PROVIDED BY OPERATING ACTIVITIES:			
Depreciation, depletion and amortization	105,591	52,768	26,628
Deferred taxes	(3,573)	12,854	6,299
Amortization of loan costs	1,455	1,288	548
Amortization of bond discount	217	563	567
Bad debt expense	299	114	308
Gain on sale of fixed assets	(1,593)	(2,511)	(108)
Impairment of oil and gas assets	236,000	—	—
Extraordinary loss	6,620	—	—
Equity in earnings of oil field service company	(499)	—	—
CHANGES IN ASSETS AND LIABILITIES:			
(Increase) decrease in short-term investments	(102,858)	622	—
(Increase) decrease in accounts receivable	(19,987)	(3,524)	(22,510)
(Increase) decrease in inventory	(1,467)	78	(1,203)
(Increase) decrease in other current assets	1,466	(1,525)	614
Increase (decrease) in accounts payable, accrued liabilities and other	48,085	25,834	19,387
Increase (decrease) in current and non-current revenues and royalties due others	(2,290)	11,056	12,540
Cash provided by operating activities	<u>84,089</u>	<u>120,972</u>	<u>54,731</u>
CASH FLOWS FROM INVESTING ACTIVITIES:			
Exploration, development and acquisition of oil and gas properties	(468,462)	(342,045)	(117,831)
Proceeds from sale of oil and gas equipment, leasehold and other	3,095	6,167	11,953
Other proceeds from sales	6,428	698	1,104
Long term loans made to third parties	(20,000)	—	—
Investment in oil field service company	(3,048)	—	—
Investment in gas marketing company, net of cash acquired	—	(363)	—
Other investments	(8,000)	—	—
Other property and equipment additions	(33,867)	(8,846)	(7,929)
Cash used in investing activities	<u>(523,854)</u>	<u>(344,389)</u>	<u>(112,703)</u>
CASH FLOWS FROM FINANCING ACTIVITIES:			
Proceeds from issuance of Common Stock	288,091	99,498	—
Proceeds from long-term borrowings	342,626	166,667	128,834
Payments on long-term borrowings	(119,581)	(48,634)	(32,370)
Cash received from exercise of stock options	1,387	1,989	818
Other financing	(379)	—	—
Cash provided by financing activities	<u>512,144</u>	<u>219,520</u>	<u>97,282</u>
Net increase (decrease) in cash and cash equivalents	72,379	(3,897)	39,310
Cash and cash equivalents, beginning of period	51,638	55,535	16,225
Cash and cash equivalents, end of period	<u>\$ 124,017</u>	<u>\$ 51,638</u>	<u>\$ 55,535</u>
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION			
CASH PAYMENTS FOR:			
Interest	\$ 25,854	\$ 17,179	\$ 6,488
Income taxes	\$ —	\$ —	\$ —

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

CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS — (Continued)

SUPPLEMENTAL SCHEDULE OF NON-CASH INVESTING AND FINANCING ACTIVITIES:

The Company has a financing arrangement with a vendor to supply certain oil and gas equipment inventory. The total amounts owed at June 30, 1997, 1996 and 1995 were \$1,380,000, \$3,156,000 and \$6,513,000, respectively. No cash consideration is exchanged for inventory under this financing arrangement until actual draws on the inventory are made.

In fiscal 1997, 1996 and 1995, the Company recognized income tax benefits of \$4,808,000, \$7,950,000 and \$1,229,000, respectively, related to the disposition of stock options by directors and employees of the Company. The tax benefits were recorded as an adjustment to deferred income taxes and paid-in capital.

Proceeds from the issuance of \$150 million of 7.875% Senior Notes and \$150 million of 8.5% Senior Notes in March 1997 are net of \$6.4 million in offering fees and expenses which were deducted from the actual cash received.

Proceeds from the issuances of \$90 million of 10.5% Senior Notes in May 1995 and \$120 million of 9.125% Senior Notes in April 1996 are net of \$2.7 million and \$3.9 million, respectively, in offering fees and expenses which were deducted from the actual cash received.

On June 13, 1997 the Company declared a dividend of \$0.02 per common share, or \$1,405,000, which was paid on July 15, 1997.

CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

	Year Ended June 30,		
	1997	1996	1995
	(\$ in thousands)		
COMMON STOCK:			
Balance, beginning of period	3,008	58	51
Issuance of 8,972,000 shares of Common Stock	90	—	—
Issuance of 5,989,500 shares of Common Stock	—	299	—
Exercise of stock options and warrants	12	79	7
Change in par value	(2,407)	2,572	—
Balance, end of period	703	3,008	58
COMMON STOCK WARRANTS:			
Balance, beginning of period	—	—	5
Exercise of Common Stock Warrants	—	—	(5)
Balance, end of period	—	—	—
PAID-IN CAPITAL:			
Balance, beginning of period	\$ 136,782	\$ 30,295	\$28,243
Exercise of stock options and warrants	1,375	1,910	823
Issuance of Common Stock	301,593	105,516	—
Offering expenses and other	(13,974)	(6,317)	—
Tax benefit from exercise of stock options	4,808	7,950	1,229
Change in par value	2,407	(2,572)	—
Balance, end of period	432,991	136,782	30,295
ACCUMULATED EARNINGS (DEFICIT):			
Balance, beginning of period	37,977	14,622	2,961
Net income (loss)	(183,377)	23,355	11,661
Dividends on common stock of \$0.02 per share	(1,405)	—	—
Balance, end of period	(146,805)	37,977	14,622
TOTAL STOCKHOLDERS' EQUITY	\$ 286,889	\$177,767	\$44,975

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

CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Presentation and Summary of Significant Accounting Policies

Description of Company

The Company is a U.S. petroleum exploration and production company engaged in the acquisition, exploration, and development of properties for the production of crude oil and natural gas from underground reservoirs. The Company's properties are located primarily in Texas, Louisiana, Oklahoma, Montana, North Dakota and New Mexico.

Principles of Consolidation

The accompanying consolidated financial statements of Chesapeake Energy Corporation (the "Company" or "Parent") include the accounts of Chesapeake Operating, Inc. ("COI"), Chesapeake Exploration Limited Partnership ("CEX"), a limited partnership, Chesapeake Louisiana, L.P. ("CLLP"), a limited partnership, Chesapeake Gas Development Corporation ("CGDC"), Chesapeake Energy Marketing, Inc. ("CEMI"), Chesapeake Canada Corporation ("CCC"), Chesapeake Energy Louisiana Corporation ("CELC"), Lindsay Oil Field Supply, Inc. ("LOF"), Sander Trucking Company, Inc. ("STCO") and subsidiaries of those entities. As of June 30, 1997, CGDC had been merged into CEX and LOF and STCO had been dissolved. All significant intercompany accounts and transactions have been eliminated.

Accounting Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

Cash Equivalents

For purposes of the consolidated financial statements, the Company considers investments in all highly liquid debt instruments with maturities of three months or less at date of purchase to be cash equivalents.

Investments

The Company invests in various equity securities and short-term debt instruments including corporate bonds and auction preferreds, commercial paper and government agency notes. The Company has classified all of its short-term investments in equity and debt instruments as trading securities, which are carried at fair value with unrealized holding gains and losses included in earnings. At June 30, 1997, the Company had an unrealized holding loss of \$0.6 million included in interest and other revenue. At June 30, 1996 the Company had no trading securities. Investments in equity securities and limited partnerships that do not have readily determinable fair values are stated at cost and are included in noncurrent other assets. In determining realized gains and losses, the cost of securities sold is based on the average cost method.

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 is carried at the lower of cost or market using the specific identification method.

Oil and Gas Properties

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

CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

that can be directly identified with its acquisition, exploration and development activities and does not include any costs related to production, general corporate overhead or similar activities (see Note 11). 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 as well as the Company's internal engineers. The average composite rates used for depreciation, depletion and amortization were \$1.31, \$0.85 and \$0.80 per equivalent Mcf in 1997, 1996, and 1995, 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. The costs of unproved properties are excluded from amortization until the properties are evaluated. The Company reviews the carrying value of its oil and gas properties under the full cost accounting rules of the Securities and Exchange Commission on a quarterly basis. Under these rules, capitalized costs, less accumulated amortization and related deferred income taxes, shall not exceed an amount equal to the sum of the present value of estimated future net revenues less estimated future expenditures to be incurred in developing and producing the proved reserves, less any related income tax effects. At June 30, 1997, capitalized costs of oil and gas properties exceeded the estimated present value of future net revenues from the Company's proved reserves, net of related income tax considerations, resulting in a fourth quarter writedown in the carrying value of oil and gas properties of \$236 million.

Other Property and Equipment

Other property and equipment consists primarily of gas gathering and processing facilities, vehicles, land, 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 three to 30 years.

Leases

The Company has various operating leases primarily for transportation equipment and field offices. Minimum lease payments under these operating leases are as follows (\$ in thousands):

	Operating Leases
1998	\$ 579
1999	500
2000	446
2001	446
2002	306
Total minimum lease payments	<u>\$2,277</u>

Capitalized Interest

During fiscal 1997, 1996 and 1995, interest of approximately \$12,935,000, \$6,428,000 and \$1,574,000 was capitalized on significant investments in unproved properties that are not being currently depreciated, depleted, or amortized and on which exploration activities are in progress.

Service Operations

Certain subsidiaries of the Company performed contractual services on wells the Company operated as well as for third parties until June 30, 1996. Oil and gas service operations revenues and costs and expenses reflected in the accompanying consolidated statements of operations include amounts derived from certain of

CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

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.

On June 30, 1996, Peak USA Energy Services, Ltd., a limited partnership ("Peak"), was formed by Peak Oilfield Services Company (a joint venture between Cook Inlet Region, Inc. and Nabors Industries, Inc.) and the Company for the purpose of purchasing the Company's oilfield service assets and providing rig moving, transportation and related site construction services. The Company sold its service company assets to Peak for \$6.4 million, and simultaneously invested \$2.5 million in exchange for a 33.3% partnership interest in Peak. This transaction resulted in recognition of a \$1.8 million pre-tax gain during the fourth fiscal quarter of 1996 reported in Interest and other. A deferred gain from the sale of service company assets of \$0.9 million was recorded as a reduction in the Company's investment in Peak and will be amortized to income over the estimated useful lives of the Peak assets. The Company's investment in Peak is accounted for using the equity method.

Income Taxes

The Company has adopted Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes ("SFAS 109"). SFAS 109 requires deferred tax liabilities or assets to 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 (Loss) Per Share

Primary and fully diluted earnings (loss) per share for all periods have been computed based upon the weighted average number of shares of Common Stock outstanding after giving retroactive effect to all stock splits and the issuance of common stock equivalents when their effect is dilutive. 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.

In February 1997, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 128, Earnings Per Share ("SFAS 128"). SFAS 128 requires presentation of "basic" and "diluted" earnings per share, as defined, on the face of the statement of operations for all entities with complex capital structures. SFAS 128 is effective for financial statements issued for periods ending after December 15, 1997 and requires restatement of all prior period earnings per share amounts. The Company does not believe that SFAS 128 will have a material impact on its earnings per share when adopted.

Gas Imbalances — Revenue Recognition

Revenues from the sale of oil and gas production are recognized when title passes, net of royalties. The Company follows the "sales method" of accounting for its gas revenue whereby the Company recognizes sales revenue on all 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, 1997 and 1996 were not material.

Hedging

The Company periodically uses certain instruments to hedge its exposure to price fluctuations on oil and natural gas transactions. Recognized gains and losses on hedge contracts are reported as a component of the related transaction. Results for hedging transactions are reflected in oil and gas sales to the extent related to the Company's oil and gas production (see Note 10).

CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Debt Issue Costs

Other assets include debt issue costs associated with the issuance of the 10.5% Senior Notes on May 25, 1995, the 9.125% Senior Notes on April 9, 1996, and the 7.875% and 8.5% Senior Notes on March 17, 1997 (see Note 2). The remaining unamortized costs on these issuances of Senior Notes at June 30, 1997 totaled \$12.5 million and are being amortized over the life of the Senior Notes.

Stock Options

In October 1995, the Financial Accounting Standards Board issued Statement No. 123 ("SFAS 123"), "Accounting for Stock Based Compensation". As permitted by SFAS 123, the Company has continued its previous method of accounting for stock compensation and has adopted the disclosure requirements of this Statement in fiscal 1997.

Reclassifications

Certain reclassifications have been made to the consolidated financial statements for the years ended June 30, 1996 and 1995 to conform to the presentation used for the June 30, 1997 consolidated financial statements.

2. Senior Notes

On March 17, 1997, the Company issued \$150 million principal amount of 7.875% Senior Notes due 2004 ("7.875% Senior Notes"). The 7.875% Senior Notes are redeemable at the option of the Company at any time at the make-whole prices determined in accordance with the indenture.

On March 17, 1997, the Company issued \$150 million principal amount of 8.5% Senior Notes due 2012 ("8.5% Senior Notes"). The 8.5% Senior Notes are redeemable at the option of the Company at any time at the make-whole prices determined in accordance with the indenture, or on or after March 15, 2004, at the redemption price set forth therein.

On April 9, 1996, the Company issued \$120 million principal amount of 9.125% Senior Notes due 2006 ("9.125% Senior Notes"). The 9.125% Senior Notes are redeemable at the option of the Company at any time prior to April 15, 2001 at the make-whole prices determined in accordance with the indenture and on or after April 15, 2001, at the redemption prices set forth therein. The Company may also redeem at its option at any time on or prior to April 15, 1999 up to \$42 million of the 9.125% Senior Notes at 109.125% of the principal amount thereof with the proceeds of an equity offering.

On May 25, 1995, the Company issued \$90 million principal amount of 10.5% Senior Notes due 2002 ("10.5% Senior Notes"). The 10.5% Senior Notes are redeemable at the option of the Company at any time on or after June 1, 1999. The Company may also redeem at its option at any time on or prior to June 1, 1998 up to \$30 million of the 10.5% Senior Notes at 110% of the principal amount thereof with the proceeds of an equity offering.

The Company is a holding company and owns no operating assets and has no significant operations independent of its subsidiaries. The Company's obligations under the 10.5% Senior Notes, the 9.125% Senior Notes, the 7.875% Senior Notes and the 8.5% Senior Notes have been fully and unconditionally guaranteed, on a joint and several basis, by each of the Company's "Restricted Subsidiaries" (as defined in the respective indentures governing the Senior Notes) (collectively, the "Guarantor Subsidiaries"). Each of the Guarantor Subsidiaries is a direct or indirect wholly-owned subsidiary of the Company.

The 10.5%, 9.125%, 7.875% and 8.5% Senior Note Indentures contain certain covenants, including covenants limiting the Company and the Guarantor Subsidiaries with respect to asset sales; restricted payments; the incurrence of additional indebtedness and the issuance of preferred stock; liens; sale and

CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

leaseback transactions; lines of business; dividend and other payment restrictions affecting Guarantor Subsidiaries; mergers or consolidations; and transactions with affiliates. The Company is obligated to repurchase the 10.5% and 9.125% Senior Notes in the event of a change of control or certain asset sales.

Set forth below are condensed consolidating financial statements of the Guarantor Subsidiaries, the Company's subsidiaries which are not guarantors of the Senior Notes (the "Non-Guarantor Subsidiaries") and the Company. Separate audited financial statements of each Guarantor Subsidiary have not been provided because management has determined that they are not material to investors.

As of and for the year ended June 30, 1997, the Guarantor Subsidiaries were COI, CEX, CLLP, CELC and CGDC, and the Non-Guarantor Subsidiaries were CEMI and CCC. Prior to fiscal 1997, the Guarantor Subsidiaries were COI, CEX and two service company subsidiaries the assets of which were sold effective June 30, 1996, and the Non-Guarantor Subsidiaries were CGDC and CEMI (which was acquired in December 1995).

CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

CONDENSED CONSOLIDATING BALANCE SHEET

As of June 30, 1997

(\$ in thousands)

ASSETS

	<u>Guarantor Subsidiaries</u>	<u>Non- Guarantor Subsidiaries</u>	<u>Company (Parent)</u>	<u>Eliminations</u>	<u>Consolidated</u>
CURRENT ASSETS:					
Cash and cash equivalents	\$ (6,534)	\$ 4,363	\$126,188	\$ —	\$ 124,017
Short-term investments	—	4,324	100,161	—	104,485
Accounts receivable	47,379	19,943	3,022	(6,787)	63,557
Inventory	4,795	59	—	—	4,854
Other	666	26	—	—	692
Total Current Assets	<u>46,306</u>	<u>28,715</u>	<u>229,371</u>	<u>(6,787)</u>	<u>297,605</u>
PROPERTY AND EQUIPMENT:					
Oil and gas properties	865,485	31	—	—	865,516
Unevaluated leasehold	128,519	(14)	—	—	128,505
Other property and equipment	33,486	1,904	14,989	—	50,379
Less: accumulated depreciation, depletion and amortization	<u>(436,276)</u>	<u>—</u>	<u>(758)</u>	<u>—</u>	<u>(437,034)</u>
	<u>591,214</u>	<u>1,921</u>	<u>14,231</u>	<u>—</u>	<u>607,366</u>
INVESTMENTS IN SUBSIDIARIES AND INTERCOMPANY ADVANCES					
	<u>817</u>	<u>—</u>	<u>680,439</u>	<u>(681,256)</u>	<u>—</u>
OTHER ASSETS	<u>4,961</u>	<u>673</u>	<u>38,463</u>	<u>—</u>	<u>44,097</u>
TOTAL ASSETS	<u>\$643,298</u>	<u>\$31,309</u>	<u>\$962,504</u>	<u>\$(688,043)</u>	<u>\$ 949,068</u>

LIABILITIES AND STOCKHOLDERS' EQUITY

CURRENT LIABILITIES:					
Notes payable and current maturities of long-term debt	\$ 1,380	\$ —	\$ —	\$ —	\$ 1,380
Accounts payable and other	122,241	17,527	11,965	(6,787)	144,946
Total Current Liabilities	<u>123,621</u>	<u>17,527</u>	<u>11,965</u>	<u>(6,787)</u>	<u>146,326</u>
LONG-TERM DEBT	<u>—</u>	<u>—</u>	<u>508,950</u>	<u>—</u>	<u>508,950</u>
REVENUES AND ROYALTIES DUE					
OTHERS	<u>6,903</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>6,903</u>
DEFERRED INCOME TAXES	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>
INTERCOMPANY PAYABLES	<u>589,111</u>	<u>1,492</u>	<u>—</u>	<u>(590,603)</u>	<u>—</u>
STOCKHOLDERS' EQUITY:					
Common Stock	11	1	693	(2)	703
Other	(76,348)	12,289	440,896	(90,651)	286,186
	<u>(76,337)</u>	<u>12,290</u>	<u>441,589</u>	<u>(90,653)</u>	<u>286,889</u>
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	<u>\$643,298</u>	<u>\$31,309</u>	<u>\$962,504</u>	<u>\$(688,043)</u>	<u>\$ 949,068</u>

CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

CONDENSED CONSOLIDATING BALANCE SHEET

As Of June 30, 1996

(\$ in thousands)

ASSETS

	<u>Guarantor Subsidiaries</u>	<u>Non- Guarantor Subsidiaries</u>	<u>Company (Parent)</u>	<u>Eliminations</u>	<u>Consolidated</u>
CURRENT ASSETS:					
Cash and cash equivalents	\$ 4,061	\$ 2,751	\$ 44,826	\$ —	\$ 51,638
Accounts receivable	44,080	7,723	—	(1,589)	50,214
Inventory	4,947	216	—	—	5,163
Other	2,155	3	—	—	2,158
Total Current Assets	<u>55,243</u>	<u>10,693</u>	<u>44,826</u>	<u>(1,589)</u>	<u>109,173</u>
PROPERTY AND EQUIPMENT:					
Oil and gas properties	338,610	24,603	—	—	363,213
Unevaluated leasehold	165,441	—	—	—	165,441
Other property and equipment	9,608	61	8,493	—	18,162
Less: accumulated depreciation, depletion and amortization	<u>(87,193)</u>	<u>(8,007)</u>	<u>(442)</u>	<u>—</u>	<u>(95,642)</u>
	<u>426,466</u>	<u>16,657</u>	<u>8,051</u>	<u>—</u>	<u>451,174</u>
INVESTMENTS IN SUBSIDIARIES AND INTERCOMPANY ADVANCES ..					
	<u>519,386</u>	<u>8,132</u>	<u>382,388</u>	<u>(909,906)</u>	<u>—</u>
OTHER ASSETS	<u>2,310</u>	<u>940</u>	<u>8,738</u>	<u>—</u>	<u>11,988</u>
TOTAL ASSETS	<u>\$1,003,405</u>	<u>\$36,422</u>	<u>\$444,003</u>	<u>\$(911,495)</u>	<u>\$572,335</u>

LIABILITIES AND STOCKHOLDERS' EQUITY

CURRENT LIABILITIES:					
Notes payable and current maturities of long-term debt	\$ 3,846	\$ 2,880	\$ 29	\$ —	\$ 6,755
Accounts payable and other	91,069	7,339	5,260	(1,589)	102,079
Total Current Liabilities	<u>94,915</u>	<u>10,219</u>	<u>5,289</u>	<u>(1,589)</u>	<u>108,834</u>
LONG-TERM DEBT	<u>2,113</u>	<u>10,020</u>	<u>256,298</u>	<u>—</u>	<u>268,431</u>
REVENUES AND ROYALTIES DUE					
OTHERS	<u>5,118</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>5,118</u>
DEFERRED INCOME TAXES	<u>23,950</u>	<u>1,335</u>	<u>(13,100)</u>	<u>—</u>	<u>12,185</u>
INTERCOMPANY PAYABLES	<u>824,307</u>	<u>8,182</u>	<u>73,647</u>	<u>(906,136)</u>	<u>—</u>
STOCKHOLDERS' EQUITY:					
Common Stock	117	2	2,891	(2)	3,008
Other	52,885	6,664	118,978	(3,768)	174,759
	<u>53,002</u>	<u>6,666</u>	<u>121,869</u>	<u>(3,770)</u>	<u>177,767</u>
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	<u>\$1,003,405</u>	<u>\$36,422</u>	<u>\$444,003</u>	<u>\$(911,495)</u>	<u>\$572,335</u>

CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

CONDENSED CONSOLIDATING STATEMENTS OF OPERATIONS
(\$ in thousands)

	Guarantor Subsidiaries	Non- Guarantor Subsidiaries	Company (Parent)	Eliminations	Consolidated
For the Year Ended June 30, 1997:					
REVENUES:					
Oil and gas sales	\$ 191,303	\$ —	\$ —	\$ 1,617	\$ 192,920
Oil and gas marketing sales	—	145,942	—	(69,770)	76,172
Interest and other	778	749	49,224	(39,528)	11,223
Total Revenues	192,081	146,691	49,224	(107,681)	280,315
COSTS AND EXPENSES:					
Production expenses and taxes	15,107	—	—	—	15,107
Oil and gas marketing expenses	—	143,293	—	(68,153)	75,140
Impairment of oil and gas properties	236,000	—	—	—	236,000
Oil and gas depreciation, depletion and amortization	103,264	—	—	—	103,264
Other depreciation and amortization	2,152	80	1,550	—	3,782
General and administrative	6,313	921	1,568	—	8,802
Interest	37,644	10	20,424	(39,528)	18,550
Total Costs & Expenses	400,480	144,304	23,542	(107,681)	460,645
INCOME (LOSS) BEFORE INCOME TAXES AND EXTRAORDINARY ITEM					
	(208,399)	2,387	25,682	—	(180,330)
INCOME TAX EXPENSE (BENEFIT)					
	(4,129)	47	509	—	(3,573)
NET INCOME (LOSS) BEFORE EXTRAORDINARY ITEM	(204,270)	2,340	25,173	—	(176,757)
EXTRAORDINARY ITEM:					
Loss on early extinguishment of debt, net of applicable income tax	(769)	—	(5,851)	—	(6,620)
NET INCOME (LOSS)	\$(205,039)	\$ 2,340	\$ 19,322	\$ —	\$(183,377)
For the Year Ended June 30, 1996:					
REVENUES:					
Oil and gas sales	\$ 103,712	\$ 6,884	\$ —	\$ 253	\$ 110,849
Gas marketing sales	—	34,973	—	(6,545)	28,428
Oil and gas service operations	6,314	—	—	—	6,314
Interest and other	1,917	238	1,676	—	3,831
	111,943	42,095	1,676	(6,292)	149,422
COSTS AND EXPENSES:					
Production expenses and taxes	7,557	746	—	—	8,303
Gas marketing expenses	—	33,744	—	(6,292)	27,452
Oil and gas service operations	4,895	—	—	—	4,895
Oil and gas depreciation, depletion and amortization	48,333	2,566	—	—	50,899
Other depreciation and amortization	1,924	73	1,160	—	3,157
General and administrative	3,683	496	649	—	4,828
Interest and other	508	711	12,460	—	13,679
	66,900	38,336	14,269	(6,292)	113,213
Income (loss) before income taxes	45,043	3,759	(12,593)	—	36,209
Income tax expense (benefit)	15,990	1,335	(4,471)	—	12,854
Net income (loss)	\$ 29,053	\$ 2,424	\$ (8,122)	\$ —	\$ 23,355
For the Year Ended June 30, 1995:					
REVENUES:					
Oil and gas sales	\$ 55,417	\$ 1,566	\$ —	\$ —	\$ 56,983
Oil and gas service operations	8,836	—	—	—	8,836
Interest and other	1,394	—	130	—	1,524
	65,647	1,566	130	—	67,343
COSTS AND EXPENSES:					
Production expenses and taxes	4,045	211	—	—	4,256
Oil and gas service operations	7,747	—	—	—	7,747
Oil and gas depreciation, depletion and amortization	24,775	635	—	—	25,410
Other depreciation and amortization	1,245	5	515	—	1,765
General and administrative	2,620	58	900	—	3,578
Interest and other	570	184	5,873	—	6,627
	41,002	1,093	7,288	—	49,383
Income (loss) before income taxes	24,645	473	(7,158)	—	17,960
Income tax expense (benefit)	8,639	165	(2,505)	—	6,299
Net Income (loss)	\$ 16,006	\$ 308	\$ (4,653)	\$ —	\$ 11,661

CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

CONDENSED CONSOLIDATING STATEMENTS OF CASH FLOWS
(\$ in thousands)

	<u>Guarantor Subsidiaries</u>	<u>Non-Guarantor Subsidiaries</u>	<u>Company (Parent)</u>	<u>Eliminations</u>	<u>Consolidated</u>
For the Year Ended June 30, 1997:					
CASH FLOWS FROM OPERATING ACTIVITIES	\$ 165,850	\$(11,008)	\$ (70,753)	\$ —	\$ 84,089
CASH FLOWS FROM INVESTING ACTIVITIES					
Oil and gas properties	(468,519)	57	—	—	(468,462)
Proceeds from sale of assets	9,523	—	—	—	9,523
Investment in service operations	(3,048)	—	—	—	(3,048)
Long-term loans to third parties	(2,000)	—	(18,000)	—	(20,000)
Other investments	—	—	(8,000)	—	(8,000)
Other additions	(24,318)	(1,999)	(7,550)	—	(33,867)
	<u>(488,362)</u>	<u>(1,942)</u>	<u>(33,550)</u>	<u>—</u>	<u>(523,854)</u>
CASH FLOWS FROM FINANCING ACTIVITIES:					
Proceeds from borrowings	50,000	—	292,626	—	342,626
Payments on borrowings	(118,901)	—	(680)	—	(119,581)
Exercise of stock options	—	—	1,387	—	1,387
Issuance of common stock	—	—	288,091	—	288,091
Other financing	—	—	(379)	—	(379)
Intercompany advances, net	380,735	14,645	(395,380)	—	—
	<u>311,834</u>	<u>14,645</u>	<u>185,665</u>	<u>—</u>	<u>512,144</u>
Net increase (decrease) in cash and cash equivalents	(10,678)	1,695	81,362	—	72,379
Cash, beginning of period	4,144	2,668	44,826	—	51,638
Cash, end of period	<u>\$ (6,534)</u>	<u>\$ 4,363</u>	<u>\$ 126,188</u>	<u>\$ —</u>	<u>\$ 124,017</u>
For the Year Ended June 30, 1996:					
CASH FLOWS FROM OPERATING ACTIVITIES	\$ 126,868	\$ 4,204	\$ (10,100)	\$ —	\$ 120,972
CASH FLOWS FROM INVESTING ACTIVITIES					
Oil and gas properties	(341,246)	(6,099)	—	5,300	(342,045)
Proceeds from sales	12,165	—	—	(5,300)	6,865
Investment in gas marketing company	—	266	(629)	—	(363)
Other additions	(4,683)	(109)	(4,054)	—	(8,846)
	<u>(333,764)</u>	<u>(5,942)</u>	<u>(4,683)</u>	<u>—</u>	<u>(344,389)</u>
CASH FLOWS FROM FINANCING ACTIVITIES:					
Proceeds from borrowings	40,350	10,300	116,017	—	166,667
Payments on borrowings	(45,397)	(3,200)	(37)	—	(48,634)
Exercise of stock options	—	—	1,989	—	1,989
Issuance of common stock	—	—	99,498	—	99,498
Intercompany advances, net	162,777	(2,616)	(160,161)	—	—
	<u>157,730</u>	<u>4,484</u>	<u>57,306</u>	<u>—</u>	<u>219,520</u>
Net increase (decrease) in cash and cash equivalents	(49,166)	2,746	42,523	—	(3,897)
Cash, beginning of period	53,227	5	2,303	—	55,535
Cash, end of period	<u>\$ 4,061</u>	<u>\$ 2,751</u>	<u>\$ 44,826</u>	<u>\$ —</u>	<u>\$ 51,638</u>
For the Year Ended June 30, 1995:					
CASH FLOWS FROM OPERATING ACTIVITIES	\$ 60,049	\$ 305	\$ (4,692)	\$ (931)	\$ 54,731
CASH FLOWS FROM INVESTING ACTIVITIES:					
Oil and gas properties	(113,722)	(4,109)	—	—	(117,831)
Proceeds from sales	24,557	—	—	(11,500)	13,057
Purchase of oil and gas properties	—	(11,500)	—	11,500	—
Other additions	(7,929)	—	—	—	(7,929)
	<u>(97,094)</u>	<u>(15,609)</u>	<u>—</u>	<u>—</u>	<u>(112,703)</u>
CASH FLOWS FROM FINANCING ACTIVITIES:					
Proceeds from borrowings	30,034	11,500	87,300	—	128,834
Payments on borrowings	(32,032)	(700)	362	—	(32,370)
Intercompany advances, net	78,324	4,509	(83,764)	931	—
Other financing	—	—	818	—	818
	<u>76,326</u>	<u>15,309</u>	<u>4,716</u>	<u>931</u>	<u>97,282</u>
Net increase (decrease) in cash and cash equivalents	39,281	5	24	—	39,310
Cash, beginning of period	13,946	—	2,279	—	16,225
Cash, end of period	<u>\$ 53,227</u>	<u>\$ 5</u>	<u>\$ 2,303</u>	<u>\$ —</u>	<u>\$ 55,535</u>

CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

3. Notes Payable and Long-Term Debt

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

	June 30,	
	1997	1996
	(\$ in thousands)	
7.875% Senior Notes (see Note 2)	\$150,000	\$ —
Discount on 7.875% Senior Notes	(115)	—
8.5% Senior Notes (see Note 2)	150,000	—
Discount on 8.5% Senior Notes	(862)	—
9.125% Senior Notes (see Note 2)	120,000	120,000
Discount on 9.125% Senior Notes	(73)	(81)
10.5% Senior Notes (see Note 2)	90,000	90,000
12% Senior Notes	—	47,500
Discount on 12% Senior Notes	—	(1,772)
Term note payable to Union Bank collateralized by CGDC, not guaranteed by the Company, variable interest at Union Bank's base rate (8.25% per annum at June 30, 1996), or at Eurodollar rate +1.875% collateralized by CGDC's producing oil and gas properties, payable in monthly installments through November 2002	—	12,900
Note payable to a vendor, collateralized by oil and gas tubulars, payments due 60 days from shipment of the tubulars	1,380	3,156
Note payable to a bank, variable interest at a referenced base rate + 1.75% (10% per annum at June 30, 1996), collateralized by office buildings, payments due in monthly installments through May 1998	—	680
Notes payable to various entities to acquire oil service equipment, interest varies from 7% to 11% per annum, collateralized by equipment, payments due in monthly installments through December 2000	—	1,212
Other collateralized	—	1,469
Other unsecured	—	122
Total notes payable and long-term debt	510,330	275,186
Less — Current maturities	(1,380)	(6,755)
Notes payable and long-term debt, net of current maturities	\$508,950	\$268,431

The aggregate scheduled maturities of notes payable and long-term debt for the next five fiscal years ending June 30, 2002 and thereafter were as follows as of June 30, 1997 (in thousands of dollars):

1998	\$ 1,380
1999	—
2000	—
2001	—
2002	90,000
After 2002	418,950
	\$510,330

During the quarter ended December 31, 1996, the Company exercised its covenant defeasance rights with respect to all of its outstanding \$47.5 million of 12% Senior Notes due 2001. A combination of cash and non-

CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

callable U.S. Government Securities in the amount of \$55.0 million was irrevocably deposited in trust to satisfy the Company's obligations, including accrued but unpaid interest through the date of defeasance of \$1.3 million.

4. Contingencies and Commitments

The Company and certain of its officers and directors are currently involved in various purported class actions alleging violations of the Securities Exchange Act of 1934. The plaintiffs assert that the defendants made materially false and misleading statements and failed to disclose material facts about the success of the Company's exploration efforts, principally in the Louisiana Trend. As a result, the complaints allege, the price of the Company's common stock was artificially inflated during periods beginning as early as January 25, 1996 and ending on June 27, 1997, when the Company issued a press release announcing disappointing drilling results in the Louisiana Trend and a full-cost ceiling writedown to be reflected in its June 30, 1997 financial statements. The plaintiffs further allege that certain of the named individual defendants sold common stock during the class period when they knew or should have known adverse nonpublic information. Each case seeks a determination that the suit is a proper class action, certification of the plaintiff as a class representative and damages in an unspecified amount, together with costs of litigation, including attorneys' fees. The Company and the individual defendants believe that these actions are without merit, and intend to defend against them vigorously.

On October 15, 1996, Union Pacific Resources Company ("UPRC") filed suit against the Company in the U.S. District Court for the Northern District of Texas, Fort Worth Division alleging (a) infringement and inducing infringement of UPRC's claim to a patent (the "UPRC Patent") for an invention involving a method of maintaining a borehole in a stratigraphic zone during drilling, and (b) tortious interference with certain business relations between UPRC and certain of its former employees. UPRC's claims against the Company are based on services provided by a third party vendor to the Company. UPRC is seeking injunctive relief, damages of an unspecified amount, including actual, enhanced, consequential and punitive damages, interest, costs and attorneys' fees. The Company believes that it has meritorious defenses to UPRC's allegations and has requested the court to declare the UPRC Patent invalid. The Company has also filed a motion to limit the scope of UPRC's claims and for summary judgment. No prediction can be made as to the outcome of the matter.

The Company is currently involved in various other routine disputes incidental to its business operations. 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 such 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.

The Company has employment contracts with its two principal shareholders and its chief financial officer and various other senior management personnel 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. These agreements expire at various times from June 30, 1998 through June 30, 2000.

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 material environmental issues or claims.

As of June 30, 1997, the Company had guaranteed \$1.3 million of debt owed by Peak.

CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

5. Income Taxes

The components of the income tax provision (benefit) for each of the periods are as follows:

	Year Ended June 30,		
	1997	1996	1995
	(\$ in thousands)		
Current	\$ —	\$ —	\$ —
Deferred	(3,573)	12,854	6,299
Total	<u>\$ (3,573)</u>	<u>\$ 12,854</u>	<u>\$ 6,299</u>

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

	Year Ended June 30,		
	1997	1996	1995
	(\$ in thousands)		
Computed "expected" income tax provision (benefit)	\$(63,116)	\$12,673	\$6,286
Tax percentage depletion	(294)	(238)	(144)
Valuation allowance	64,116	—	—
State income taxes and other	(4,279)	419	157
	<u>\$ (3,573)</u>	<u>\$ 12,854</u>	<u>\$ 6,299</u>

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:

	Year Ended June 30,		
	1997	1996	1995
	(\$ in thousands)		
Deferred tax liabilities:			
Acquisition, exploration and development costs and related depreciation, depletion and amortization	\$(49,831)	\$(63,725)	\$(31,220)
Deferred tax assets:			
Net operating loss carryforwards	112,889	50,776	23,414
Percentage depletion carryforward	1,058	764	526
	<u>113,947</u>	<u>51,540</u>	<u>23,940</u>
Net deferred tax asset (liability)	\$ 64,116	\$(12,185)	\$ (7,280)
Less: Valuation allowance	(64,116)	—	—
Total deferred tax asset (liability)	<u>\$ —</u>	<u>\$ (12,185)</u>	<u>\$ (7,280)</u>

SFAS 109 requires that the Company record a valuation allowance when it is more likely than not that some portion or all of the deferred tax assets will not be realized. In the fourth quarter of fiscal 1997, the Company recorded a \$236 million write-down related to the impairment of oil and gas properties. This write-down and significant tax net operating loss carryforwards (caused primarily by expensing intangible drilling costs for tax purposes) result in a net deferred tax asset at June 30, 1997. Management believes it is more likely than not that the Company will generate future tax net operating losses for at least the next five years, based in part on the Company's continued drilling efforts. Therefore, the Company has recorded a valuation allowance equal to the net deferred tax asset.

CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES
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At June 30, 1997, the Company had regular tax net operating loss carryforwards of approximately \$300 million and alternative minimum tax net operating loss carryforwards of approximately \$45 million. These loss carryforward amounts will expire during the years 2007 through 2012. The Company also had a percentage depletion carryforward of approximately \$2.8 million at June 30, 1997, which is available to offset future federal income taxes payable and has no expiration date.

In accordance with certain provisions of the Tax Reform Act of 1986, a change of greater than 50% of the beneficial ownership of the Company within a three-year period (an "Ownership Change") would place an annual limitation on the Company's ability to utilize its existing tax carryforwards. Under regulations issued by the Internal Revenue Service, the Company has had an Ownership Change. However, management believes this will not result in a significant limitation of the utilization of the tax carryforwards.

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, 1997, 1996 and 1995 the Company had accounts receivable for these costs of \$7.4 million, \$2.9 million and \$4.4 million, respectively.

During fiscal 1997, 1996 and 1995 the Company incurred legal expenses of \$207,000, \$347,000 and \$516,000, respectively, for legal services provided by the law firm of which a director is a member.

7. Employee Benefit Plans

The Company maintains the Chesapeake Energy Corporation Savings and Incentive Stock Bonus Plan, a 401(k) profit sharing plan. Eligible employees may make voluntary contributions to the plan which are matched by the Company up to 10% of the employees' annual salary with the Company's common stock. The amount of employee contributions is limited as specified in the plan. The Company may, at its discretion, make additional contributions to the plan. The Company contributed \$603,000, \$187,000 and \$95,000 to the plan during the fiscal years ended June 30, 1997, 1996 and 1995, respectively.

8. Major Customers

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

<u>Year</u>		<u>Amount</u> (\$ in thousands)	<u>Percent of</u> <u>oil and gas sales</u>
1997	Aquila Southwest Pipeline Corporation	\$53,885	28%
	Koch Oil Company	\$29,580	15%
	GPM Gas Corporation	\$27,682	14%
1996	Aquila Southwest Pipeline Corporation	\$41,900	38%
	GPM Gas Corporation	\$28,700	26%
	Wickford Energy Marketing, L.C.	\$18,500	17%
1995	Aquila Southwest Pipeline Corporation	\$18,548	33%
	Wickford Energy Marketing, L.C.	\$15,704	28%
	GPM Gas Corporation	\$11,686	21%

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.

CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

9. Stockholders' Equity And Stock Based Compensation

On December 2, 1996, the Company completed a public offering of 8,972,000 shares of Common Stock at a price of \$33.63 per share, which resulted in net proceeds to the Company of approximately \$288.1 million.

On April 12, 1996 the Company completed a public offering of 5,989,500 shares of Common Stock at a price of \$17.67 per share, resulting in net proceeds to the Company of approximately \$99.4 million.

A 2-for-1 stock split of the Common Stock in December 1994, a 3-for-2 stock split of the Common Stock in December 1995 and June 1996, and a 2-for-1 stock split of the Common Stock in December 1996 have 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 3,762,000 shares. The maximum period for exercise of an option may not be more than 10 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 the 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 16, 1994.

Under the Company's 1992 Nonstatutory Stock Option Plan (the "NSO Plan"), non-qualified 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 3,132,000 shares. The maximum period for exercise of an option may not be more than 10 years from the date of grant, and the exercise price may not be less than the fair market value of the shares underlying the 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.

Under the Company's 1994 Stock Option Plan (the "1994 Plan"), and its 1996 Stock Option Plan (the "1996 Plan"), incentive and nonqualified stock options to purchase Common Stock may be granted to employees of the Company and its subsidiaries. Subject to any adjustment as provided by the respective plans, the aggregate number of shares which may be issued and sold may not exceed 4,886,910 shares under the 1994 Plan and 6,000,000 shares under the 1996 Plan. The maximum period for exercise of an option may not be more than 10 years from the date of grant, and the exercise price may not be less than the fair market value of the shares underlying the 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 1994 Plan after December 16, 2004 or under the 1996 Plan after October 14, 2006.

The Company has elected to follow APB No. 25, Accounting for Stock Issued to Employees and related Interpretations in accounting for its employee stock options. Under APB No. 25, compensation expense is recognized for the difference between the option price and market value on the measurement date. No compensation expense has been recognized because the exercise price of the stock options equaled the market price of the underlying stock on the date of grant.

Pro forma information regarding net income and earnings per share is required by SFAS No. 123 and has been determined as if the Company had accounted for its employee stock options under the fair value method of the Statement. The fair value for these options was estimated at the date of grant using a Black-Scholes option pricing model with the following weighted-average assumptions for fiscal 1997 and 1996, respectively:

CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

interest rates (zero-coupon U.S. government issues with a remaining life equal to the expected term of the options) of 6.74% and 6.21%; dividend yields of 0.9% and 0.9%; volatility factors of the expected market price of the Company's common stock of .60 and .60; and weighted-average expected life of the options of four years.

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because the Company's employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options.

The Company's pro forma information follows:

	Year Ended June 30,	
	1997	1996
	(In thousands, except per share amounts)	
Net Income (Loss)		
As reported	\$(183,377)	\$23,355
Pro forma	(190,160)	22,081
Earnings (Loss) per Share		
As reported	\$ (2.79)	\$ 0.40
Pro forma	(2.89)	0.38

For purposes of the pro forma disclosures, the estimated fair value of the options is amortized to expense over the options' vesting period, which is four years. Because the Company's stock options vest generally over four years and additional awards are typically made each year, the above pro forma disclosures are not likely to be representative of the effects on pro forma net income for future years. A summary of the Company's stock option activity and related information follows:

	Year Ended June 30,					
	1997		1996		1995	
	Options	Weighted-Avg Exercise Price	Options	Weighted-Avg Exercise Price	Options	Weighted-Avg Exercise Price
Outstanding — Beginning of Year	7,602,884	\$ 4.66	6,828,592	\$1.97	5,033,340	\$0.72
Granted	3,564,884	19.35	2,426,850	9.98	3,185,550	3.38
Exercised	(1,197,998)	1.95	(1,574,046)	1.31	(1,288,732)	0.67
Forfeited	(2,066,111)	22.26	(78,512)	2.61	(101,566)	0.92
Outstanding — End of Year	7,903,659	7.09	7,602,884	4.66	6,828,592	1.97
Exercisable — End of Year	3,323,824		2,974,386		2,489,742	
Shares Authorized for Future Grants	5,212,056		713,826		3,102,982	
Fair Value of Options Granted During the Year		\$ 7.51		\$4.84		N/A

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The following table summarizes information about stock options outstanding at June 30, 1997:

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Number Outstanding 6/30/97	Weighted-Avg. Remaining Contractual Life	Weighted-Avg. Exercise Price	Number Exercisable 6/30/97	Weighted-Avg. Exercise Price
\$ 0.56-\$ 0.67	843,767	5.36	\$ 0.59	843,767	\$ 0.59
\$ 0.71-\$ 1.33	784,116	4.36	\$ 1.00	784,116	\$ 1.00
\$ 2.25-\$ 2.25	1,128,883	7.30	\$ 2.25	406,183	\$ 2.25
\$ 2.43-\$ 4.92	408,689	7.43	\$ 3.15	394,159	\$ 3.08
\$ 4.92-\$ 4.92	974,910	7.82	\$ 4.92	390,774	\$ 4.92
\$ 5.67-\$ 5.67	1,213,534	8.17	\$ 5.67	217,140	\$ 5.67
\$ 6.47-\$ 6.47	180,000	8.28	\$ 6.47	180,000	\$ 6.47
\$14.25-\$14.25	1,513,010	9.82	\$14.25	0	\$ 0.00
\$14.75-\$25.88	756,750	6.30	\$17.85	7,685	\$17.67
\$30.63-\$30.63	100,000	9.27	\$30.63	100,000	\$30.63
\$ 0.56-\$30.63	7,903,659	7.44	\$ 7.09	3,323,824	\$ 3.29

The exercise of certain stock options results in state and federal income tax benefits to the Company related to the difference between the market price of the Common Stock at the date of disposition (or sale) and the option price. During fiscal 1997, 1996 and 1995, \$4,808,000, \$7,950,000 and \$1,229,000, respectively, were recorded as adjustments to additional paid-in capital and deferred income taxes with respect to such tax benefits.

10. Financial Instruments and Hedging Activities

The Company has only limited involvement with derivative financial instruments, as defined in Statement of Financial Accounting Standards No. 119 "Disclosure About Derivative Financial Instruments and Fair Value of Financial Instruments" and does not use them for trading purposes. The Company's objective is to hedge a portion of its exposure to price volatility from producing crude oil and natural gas. These arrangements may expose the Company to credit risk from its counterparties and to basis risk. The Company does not expect that the counterparties will fail to meet their obligations given their high credit ratings.

Hedging Activities

Periodically the Company utilizes hedging strategies to hedge the price of a portion of its future oil and gas production. These strategies include (1) swap arrangements that establish an index-related price above which the Company pays the counterparty and below which the Company is paid by the counterparty, (2) the purchase of index-related puts that provide for a "floor" price below which the counterparty pays the Company the amount by which the price of the commodity is below the contracted floor, (3) the sale of index-related calls that provide for a "ceiling" price above which the Company pays the counterparty the amount by which the price of the commodity is above the contracted ceiling, and (4) basis protection swaps. Results from hedging transactions are reflected in oil and gas sales to the extent related to the Company's oil and gas production. The Company has not entered into hedging transactions unrelated to the Company's oil and gas production or physical purchase or sale commitments.

CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

As of June 30, 1997, the Company had the following oil swap arrangements for periods after June 1997:

<u>Month</u>	<u>Volume (Bbls)</u>	<u>NYMEX-Index Strike Price (per Bbl)</u>
July 1997	31,000	\$18.60
August 1997	31,000	\$18.43
September 1997	30,000	\$18.30
October 1997	31,000	\$18.19
November 1997	30,000	\$18.13
December 1997	31,000	\$18.08
January through June 1998	724,000	\$19.82

The Company entered into oil swap arrangements to cancel the effect of the swaps for the months of August through December at an average price of \$21.07 per Bbl.

As of June 30, 1997, the Company had the following gas swap arrangements for periods after June 1997:

<u>Months</u>	<u>Volume (MMBtu)</u>	<u>Houston Ship Channel Index Strike Price (per MMBtu)</u>
July 1997	1,240,000	\$2.313
August 1997	1,240,000	\$2.301
September 1997	1,200,000	\$2.285
October 1997	1,240,000	\$2.300

The Company entered into gas swap arrangements to cancel the effect of the swaps for the months of July through October at an average price of \$2.133 per MMBtu.

The Company has entered into a curve lock for 4.9 Bcf of gas which allows the Company the option to hedge April 1999 through November 1999 gas based upon a negative \$0.285 differential to December 1998 gas any time between the strike date and December 1998.

Gains or losses on the crude oil and natural gas hedging transactions are recognized as price adjustments in the month of related production. The Company estimates that had all of the crude oil and natural gas swap agreements in effect for production periods beginning July 1, 1997 terminated on June 30, 1997, based on the closing prices for NYMEX futures contracts as of that date, the Company would have paid the counterparty approximately \$185,000, which would have represented the "fair value" at that date. These agreements were not terminated. The fair value of hedging instruments at June 30, 1996 was a loss of approximately \$4.6 million.

Periodically, the Company's oil and gas marketing subsidiary CEMI enters into various hedging transactions designed to hedge against physical purchase commitments made by CEMI. Gains or losses on these transactions are recorded as adjustments to Oil and Gas Marketing Sales in the consolidated statements of operations and are not considered by management to be material.

Concentration of Credit Risk

Other financial instruments which potentially subject the Company to concentrations of credit risk consist principally of cash, short-term investments in debt instruments and trade receivables. The Company's accounts receivable are primarily from purchasers of oil and natural gas products and exploration and production companies which own interests in properties operated by the Company. The industry concentration has the potential to impact the Company's overall exposure to credit risk, either positively or negatively, in that the customers may be similarly affected by changes in economic, industry or other conditions. The Company generally requires letters of credit for receivables from customers which are not considered

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

investment grade, unless the credit risk can otherwise be mitigated. The cash and investments in debt securities are with major banks or institutions with high credit ratings.

Fair Value of Financial Instruments

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

The carrying values of items comprising current assets and current liabilities approximate fair values due to the short-term maturities of these instruments. The carrying value of financial instruments included in noncurrent other assets approximates fair value at June 30, 1997. The Company estimates the fair value of its long-term, fixed-rate debt using quoted market prices. The Company's carrying amount for such debt at June 30, 1997 and 1996 was \$508.9 million and \$255.6 million, respectively, compared to approximate fair values of \$514.1 million and \$261.2 million, respectively. The carrying value of other long-term debt approximates its fair value as interest rates are primarily variable, based on prevailing market rates.

11. 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:

	June 30,	
	1997	1996
	(\$ in thousands)	
Oil and gas properties:		
Proved	\$865,516	\$363,213
Unproved	128,505	165,441
Total	994,021	528,654
Less accumulated depreciation, depletion and amortization	(431,983)	(92,720)
Net capitalized costs	\$562,038	\$435,934

Unproved properties not subject to amortization at June 30, 1997 and 1996 consisted mainly of lease acquisition costs. The Company capitalized approximately \$12,935,000 and \$6,428,000 of interest during the years ended June 30, 1997 and 1996 on significant investments in unproved properties that were not being depreciated, depleted, or amortized and on which exploration or development activities were not 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.

CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

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:

	June 30,		
	1997	1996	1995
	(\$ in thousands)		
Development costs	\$187,736	\$138,188	\$ 78,679
Exploration costs	136,473	39,410	14,129
Acquisition costs:			
Unproved properties	140,348	138,188	24,437
Proved properties	—	24,560	—
Capitalized intenal costs	3,905	1,699	586
Proceeds from sale of leasehold, equipment and other	(3,095)	(6,167)	(11,953)
Total	<u>\$465,367</u>	<u>\$335,878</u>	<u>\$105,878</u>

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, 1997, 1996 and 1995, 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.

	June 30,		
	1997	1996	1995
	(\$ in thousands)		
Oil and gas sales	\$ 192,920	\$110,849	\$ 56,983
Production costs (a)	(15,107)	(8,303)	(4,256)
Impairment of oil and gas properties	(236,000)	—	—
Depletion and depreciation	(103,264)	(50,899)	(25,410)
Imputed income tax (provision) benefit(b)	60,544	(18,335)	(9,561)
Results of operations from oil and gas producing activities	<u>\$(100,907)</u>	<u>\$ 33,312</u>	<u>\$ 17,756</u>

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

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

Capitalized costs, less accumulated amortization and related deferred income taxes, shall not exceed an amount equal to the sum of the present value of estimated future net revenues less estimated future expenditures to be incurred in developing and producing the proved reserves, less any related income tax effects. At June 30, 1997, capitalized costs of oil and gas properties exceeded the estimated present value of future net revenues for the Company's proved reserves, net of related income tax considerations, resulting in a fourth quarter writedown in the carrying value of oil and gas properties of \$236 million.

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") and the Company's petroleum engineers as of June 30, 1997, 1996 and 1995. The reserves evaluated internally by the Company constituted

CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

approximately 50.0%, 0.6% and 0.5% of total proved reserves as of June 30, 1997, 1996 and 1995, respectively. 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. All of the Company's oil and gas reserves are located in the United States.

Presented below is a summary of changes in estimated reserves of the Company based upon the reports prepared by Williamson and the Company's petroleum engineers for 1997, 1996 and 1995:

	June 30,					
	1997		1996		1995	
	<u>Oil (MBbl)</u>	<u>Gas (MMcf)</u>	<u>Oil (MBbl)</u>	<u>Gas (MMcf)</u>	<u>Oil (MBbl)</u>	<u>Gas (MMcf)</u>
Proved reserves, beginning of year	12,258	351,224	5,116	211,808	4,154	117,066
Extensions, discoveries and other additions	13,874	147,485	8,781	158,052	2,549	138,372
Revisions of previous estimate	(5,989)	(137,938)	(669)	12,987	(448)	(18,516)
Production	(2,770)	(62,005)	(1,413)	(51,710)	(1,139)	(25,114)
Sale of reserves-in-place	—	—	—	—	—	—
Purchase of reserves-in-place	—	—	443	20,087	—	—
Proved reserves, end of year	<u>17,373</u>	<u>298,766</u>	<u>12,258</u>	<u>351,224</u>	<u>5,116</u>	<u>211,808</u>
Proved developed reserves, end of year	<u>7,324</u>	<u>151,879</u>	<u>3,648</u>	<u>144,721</u>	<u>1,973</u>	<u>77,764</u>

As of the fiscal year ended June 30, 1997, the Company recorded revisions to the previous years' reserve estimates of approximately six million barrels of oil and 138 million Mcf, or approximately 174 Bcfe. The reserve revisions are primarily attributable to the decrease in oil and gas pricing between periods, escalating development costs at June 30, 1997, and unfavorable developmental drilling and production results during fiscal 1997. Specifically, the Company recorded downward adjustments to proved reserves of 159 Bcfe in the Knox, Giddings and Louisiana Trend areas.

On April 30, 1996, the Company purchased interests in certain producing and non-producing oil and gas properties, including approximately 14,000 net acres of unevaluated leasehold, from Amerada Hess Corporation for \$37.8 million. The properties are located in the Knox and Golden Trend fields of southern Oklahoma, most of which are operated by the Company. In fiscal 1996 the reserves acquired from Amerada Hess Corporation were included in both "Extensions, discoveries and other additions" and "Purchase of reserves in-place". The fiscal 1996 presentation has been restated in the current year to remove the acquired reserves from "Extensions, discoveries and other additions" with a corresponding offset to "Revisions of previous estimate". This revision resulted in no net change to total oil and gas reserves.

In prior years, the Company reported "Extensions, discoveries and other additions" net of current year production related thereto. The Company began reporting this category inclusive of current year production in fiscal 1997 and restated fiscal 1996 and fiscal 1995 quantities accordingly. A corresponding change in fiscal

CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

1996 and fiscal 1995 was recorded to "Revisions of previous estimate" with no net change to year-end reserve quantities.

Standardized Measure of Discounted Future Net Cash Flows (unaudited)

Statement of Financial Accounting Standards No. 69 ("SFAS 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 69:

	June 30,		
	1997	1996	1995
	(\$ in thousands)		
Future cash inflows	\$ 954,839	\$1,101,642	\$ 427,377
Future production costs	(190,604)	(168,974)	(75,927)
Future development costs	(152,281)	(137,068)	(76,543)
Future income tax provision	<u>(104,183)</u>	<u>(135,543)</u>	<u>(51,789)</u>
Future net cash flows	507,771	660,057	223,118
Less effect of a 10% discount factor	<u>(92,273)</u>	<u>(198,646)</u>	<u>(63,207)</u>
Standardized measure of discounted future net cash flows	<u>\$ 415,498</u>	<u>\$ 461,411</u>	<u>\$ 159,911</u>

CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES
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The principal sources of change in the standardized measure of discounted future net cash flows are as follows:

	June 30,		
	1997	1996	1995
	(\$ in thousands)		
Standardized measure, beginning of year	\$ 461,411	\$ 159,911	\$118,608
Sales of oil and gas produced, net of production costs	(177,813)	(102,546)	(52,727)
Net changes in prices and production costs	(99,234)	88,729	(24,807)
Extensions and discoveries, net of production and development costs	287,068	275,916	108,644
Changes in future development costs	(12,831)	(11,201)	3,406
Development costs incurred during the period that reduced future development costs	46,888	43,409	23,678
Revisions of previous quantity estimates	(199,738)	12,728	(21,595)
Purchase of reserves-in-place	—	29,641	—
Accretion of discount	54,702	18,814	14,126
Net change in income taxes	63,719	(57,382)	(5,586)
Changes in production rates and other	(8,674)	3,392	(3,836)
Standardized measure, end of year	<u>\$ 415,498</u>	<u>\$ 461,411</u>	<u>\$159,911</u>

For an explanation of the reclassifications made to the standardized measure of discounted future net cash flows in fiscal 1996 and fiscal 1995, see discussion of Oil and Gas Reserve Quantities included above.

CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

12. Quarterly Financial Data (unaudited)

Summarized unaudited quarterly financial data for fiscal 1997 and 1996 are as follows (\$ in thousands except per share data):

	Quarter Ended			
	September 30, 1996	December 31, 1996	March 31, 1997	June 30, 1997
Net sales	\$48,937	\$71,249	\$79,809	\$ 69,097
Gross profit (loss) (a)	14,889	28,057	25,737	(241,686)
Net income (loss) before extraordinary item	8,204	10,274	15,928	(217,783)
Net income (loss) per share before extraordinary item:				
Primary .....	.13	.15	.22	(3.12)
Fully-diluted .....	.13	.15	.22	(3.12)

	Quarter Ended			
	September 30, 1995	December 31, 1995	March 31, 1996	June 30, 1996
Net sales	\$21,988	\$31,766	\$44,145	\$ 47,692
Gross profit(a)	6,368	11,368	14,741	13,580
Net income	2,915	5,459	7,623	7,358
Net income per share:				
Primary .....	.05	.10	.13	.12
Fully-diluted .....	.05	.09	.13	.12

(a) Total revenue excluding interest and other income, less total costs and expenses excluding interest and other expense.

Capitalized costs, less accumulated amortization and related deferred income taxes, can not exceed an amount equal to the sum of the present value of estimated future net revenues less estimated future expenditures to be incurred in developing and producing the proved reserves, less any related income tax effects. At June 30, 1997, capitalized costs of oil and gas properties exceeded the estimated present value of future net revenues for the Company's proved reserves, net of related income tax considerations, resulting in a fourth quarter writedown in the carrying value of oil and gas properties of \$236 million.

ITEM 9. *Changes in and Disagreements with Accountants on Accounting and Financial Disclosure*

Effective July 1, 1996, Price Waterhouse LLP sold its Oklahoma City practice to Coopers & Lybrand L.L.P. and resigned as the Company's independent accountants. The Company's decision to change independent accountants and retain Coopers & Lybrand L.L.P. was approved by the Audit Committee of the Board of Directors and by the Board of Directors. During the period Price Waterhouse LLP was engaged by the Company, Price Waterhouse LLP did not issue any report on the Company's financial statements containing an adverse opinion, disclaimer of opinion, or qualification. There were no disagreements between the Company and Price Waterhouse LLP on any matter of accounting principles or practices, financial statement disclosure or auditing scope or procedure, nor were there any reportable events.

PART III

ITEM 10. *Directors and Executive Officers of the Registrant*

Information Regarding Directors

Pursuant to provisions of the Company's Certificate of Incorporation and Bylaws, the Board of Directors has fixed the number of directors at seven. The Company's Certificate of Incorporation and Bylaws provide for three classes of directors serving staggered three-year terms, with each class to be as nearly equal in number as possible. The Board of Directors has nominated Breene M. Kerr and Walter C. Wilson for re-election as directors at the Company's annual meeting of shareholders scheduled to be held on December 12, 1997. The following information is furnished for each person who is a director of the Company.

Nominees for Re-election as Directors for Terms Expiring in 2000

Breene M. Kerr, age 68, has been a director of the Company since 1993. In 1969, he founded Kerr Consolidated, Inc. and remains Chairman and President of this private company with investments in the oil and gas and trucking industries. Additionally, in 1969, Mr. Kerr co-founded the Resource Analysis and Management Group and remained its senior partner until 1982. From 1967 to 1969, he was Vice President of Kerr-McGee Chemical Corporation. From 1951 through 1967, Mr. Kerr worked for Kerr-McGee Corporation as a geologist and land manager. Mr. Kerr has served as Chairman of the Investment Committee for the Massachusetts Institute of Technology and is a life member of the Corporation (Board of Trustees) of that university. He served as a director of Kerr-McGee Corporation from 1957 to 1981. Mr. Kerr currently is a trustee and serves on the Investment Committee of the Brookings Institute in Washington, D.C., and has been an associate director since 1987 of Aven Gas & Oil, Inc., an oil and gas property management company located in Oklahoma City. Mr. Kerr graduated in 1951 from the Massachusetts Institute of Technology.

Walter C. Wilson, age 62, has been a director of the Company since 1993. From 1963 to 1974 and from 1978 to 1997, Mr. Wilson was a general agent with Massachusetts Mutual Life Insurance Company. From 1974 to 1978, he was Senior Vice President of Massachusetts Mutual Life Insurance Company, and from 1958 to 1963, he was an agent with that company. Mr. Wilson is a member of the Board of Trustees of Springfield College in Springfield, Massachusetts, and is a director of Earth Satellite Corporation of Rockville, Maryland and Amerac Energy Corporation of Houston, Texas. Mr. Wilson graduated in 1958 from Dartmouth College.

Directors Whose Terms Expire in 1998

Tom L. Ward, age 38, has served as President, Chief Operating Officer, and a director of the Company since its inception in 1989. From 1982 to 1989, Mr. Ward was an independent producer of oil and gas in affiliation with Aubrey K. McClendon, the Company's Chairman and Chief Executive Officer. Mr. Ward is a member of the Board of Trustees of Anderson University in Anderson, Indiana. Mr. Ward graduated from the University of Oklahoma in 1981.

E. F. Heizer, Jr., age 68, has been a director of the Company since 1993. From 1985 to the present, Mr. Heizer has been a private venture capitalist. He founded Heizer Corp., an American Stock Exchange-

listed business development company, in 1969 and served as Chairman and Chief Executive Officer from 1969 until 1986, when Heizer Corporation was reorganized into a number of public and private companies. Mr. Heizer was assistant treasurer of the Allstate Insurance Company from 1962 to 1969. He was employed by Booz, Allen and Hamilton from 1958 to 1962, Kidder, Peabody & Co. from 1956 to 1958, and Arthur Andersen & Co. from 1954 to 1956. He serves on the advisory board of the Kellogg School of Management at Northwestern University and the Executive Committee of Yale Law School. Mr. Heizer is a director of Amdahl Corporation in Santa Clara, California, Material Science Corporation, Elk Grove, Illinois, and numerous private companies. Mr. Heizer graduated in 1951 from Northwestern University and from Yale University Law School in 1954.

Frederick B. Whittemore, age 66, has been a director of the Company since 1993. Mr. Whittemore has been an advisory director of Morgan Stanley & Co. since 1989 and was a managing director of Morgan Stanley & Co. from 1970 to 1989. He was Vice-Chairman of the American Stock Exchange from 1982 to 1984. Mr. Whittemore was a partner with Morgan Stanley & Co. from 1967 to 1970 and an associate from 1958 to 1967. Mr. Whittemore is a director of Integon Insurance Company in Winston-Salem, North Carolina, Partner Reinsurance Company, Limited in Bermuda and Southern Pacific Petroleum, N.L. of Sydney, Australia. Mr. Whittemore graduated in 1953 from Dartmouth College and from the Amos Tuck School of Business Administration in 1954.

Directors Whose Terms Expire in 1999

Aubrey K. McClendon, age 38, has served as Chairman of the Board, Chief Executive Officer and director of the Company since its inception in 1989. From 1982 to 1989, Mr. McClendon was an independent producer of oil and gas in affiliation with Tom L. Ward, the Company's President and Chief Operating Officer. Mr. McClendon is a member of the Board of Visitors of the Fuqua School of Business at Duke University, an Executive Committee member of the Texas Independent Producers and Royalty Owners Association, a director of the Oklahoma Independent Petroleum Association, and a director of the Louisiana Independent Oil and Gas Association. Mr. McClendon is a 1981 graduate of Duke University.

Shannon T. Self, age 41, has been a director of the Company since 1993. He is a shareholder of Self, Giddens & Lees, Inc., Attorneys at Law, in Oklahoma City, which he co-founded in 1991. Mr. Self was an associate and shareholder in the law firm of Hastie and Kirschner, Oklahoma City, from 1984 to 1991 and was employed by Arthur Young & Co. from 1979 to 1980. Mr. Self is a certified public accountant. He graduated from the University of Oklahoma in 1979 and from Northwestern University Law School in 1984.

Information Regarding Officers

Executive Officers

In addition to Messrs. McClendon and Ward, the following are also executive officers of the Company.

Marcus C. Rowland, age 45, was appointed Senior Vice President - Finance and Chief Financial Officer in September 1997. He served as Vice President - Finance and Chief Financial Officer from 1993 to 1997. From 1990 until his association with the Company, Mr. Rowland was Chief Operating Officer of Anglo-Suisse, L.P. assigned to the White Nights Russian Enterprise, a joint venture of Anglo-Suisse, L.P. and Phibro Energy Corporation, a major foreign operation which was granted the right to engage in oil and gas operations in Russia. Prior to his association with White Nights Russian Enterprise, Mr. Rowland owned and managed his own oil and gas company and prior to that was Chief Financial Officer of a private exploration company in Oklahoma City from 1981 to 1985. Mr. Rowland is a certified public accountant and graduated from Wichita State University in 1975.

Steven C. Dixon, age 39, has been Senior Vice President - Operations since 1995 and served as Vice President -Exploration from 1991 to 1995. Mr. Dixon was a self-employed geological consultant in Wichita, Kansas from 1983 through 1990. He was employed by Beren Corporation in Wichita, Kansas from 1980 to 1983 as a geologist. Mr. Dixon graduated from the University of Kansas in 1980.

J. Mark Lester, age 44, has been Senior Vice President - Exploration since 1995 and served as Vice President - Exploration from 1989 to 1995. From 1986 to 1989, Mr. Lester was employed by Messrs. McClendon and Ward. He was employed by various independent oil companies in Oklahoma City from 1980 to 1986, and was employed by Union Oil Company of California from 1977 to 1980 as a geophysicist. Mr. Lester graduated from Purdue University in 1975 and in 1977.

Henry J. Hood, age 37, was appointed Senior Vice President - Land and Legal in September 1997 and served as Vice President - Land and Legal from 1995. Mr. Hood was retained as a consultant to the Company during the two years prior to his joining the Company. He was associated with the law firm of Watson & McKenzie from 1987 to 1992. From 1991 to 1992, Mr. Hood was of counsel with the Oklahoma City law firm of White, Coffey, Galt & Fite. Mr. Hood is a member of the Oklahoma and Texas Bar Associations. Mr. Hood graduated from Duke University in 1982 and from the University of Oklahoma College of Law in 1985.

Ronald A. Lefaive, age 50, has served as Controller and Chief Accounting Officer since 1993. From 1991 until his association with the Company, Mr. Lefaive was Controller for Phibro Energy Production, Inc., an international exploration and production subsidiary of Phibro Energy, whose principal operations were located in Russia. From 1982 to 1991, Mr. Lefaive served as Assistant Controller, General Auditor and Manager of Management Information Systems at Conquest Exploration Company in Houston, Texas. Prior to joining Conquest, Mr. Lefaive held various financial staff and management positions with The Superior Oil Company from 1980 to 1982 and Shell Oil Company from 1975 to 1982. Mr. Lefaive is a certified public accountant and graduated from the University of Houston in 1975.

Martha A. Burger, age 44, has served as Treasurer since 1995 and as Treasurer and Human Resources Manager since 1996. From 1994 to 1995, she served in various accounting positions with the Company including Assistant Controller-Operations. From 1989 to 1993, Ms. Burger was employed by Hadson Corporation as Assistant Treasurer and from 1994 to 1995, served as Vice President and Controller of Hadson. Prior to joining Hadson, Ms. Burger was employed by Phoenix Resource Companies, Inc. as Assistant Treasurer and by Arthur Andersen & Co. Ms. Burger is a certified public accountant and graduated from the University of Central Oklahoma in 1982 and from Oklahoma City University in 1992.

Other Officers

Thomas S. Price, Jr., age 45, has served as Vice President - Corporate Development since 1992 and was a consultant to the Company during the prior two years. He was employed by Kerr-McGee Corporation, Oklahoma City, from 1988 to 1990 and by Flag-Redfern Oil Company in Oklahoma City from 1984 to 1988. Mr. Price graduated from the University of Central Oklahoma in 1983, from the University of Oklahoma in 1989, and from the American Graduate School of International Management in 1992.

Dale W. Bossert, age 53, has served as Vice President - Production since January 1997. Mr. Bossert was previously employed by Celsius Energy Company as Consulting General Manager - Canada in 1996 and by Union Pacific Resources Company of Fort Worth, Texas from 1978 serving in various capacities, including Vice President - Production from 1989 to 1993 and as Vice President - Exploration and Production Services from 1993 to 1995. Mr. Bossert graduated from the University of Alberta in 1966.

Charles W. Imes, age 50, has served as Vice President - Information Technology since 1997 and served as Director -Management Information Systems since 1993. From 1983 to 1993, Mr. Imes owned Imes Software Systems in Oklahoma City and served as a consultant and supplier of software to the Company from 1990 to 1993. Mr. Imes graduated from the University of Oklahoma in 1969.

Terry L. Kite, age 43, has served as Vice President - Information Technology since February 1997. From 1981 to 1996, Mr. Kite served in various positions in information technology at Amerada Hess Corporation in Houston, Texas, including Manager - Geoscience and Engineering Systems. Prior to joining Amerada Hess, Mr. Kite held information systems staff positions with Earth Science Programming in Tulsa from 1979 to 1980 and with Seismograph Service Corporation in Tulsa from 1976 to 1979. Mr. Kite graduated from the Colorado School of Mines in 1976.

Janice A. Dobbs, age 49, has served as Corporate Secretary and Compliance Manager since 1993. From 1975 until her association with the Company, Ms. Dobbs was the corporate/securities legal assistant with the law firm of Andrews Davis Legg Bixler Milsten & Price, Inc. in Oklahoma City. From 1973 to 1975, Ms. Dobbs was the Administrative Assistant to the President and General Counsel of Texas International Company, an oil and gas exploration and production company in Oklahoma City. Ms. Dobbs is a certified legal assistant, an associate member of the American Bar Association, a member of the American Society of Corporate Secretaries and the Society of Human Resources Management.

Section 16(a) Beneficial Ownership Reporting Compliance

Section 16(a) of the Securities Exchange Act of 1934 (the "Exchange Act") requires the Company's directors and executive officers and persons who beneficially own more than 10% of the Company's Common Stock to file reports of ownership and subsequent changes with the Securities and Exchange Commission.

Executive officers of the Company, Marcus C. Rowland, Steven C. Dixon, J. Mark Lester, Henry J. Hood, Ronald A. Lefaive and Martha A. Burger were late in filing Form 4's to report the cancelation of stock options and also failed to timely report on Form 5 options granted to replace such options.

Shannon T. Self, a director of the Company, has advised the Company that the acquisition of 52,000 shares of Common Stock acquired through the exercise of a stock option granted by the Company and the disposition of 50,000 of those shares were reported on a late filed Form 4.

ITEM 11. Executive Compensation

Summary Compensation Table

The following table sets forth for the last three fiscal years the cash compensation of (i) the Company's chief executive officer and (ii) the five other most highly compensated executive officers:

Name and Principal Position	Fiscal Year	Annual Compensation			Securities Underlying Option Awards (b) (# of Shares)	All Other Compensation (c)
		Salary	Bonus	Other Annual Compensation (a)		
Aubrey K. McClendon Chairman of the Board and Chief Executive Officer	1997	\$250,000	\$120,000	\$74,450	463,000	\$11,050
	1996	\$185,000	\$ 40,000	\$65,408	288,000	\$ 8,295
	1995	\$180,000	\$ 65,400	\$57,640	540,000	\$ 4,620
Tom L. Ward President and Chief Operating Officer	1997	\$250,000	\$120,000	\$75,408	463,000	\$13,700
	1996	\$185,000	\$ 40,000	\$66,850	288,000	\$ 8,368
	1995	\$180,000	\$ 65,400	\$57,340	540,000	\$ 4,620
Marcus C. Rowland Senior Vice President — Finance and Chief Financial Officer	1997	\$185,000	\$ 50,000	(d)	36,000	\$ 9,500
	1996	\$165,000	\$ 20,000	(d)	171,000	\$11,333
	1995	\$155,000	\$ 45,400	(d)	324,000	\$ 4,620
Steven C. Dixon Senior Vice President — Operations	1997	\$145,000	\$ 45,000	(d)	30,000	\$11,500
	1996	\$125,000	\$ 12,500	(d)	97,500	\$ 9,870
	1995	\$112,500	\$ 27,900	(d)	184,500	\$ 3,510
Henry J. Hood Senior Vice President — Land and Legal	1997	\$135,000	\$ 30,000	(d)	19,500	\$ 2,920
	1996	\$120,000	\$ 12,000	(d)	51,000	\$ 6,400
	1995	\$120,000	\$ 6,300	(d)	20,250	—
J. Mark Lester Senior Vice President — Exploration	1997	\$132,500	\$ 30,000	(d)	19,500	\$10,400
	1996	\$110,000	\$ 11,000	(d)	64,500	\$ 7,635
	1995	\$105,000	\$ 14,800	(d)	81,000	\$ 2,063

(a) Represents the cost of personal benefits provided by the Company, including for fiscal 1997 personal accounting support (\$53,000 for Mr. McClendon and \$53,350 for Mr. Ward), personal vehicle (\$18,000 each) and country club membership dues (\$3,450 for Mr. McClendon and \$4,058 for Mr. Ward).

(b) No awards of restricted stock or payments under long-term incentive plans were made by the Company to any of the named executives in any period covered by the table.

(c) Represents Company matching contributions to the Chesapeake Energy Corporation Savings and Incentive Stock Bonus Plan.

(d) Other annual compensation did not exceed the lesser of \$50,000 or 10% of the executive officer's salary and bonus during the year.

Stock Options Granted in Fiscal 1997

The following table sets forth information concerning options to purchase Common Stock granted in fiscal 1997 to the executive officers named in the Summary Compensation Table. Amounts represent stock options granted under the Company's 1994 and 1996 Plans and include both incentive and non-qualified stock options. One-fourth of each option becomes exercisable on each of the first four grant date anniversaries. The exercise price of each option represents the market price of the Common Stock on the date of grant (110% of such market price with respect to incentive stock options granted to Messrs. McClendon and Ward).

Name	Individual Grants				Potential Realizable Value at Assumed Annual Rates of Stock Price Appreciation for Option Term (a)	
	Number of Securities Underlying Options Granted	Percent of Total Options Granted to Employees in Fiscal 1997	Exercise Price Per Share	Expiration Date	5%	10%
Aubrey K. McClendon	15,456(b)	0.4%	\$28.47	6/13/97	N/A	N/A
	184,544(b)	5.3%	\$25.87	6/13/97	N/A	N/A
	235,176	6.7%	\$14.75	6/13/07	\$958,378	\$2,117,765
	27,824	0.8%	\$16.23	6/13/02	\$ 83,824	\$ 220,993
Tom L. Ward	15,456(b)	0.4%	\$28.47	6/13/97	N/A	N/A
	184,544(b)	5.3%	\$25.87	6/13/97	N/A	N/A
	235,176	6.7%	\$14.75	6/13/07	\$958,378	\$2,117,765
	27,824	0.8%	\$16.23	6/13/02	\$ 83,824	\$ 220,993
Marcus C. Rowland	36,000	1.0%	\$14.25	4/25/07	\$322,623	\$ 817,590
Steven C. Dixon	30,000	0.9%	\$14.25	4/25/07	\$268,852	\$ 681,325
Henry J. Hood	19,500	0.6%	\$14.25	4/25/07	\$174,754	\$ 442,861
J. Mark Lester	19,500	0.6%	\$14.25	4/25/07	\$174,754	\$ 442,861

(a) The assumed annual rates of stock price appreciation of 5% and 10% are set by the Securities and Exchange Commission and are not intended as a forecast of possible future appreciation in stock prices.

(b) Option was canceled upon grant of replacement option.

Aggregated Option Exercises in Fiscal 1997 and Fiscal Year-End Option Values

The following table sets forth information about options exercised by the named executive officers during the fiscal year ended June 30, 1997 and the unexercised options to purchase Common Stock held by them at June 30, 1997.

Name	Shares Acquired on Exercise	Value Realized (b)	Number of Securities Underlying Unexercised Options at 6/30/97		Value of Unexercised In-the-Money Options at 6/30/97 (a)	
			Exercisable	Unexercisable	Exercisable	Unexercisable
Aubrey K. McClendon	315,000(c)	\$4,499,496	402,750	701,750	\$2,614,777	\$2,437,118
Tom L. Ward	—	—	717,750	701,750	\$5,520,373	\$2,437,118
Marcus C. Rowland	249,750	\$4,409,183	—	399,250	—	\$1,462,271
Steven C. Dixon	—	—	358,273	253,627	\$3,006,497	\$ 838,860
Henry J. Hood	7,876	\$ 162,847	10,687	83,251	\$ 47,775	\$ 163,812
J. Mark Lester	28,128	\$ 678,811	96,386	120,514	\$ 793,653	\$ 391,377

- (a) At June 30, 1997, the closing price of the Common Stock on the New York Stock Exchange (“NYSE”) was \$9.94. “In-the-money options” are stock options with respect to which the market value of the underlying shares of Common Stock exceeded the exercise price at June 30, 1997. The values shown were determined by subtracting the aggregate exercise price of such options from the aggregate market value of the underlying shares of Common Stock on June 30, 1997.
- (b) Represents amounts determined by subtracting the aggregate exercise price of such options from the aggregate market value of the underlying shares of Common Stock on the exercise date.
- (c) Mr. McClendon has not sold any of such shares.

Employment Agreements

The Company has employment agreements with Messrs. McClendon and Ward, each of which provides, among other things, for an annual base salary of not less than \$300,000 commencing July 1, 1997; bonuses at the discretion of the Board of Directors; eligibility for stock options; and benefits, including an automobile and aircraft allowance, club membership and personal accounting support. Each agreement has a term of three years commencing July 1, 1997, which term is automatically extended for one additional year on each June 30 unless the Company provides 30 days prior notice of non-extension.

The employment agreements between the Company and Messrs. McClendon and Ward permit them to participate in each well drilled by the Company on terms no less favorable to the Company than those agreed to by unaffiliated industry partners. Messrs. McClendon and Ward have participated in all wells drilled by the Company since its initial public offering in February 1993 and intend to continue participating in wells drilled by the Company under the terms of their employment agreements. Thirty days prior to the beginning of each calendar quarter, Messrs. McClendon and Ward and the disinterested members of the Compensation Committee of the Board of Directors agree upon the working interest percentage in all wells spudded during that quarter to be purchased by Messrs. McClendon and Ward. That percentage may not be adjusted during such quarter except with the approval of such disinterested directors. No such adjustments have ever been requested or granted. The participation election by Messrs. McClendon or Ward may not exceed a 2.5% working interest in a well. Messrs. McClendon and Ward are obligated to pay within 150 days after billing all costs and expenses associated with the working interests they acquire under this arrangement. In addition, for each calendar year during which the employment agreements are in effect, Messrs. McClendon and Ward each agree to hold shares of the Company’s Common Stock having an aggregate investment value equal to 500% of his annual base salary and bonus.

The Company has a similar employment agreement with Mr. Rowland. It provides for an annual base salary of not less than \$225,000 commencing July 1, 1997. The agreement has a term of three years beginning July 1, 1997, which term is automatically extended for one additional year on each June 30 unless the Company provides 30 days prior notice of non-extension. Mr. Rowland is permitted to participate in wells drilled by the Company in the same manner as Messrs. McClendon and Ward, except that Mr. Rowland’s

working interest participation in a well may not exceed 1%. Messrs. McClendon, Ward and Rowland may not participate in any well in which their combined working interests cause the Company's working interest to be reduced to less than 12.5%. Mr. Rowland agrees to hold shares of the Company's Common Stock having an aggregate investment value equal to 100% of his annual base salary and bonus during each calendar year for the term of the agreement.

Messrs. McClendon, Ward and Rowland have agreed that they will not engage in oil and gas operations individually except pursuant to the aforementioned participation in Company wells and as a result of subsequent operations on properties owned by them or their affiliates as of July 1, 1995 or acquired from the Company with respect to Messrs. McClendon and Ward and as of March 1, 1993 with respect to Mr. Rowland.

The Company also has employment agreements with Messrs. Dixon, Lester and Hood. These agreements have a term of three years from July 1, 1997, with annual base salaries of \$175,000 for Mr. Dixon, \$160,000 for Mr. Lester and \$155,000 for Mr. Hood for the term of their agreements. The agreements require each of them to acquire and continue to hold shares of the Company's Common Stock having an annual aggregate investment value equal to 15% for Messrs. Dixon and Lester and 10% for Mr. Hood of the annual base salary and bonus compensation paid to them under their respective agreements.

The Company may terminate any of the employment agreements with its executive officers at any time without cause; however, upon such termination Messrs. McClendon, Ward and Rowland are entitled to continue to receive salary and benefits for the balance of the contract term. Messrs. Dixon, Hood and Lester are entitled to 90 days compensation and benefits. Each of the employment agreements for Messrs. McClendon, Ward and Rowland further states that if, during the term of the agreement, there is a change of control and within one year (i) the agreement expires and is not extended; (ii) the executive officer is terminated other than for cause, death or incapacity; or (iii) the executive resigns as a result of a reassignment of duties inconsistent with his position or a reduction in his compensation, then the executive officer will be entitled to a severance payment in an amount equal to 36 months of base salary compensation. Change of control is defined in these agreements to include (x) an event which results in a person acquiring beneficial ownership of securities having 35% or more of the voting power of the Company's outstanding voting securities, or (y) within two years of a tender offer or exchange offer for the voting stock of the Company or as a result of a merger, consolidation, sale of assets or contested election, a majority of the members of the Company's Board of Directors is replaced by directors who were not nominated and approved by the Board of Directors.

Directors' Compensation

During fiscal year 1997, each director who was not an officer of the Company received \$2,500 for each regular meeting of the Board attended, up to a maximum of \$10,000 during the year. Beginning in fiscal 1998, directors who are not officers of the Company will receive an annual retainer of \$10,000, payable quarterly, and \$1,250 for each meeting of the Board attended. Directors are reimbursed for travel and other expenses. Officers who also serve as directors do not receive fees for serving as directors.

During fiscal year 1997, each director who was not an officer of the Company was granted an option for 20,000 shares (10,000 shares pre-split) at an exercise price of \$30.63 (\$61.25 pre-split) per share under the Company's 1992 Nonstatutory Stock Option Plan (the "1992 NSO Plan"). During fiscal year 1998, each director who is not an officer will receive ten-year non-qualified options under the 1992 NSO Plan to purchase 15,000 shares of Common Stock, options for 3,750 shares granted on the first day of each quarter, at an exercise price equal to the market price on the date of grant.

Compensation Committee Interlocks and Insider Participation

During fiscal 1997, the Compensation Committee was composed of Aubrey K. McClendon, Tom L. Ward, E.F. Heizer, Jr. and Frederick B. Whittemore. Mr. McClendon is Chairman of the Board and Chief Executive Officer of the Company. Mr. Ward is the Company's President and Chief Operating Officer.

Messrs. McClendon and Ward administer the Company's 1992 stock options plans. The grant of new options under the 1992 Incentive Stock Option Plan (the "1992 ISO Plan") was terminated in December 1994. The only options issued under the 1992 NSO Plan during fiscal 1997 were those to the Company's non-employee directors pursuant to an annual formula award provision. Messrs. McClendon and Ward also administer the 1994 and 1996 Plans with respect to non-director employee participants. Messrs. Heizer and Whittemore, administer the 1994 and 1996 Plans with respect to executive officers or employee participants who are directors.

Messrs. McClendon and Ward participate as working interest owners in the Company's oil and gas wells pursuant to the terms of their employment agreements with the Company. See "Employment Agreements." Accounts receivable from Messrs. McClendon and Ward are generated by joint interest billings relating to such participation and as a result of miscellaneous expenses paid on their behalf by the Company. The Company has extended certain registration rights to Messrs. McClendon and Ward. Mr. Self is a partner in the firm of Self, Giddens & Lees, Inc., counsel to the Company. See "Certain Transactions."

ITEM 12. *Security Ownership*

The table below sets forth as of the Record Date (i) the name and address of each person known by management to own beneficially 5% or more of the Company's outstanding Common Stock, the number of shares beneficially owned by each such shareholder and the percentage of outstanding shares owned and (ii) the number and percentage of outstanding shares of Common Stock beneficially owned by each of the Company's nominees, directors and executive officers listed in the Summary Compensation Table below and by all directors and executive officers of the Company as a group. Unless otherwise noted, the persons named below have sole voting and investment power with respect to such shares.

<u>Beneficial Owner</u>	<u>Common Stock</u>	
	<u>Number of Shares</u>	<u>Percent of Class</u>
Tom L. Ward*† 6100 North Western Avenue Oklahoma City, OK 73118	11,263,072 (a) (b)	16%
Aubrey K. McClendon*† 6100 North Western Avenue Oklahoma City, OK 73118	11,005,978 (b) (c)	15%
Pilgrim Baxter & Associates 1255 Drummers Lane Wayne, PA 19087-1590	5,303,008 (d)	8%
Shannon T. Self*	2,731,998 (e)	4%
E. F. Heizer, Jr.*	1,054,400 (f)	1%
Frederick B. Whittemore*	919,000 (g)	1%
Steven C. Dixon†	407,584 (b) (h)	**
Breene M. Kerr*	346,250 (i)	**
Walter C. Wilson*	248,000 (j)	**
Marcus C. Rowland†	165,215 (b) (k)	**
J. Mark Lester†	106,105 (b) (l)	**
Henry J. Hood†	23,162 (b) (m)	**
All directors and executive officers as a group	30,948,588 (n)	42%

* Director

† Executive officer of the Company

** Less than 1%

- (a) Includes 1,846,860 shares held by TLW Investments, Inc., an Oklahoma corporation of which Mr. Ward is sole shareholder and chief executive officer, and 841,500 shares which may be acquired pursuant to currently exercisable stock options granted by the Company.
- (b) Includes shares purchased on behalf of the executive officer in the Chesapeake Energy Corporation Savings and Incentive Stock Bonus Plan (Tom L. Ward, 3,522 shares; Aubrey K. McClendon, 1,643 shares; Steven C. Dixon, 937 shares; Marcus C. Rowland, 985 shares; J. Mark Lester, 719 shares and Henry J. Hood, 776 shares).
- (c) Includes 508,560 shares held by Chesapeake Investments, an Oklahoma limited partnership of which Mr. McClendon is sole general partner, and 526,500 shares which may be acquired pursuant to currently exercisable stock options granted by the Company.
- (d) Based on information provided by Pilgrim Baxter & Associates.
- (e) Includes 2,382 shares held by Pearson Street Limited Partnership, an Oklahoma limited partnership of which Mr. Self is a general partner and the remaining partners are members of Mr. Self's immediate family sharing the same household; 1,098,600 shares held by Mr. Self as trustee of the Aubrey K. McClendon Children's Trust, 1,209,100 shares held by Mr. Self as trustee of the Tom L. Ward Children's Trust and 421,916 shares which Mr. Self has the right to acquire pursuant to currently exercisable stock options granted by the Company.
- (f) Includes 344,750 shares subject to currently exercisable stock options granted to Mr. Heizer by the Company.
- (g) Includes 374,000 shares subject to currently exercisable stock options granted to Mr. Whittemore by the Company.
- (h) Includes 403,647 shares subject to currently exercisable stock options granted to Mr. Dixon by the Company.
- (i) Includes 27,500 shares subject to currently exercisable stock options granted to Mr. Kerr by the Company.
- (j) Includes 248,000 shares subject to currently exercisable stock options granted to Mr. Wilson by the Company.
- (k) Includes 74,250 shares subject to currently exercisable stock options granted to Mr. Rowland by the Company.
- (l) Includes 100,886 shares subject to currently exercisable stock options granted to Mr. Lester by the Company.
- (m) Includes 20,812 shares subject to currently exercisable stock options granted to Mr. Hood by the Company.
- (n) Includes shares subject to options which are currently exercisable.

ITEM 13. *Certain Transactions*

Legal Counsel. Shannon T. Self, a director of the Company, is a shareholder in the law firm of Self, Giddens & Lees, Inc., which provides legal services to the Company. During fiscal 1997, the firm billed the Company approximately \$207,000 for such legal services.

Oil and Gas Operations. Prior to 1989, Messrs. McClendon and Ward and their affiliates, as independent oil producers, acquired various leasehold and working interests. In 1989, Chesapeake Operating, Inc. ("COI"), a wholly-owned subsidiary of the Company, was formed to drill and operate wells in which Messrs. McClendon and Ward or their affiliates owned working interests. COI entered into joint operating agreements with Messrs. McClendon and Ward and other working interest owners and billed each for their respective shares of expenses and fees.

COI continues to operate wells in which directors, executive officers and related parties own working interests. In addition, directors, executive officers and related parties have acquired working interests directly and indirectly from the Company and participated in wells drilled by COI on terms no less favorable to the

Company than available to unrelated parties. Other than interests owned prior to the Company's initial public offering in 1993, the Company's directors who are not officers have not acquired from the Company interests in any new wells drilled by the Company since their election as directors and have no present intention to acquire interests in any new wells of the Company. The table below presents information about drilling, completion, equipping and operating costs billed to the person named from July 1, 1996 to June 30, 1997, the largest amount owed by them during the period and the balance owed at July 1, 1996 and June 30, 1997. No interest is charged on amounts owing for such costs, unless such costs are not paid in a timely manner. The amounts for all other directors, executive officers and related parties were insignificant.

	<u>Aubrey K. McClendon</u>	<u>Tom L. Ward</u>	<u>Marcus C. Rowland</u>
	(in thousands)		
Balance at July 1, 1996	\$ 971	\$1,288	\$ 82
Amount billed (to June 30, 1997)	\$3,662	\$3,534	\$171
Largest outstanding balance (month end)	\$3,552	\$2,997	\$ 79
Balance at June 30, 1997	\$3,552	\$2,997	\$ 42

Miscellaneous. From time to time, the Company pays various expenses incurred on behalf of Messrs. McClendon and Ward and their affiliates, creating accounts receivable of the Company. During fiscal 1997 additions to accounts receivable (excluding joint interest billings, which are described above) from Messrs. McClendon and Ward and their affiliates were insignificant.

PART IV

ITEM 14. Exhibits, Financial Statement Schedules, and Reports on Form 8-K

(a) The following documents are filed as part of this report:

1. *Financial Statements.* The Company's Consolidated Financial Statements are included in Item 8 of this report. Reference is made to the accompanying Index to Consolidated Financial Statements.

2. *Financial Statement Schedules.* No financial statement schedules are filed with this report as no schedules are applicable or required.

3. *Exhibits.* The following exhibits are filed herewith pursuant to the requirements of Item 601 of Regulation S-K:

<u>Exhibit Number</u>	<u>Description</u>
3.1	— Registrant's Certificate of Incorporation. Incorporated herein by reference to Exhibit 3.1 to Registrant's quarterly report on Form 10-Q for the quarter ended December 31, 1996.
3.2	— Registrant's Bylaws. Incorporated herein by reference to Exhibit 3.2 to Registrant's registration statement on Form 8-B (No. 001-13726).
4.1	— Indenture dated as of March 15, 1997 among the Registrant, as issuer, Chesapeake Operating, Inc., Chesapeake Gas Development Corporation and Chesapeake Exploration Limited Partnership, as Subsidiary Guarantors, and United States Trust Company of New York, as Trustee, with respect to 7.875% Senior Notes due 2004. Incorporated herein by reference to Exhibit 4.1 to Registrant registration statement on Form S-4 (No. 333-24995).
4.2	— Indenture dated as of March 15, 1997 among the Registrant, as issuer, Chesapeake Operating, Inc., Chesapeake Gas Development Corporation and Chesapeake Exploration Limited Partnership, as Subsidiary Guarantors, and United States Trust Company of New York, as Trustee, with respect to 8.5% Senior Notes due 2012. Incorporated herein by reference to Exhibit 4.1.3 to Registrant registration statement on Form S-4 (No. 333-24995).
4.3	— Indenture dated as of May 15, 1995 among Chesapeake Energy Corporation, its subsidiaries signatory thereto as Subsidiary Guarantors and United States Trust Company of New York, as Trustee, with respect to 10.5% Senior Notes due 2002. Incorporated herein by reference to Exhibit 4.3 to Registrant's registration statement on Form S-4 (No. 33-93718).
4.4	— Indenture dated April 1, 1996 among Chesapeake Energy Corporation, its subsidiaries signatory thereto as Subsidiary Guarantors and United States Trust Company of New York, as Trustee, with respect to 9.125% Senior Notes due 2006. Incorporated herein by reference to Exhibit 4.6 to Registrant's registration statement on Form S-3 Registration Statement (No. 333-1588)
4.5*	— Agreement to furnish copies of unfiled long-term debt instruments.
4.8	— Stock Registration Agreement dated May 21, 1992 between Chesapeake Energy Corporation and various lenders, as amended by First Amendment thereto dated May 26, 1992. Incorporated herein by reference to Exhibits 10.26.1 and 10.26.2 to Registrant's registration statement on Form S-1 (No. 33-55600).
10.1.1†	— Registrant's 1992 Incentive Stock Option Plan. Incorporated herein by reference to Exhibit 10.1.1 to Registrant's registration statement on Form S-4 (No. 33-93718).

<u>Exhibit Number</u>	<u>Description</u>
10.1.2†	— Registrant's 1992 Nonstatutory Stock Option Plan, as amended. Incorporated herein by reference to Exhibit 10.1.2 to Registrant's quarterly report on Form 10-Q for the quarter ended December 31, 1996.
10.1.3†	— Registrant's 1994 Stock Option Plan, as amended. Incorporated herein by reference to Exhibit 10.1.3 to Registrant's quarterly report on Form 10-Q for the quarter ended December 31, 1996.
10.1.4†	— Registrant's 1996 Stock Option Plan. Incorporated herein by reference to Registrant's Proxy Statement for its 1996 Annual Meeting of Shareholders.
10.1.4.1*	— Amendment to the Chesapeake Energy Corporation 1996 Stock Option Plan.
10.2.1†#	— Employment Agreement dated as of July 1, 1997 between Aubrey K. McClendon and Chesapeake Energy Corporation.
10.2.2†#	— Employment Agreement dated as of July 1, 1997 between Tom L. Ward and Chesapeake Energy Corporation.
10.2.3†#	— Employment Agreement dated as of July 1, 1997 between Marcus C. Rowland and Chesapeake Energy Corporation.
10.2.4†	— Employment Agreement dated as of July 1, 1995 between Steven C. Dixon and Chesapeake Energy Corporation. Incorporated herein by reference to Exhibit 10.2.4 to Registrant's quarterly report on Form 10-Q for the quarter ended September 30, 1995.
10.2.5†*	— Employment Agreement dated as of July 1, 1997 between J. Mark Lester and Chesapeake Energy Corporation.
10.2.6†*	— Employment Agreement dated as of July 1, 1997 between Henry J. Hood and Chesapeake Energy Corporation.
10.2.7†*	— Employment Agreement dated as of July 1, 1997 between Ronald A. Lefave and Chesapeake Energy Corporation.
10.2.8†*	— Employment Agreement dated as of July 1, 1997 between Martha A. Burger and Chesapeake Energy Corporation.
10.3†	— Form of Indemnity Agreement for officers and directors of Registrant and its subsidiaries. Incorporated herein by reference to Exhibit 10.30 to Registrant's registration statement on Form S-1 (No. 33-55600).
10.9	— Indemnity and Stock Registration Agreement, as amended by First Amendment (Revised) thereto, dated as of February 12, 1993, and as amended by Second Amendment thereto dated as of October 20, 1995, among Chesapeake Energy Corporation, Chesapeake Operating, Inc., Chesapeake Investments, TLW Investments, Inc., et al. Incorporated herein by reference to Exhibit 10.35 to Registrant's annual report on Form 10-K for the year ended June 30, 1993 and Exhibit 10.4.1 to Registrant's quarterly report on Form 10-Q for the quarter ended December 31, 1995.
10.10	— Partnership Agreement of Chesapeake Exploration Limited Partnership dated December 27, 1994 between Chesapeake Energy Corporation and Chesapeake Operating, Inc. Incorporated herein by reference to Exhibit 10.10 to Registrant's registration statement on Form S-4 (No. 33-93718).
10.11*	— Amended and Restated Limited Partnership Agreement of Chesapeake Louisiana, L.P. dated June 30, 1997 between Chesapeake Operating, Inc. and Chesapeake Energy Louisiana Corporation.
11*	— Statement of Net Income (Loss) Per Share.

<u>Exhibit Number</u>	<u>Description</u>
21*	— Subsidiaries of Registrant
23.1*	— Consent of Coopers & Lybrand L.L.P.
23.2*	— Consent of Price Waterhouse LLP
23.3*	— Consent of Williamson Petroleum Consultants, Inc.
27*	— Financial Data Schedule

* Previously filed.

Filed herewith.

† Management contract or compensatory plan or arrangement.

(b) Reports on Form 8-K

During the quarter ended June 30, 1997, the Company filed the following Current Reports on Form 8-K dated

April 2, 1997 announcing the completion of its Brown #1-H in Washington County, Texas,

April 24, 1997 reporting third quarter and first nine months fiscal 1997 results, and

June 27, 1997 announcing refocused Louisiana drilling program and expected asset writedown.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

CHESAPEAKE ENERGY CORPORATION

Date October 13, 1997 By /s/ AUBREY K. McCLENDON
Aubrey K. McClendon
Chairman of the Board and
Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

<u>Signature</u>	<u>Title</u>	<u>Date</u>
<u>/s/ AUBREY K. McCLENDON</u> Aubrey K. McClendon	Chairman of the Board, Chief Executive Officer and Director (Principal Executive Officer)	October 13, 1997
<u>/s/ TOM L. WARD</u> Tom L. Ward	President, Chief Operating Officer and Director (Principal Executive Officer)	October 13, 1997
<u>/s/ MARCUS C. ROWLAND</u> Marcus C. Rowland	Vice President-Finance and Chief Financial Officer (Principal Financial Officer)	October 13, 1997
<u>/s/ RONALD A. LEFAIVE</u> Ronald A. Lefaive	Controller (Principal Accounting Officer)	October 13, 1997
<u>/s/ EDGAR F. HEIZER, JR.</u> Edgar F. Heizer, Jr.	Director	October 13, 1997
<u>/s/ BREENE M. KERR</u> Breene M. Kerr	Director	October 13, 1997
<u>/s/ SHANNON T. SELF</u> Shannon T. Self	Director	October 13, 1997
<u>/s/ FREDERICK B. WHITTEMORE</u> Frederick B. Whittemore	Director	October 13, 1997
<u>/s/ WALTER C. WILSON</u> Walter C. Wilson	Director	October 13, 1997

Corporate Information

Stock Data	High	Low	Last
Fiscal 1995 (in \$)			
First Quarter	2.39	0.86	2.36
Second Quarter	3.67	2.14	3.50
Third Quarter	4.84	2.22	4.72
Fourth Quarter	6.59	4.67	5.72
Fiscal 1996			
First Quarter	7.22	4.53	7.03
Second Quarter	11.09	6.28	11.09
Third Quarter	16.50	10.79	15.42
Fourth Quarter	29.96	16.04	29.96
Fiscal 1997			
First Quarter	35.13	20.81	31.31
Second Quarter	34.44	24.94	27.82
Third Quarter	31.38	19.38	20.88
Fourth Quarter	23.50	8.94	9.94
Fiscal 1998			
First Quarter	11.50	6.31	11.38

Stock Split History

December 1994; 2-for-1
December 1995; 3-for-2
June 1996; 3-for-2
December 1996; 2-for-1

Trustees for the Company's

Senior Notes

United States Trust Company
of New York
114 West 47th Street
New York, New York 10036

Internet Address

Company financial information, public disclosures and other information is available at Chesapeake's web site www.chesapeake-energy.com or by contacting Thomas S. Price, Jr. at the corporate office or by calling (405) 848-8000, extension 257. E-mail requests may be sent to TPrice@Chesapeake-Energy.com.

Common Stock

Chesapeake Energy Corporation's common stock is listed on the New York Stock Exchange under the symbol CHK. As of September 30, 1997, there were approximately 18,000 beneficial owners of the common stock.

Dividends

The Company initiated a quarterly dividend with the payment of \$0.02 per common share on July 15, 1997. The payment of future cash dividends, if any, will be reviewed periodically by the Board of Directors and will depend upon, among other things, the Company's financial condition, funds from operations, the level of its capital and development expenditures, its future business prospects and any contractual restrictions.

Corporate

Headquarters

6100 North Western Avenue
Oklahoma City,
Oklahoma 73118
(405) 848-8000

Independent Public

Accountants

Coopers & Lybrand L.L.P.
15 North Robinson, Suite 400
Oklahoma City,
Oklahoma 73102
(405) 236-5800

Stock Transfer Agent and Registrar

Liberty Bank and Trust
Company of Oklahoma City
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.

Forward Looking Statements

The information contained in this annual report includes certain forward-looking statements. When used in this document, the words "potential", "budgeted", "anticipate", "expect", "believes", "goals", "projects", and similar expressions are intended to identify forward-looking statements. It is important to note that Chesapeake's actual results could differ materially from those projected by such forward-looking statements. Important factors that could cause actual results to differ materially from those projected in the forward-looking statements include, but are not limited to, the following: production variances from expectations, risks related to exploration and development drilling outcomes, uncertainties about estimates of reserves, volatility of oil and gas prices, the need to develop and replace its reserves, the substantial capital expenditures required to fund its operations, environmental risks, drilling and operating risks, competition, government regulation, and the ability of the company to implement its business strategy.

CHESAPEAKE ENERGY CORPORATION

6100 North Western Avenue
Oklahoma City, Oklahoma 73118