

EUROPEAN EQUITY FUND, INC / MD  
Form SC 13G/A  
April 23, 2007

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**

**SCHEDULE 13G/A**  
**Under the Securities Exchange Act of 1934**  
Amendment No(2.)\*

**European Equity Fund Inc**  
(Name of Issuer)

**Closed End Mutual Fund**  
(Title of Class of Securities)

**298768102**  
(CUSIP Number)

**3/31/07**

(Date of Event Which Requires Filing of this Statement)

Check the appropriate box to designate the rule pursuant to which this Schedule is filed:

☒ Rule 13d-1(b)

☐ Rule 13d-1(c)

☐ Rule 13d-1(d)

CUSIP No. 769667106

- 
1. Names of Reporting Persons.  
I.R.S. Identification Nos. of above persons (entities only).

Wachovia Corporation 56-0898180

(Formerly named First Union Corporation)

- 
2. Check the Appropriate Box if a Member of a Group (See Instructions)
- (a)
- (b)

- 
3. SEC Use Only

- 
4. Citizenship or Place of Organization

North Carolina

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Number of  
Shares  
Beneficially  
Owned by  
Each Reporting  
Person With

5. Sole Voting Power

1017194

---

6. Shared Voting Power

0

---

7. Sole Dispositive Power

1017194

---

8. Shared Dispositive Power

0

---

9. Aggregate Amount Beneficially Owned by Each Reporting Person. 1017194

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10. Check if the Aggregate Amount in Row (11) Excludes Certain Shares (See Instructions) Not Applicable.

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11. Percent of Class Represented by Amount in Row (11) 8.60%

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12. Type of Reporting Person (See Instructions)

**Parent Holding Company (HC)**

Item 1.

(a) Name of Issuer

**European Equity Fund Inc**

(b) Address of Issuer's Principal Executive Offices

**345 Park Avenue**

**New York, NY 10154**

Item 2.

(a) Name of Person Filing

Wachovia Corporation

(b) Address of Principal Business Office or, if none, Residence

One Wachovia Center

Charlotte, North Carolina 28288-0137

(c) Citizenship

North Carolina

(d) Title of Class of Securities

**Common Stock**

(e) CUSIP Number

929903102

Item 3. If this statement is filed pursuant to sections 240.13d-1(b) or 240.13d-2(b) or (c), check whether the person filing is a:

- |     |                                     |                                                                                                                      |
|-----|-------------------------------------|----------------------------------------------------------------------------------------------------------------------|
| (a) | <input type="checkbox"/>            | Broker or dealer registered under section 15 of the Act (15 U.S.C. 78o).                                             |
| (b) | <input type="checkbox"/>            | Bank as defined in section 3(a)(6) of the Act (15 U.S.C. 78c).                                                       |
| (c) | <input type="checkbox"/>            | Insurance company as defined in section 3(a)(19) of the Act (15 U.S.C. 78c).                                         |
| (d) | <input type="checkbox"/>            | Investment company registered under section 8 of the Investment Company Act of 1940 (15 U.S.C 80a-8).                |
| (e) | <input type="checkbox"/>            | An investment adviser in accordance with section 240.13d-1(b)(1)(ii)(E);                                             |
| (f) | <input type="checkbox"/>            | An employee benefit plan or endowment fund in accordance with section 240.13d-1(b)(1)(ii)(F);                        |
| (g) | <input checked="" type="checkbox"/> | A parent holding company or control person in accordance with section 240.13d-1(b)(1)(ii)(G);                        |
| (h) | <input type="checkbox"/>            | A savings associations as defined in Section 3(b) of the Federal Deposit Insurance Act (12 U.S.C. 1813);             |
| (i) | <input type="checkbox"/>            | A church plan that is excluded from the definition of an investment company under section 3(c)(14) of the Investment |

Company Act of 1940 (15 U.S.C. 80a-3);

(j) [ ]

Group, in accordance with section 240.13d-1(b)(1)(ii)(J).

Item 4. Ownership.

Provide the following information regarding the aggregate number and percentage of the class of securities of the issuer identified in Item 1.

- (a) Amount beneficially owned: 1017194
- (b) Percent of class: 8.60 .
- (c) Number of shares as to which the person has:
  - (i) Sole power to vote or to direct the vote  
1017194 .
  - (ii) Shared power to vote or to direct the vote  
0 .
  - (iii) Sole power to dispose or to direct the disposition of 1017194 .
  - (iv) Shared power to dispose or to direct the disposition of 0 .

Item 5. Ownership of Five Percent or Less of a Class

If this statement is being filed to report the fact that as of the date hereof the reporting person has ceased to be the beneficial owner of more than five percent of the class of securities, check the following [ ].

Item 6. Ownership of More than Five Percent on Behalf of Another Person.

Not Applicable.

Item 7. Identification and classification of the subsidiary which acquired the security being reported on by the parent holding company.

Wachovia Corporation is filing this schedule pursuant to Rule 13d-1(b)(1)(ii)(G) as indicated under Item 3(g). The relevant subsidiaries are Wachovia Securities, LLC (IA), Evergreen Investment Management Company (IA), Tattersall Advisory Group, Inc. (IA) and Wachovia Bank, N.A. (BK). Wachovia Securities, LLC, Evergreen Investment Management Company and Tattersall Advisory Group, Inc. are investment advisors for mutual funds and / or clients; the securities reported by these subsidiaries are beneficially owned

by such mutual funds or clients. The other Wachovia entity listed above holds the securities reported in a fiduciary capacity for its respective customers.

Item 8. Identification and Classification of Members of the Group

Not Applicable.

Item 9. Notice of Dissolution of Group

Not Applicable.

Item 10. Certification

(a)

The following certification shall be included if the statement is filed pursuant to section 240.13d-1(b):

By signing below I certify that, to the best of my knowledge and belief, the securities referred to above were acquired and are held in the ordinary course of business and were not acquired and are not held for the purpose of or with the effect of changing or influencing the control of the issuer of the securities and were not acquired and are not held in connection with or as a participant in any transaction having that purpose or effect.

## SIGNATURE

After reasonable inquiry and to the best of my knowledge and belief, I certify that the information set forth in this statement is true, complete and correct.

April 23, 2007  
Date

Signature

Karen F. Knudtsen

Vice President and Trust Officer

SIGNATURE

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Name/Title

bottom">34,200,000 (0.33) No 66,338

2Q 2006

30,940,000 (0.31) No 21,892

3Q 2006

31,280,000 (0.31) No 17,380

4Q 2006

33,720,000 (0.32) No 22,268

1Q 2007

32,850,000 (0.29) No 24,990

2Q 2007

34,125,000 (0.35) No 23,208

3Q 2007

34,500,000 (0.35) No 18,471

4Q 2007

35,720,000 (0.32) No 20,078

1Q 2008

33,215,000 (0.29) No 19,800

2Q 2008

26,845,000 (0.25) No 17,689

3Q 2008

27,140,000 (0.25) No 14,136

4Q 2008

31,410,000 (0.28) No 12,716

1Q 2009

26,100,000 (0.32) No 9,076

2Q 2009

20,020,000 (0.28) No 8,026

3Q 2009

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20,240,000 (0.28) No 5,505

4Q 2009

20,240,000 (0.28) No 5,735

Cap-Swaps:

1Q 2006

7,200,000 7.11 5.06 No (28,331)

2Q 2006

11,830,000 6.84 5.13 No (40,761)

3Q 2006

11,960,000 6.85 5.13 No (42,622)

4Q 2006

11,960,000 6.89 5.13 No (49,342)

Counter Swaps:

1Q 2006

(1,800,000) (6.19) No 9,267

2Q 2006

(1,820,000) (5.35) No 9,062

3Q 2006

(1,840,000) (5.33) No 9,353

4Q 2006

(1,840,000) (5.50) No 10,103

Call Options:

1Q 2006

1,800,000 12.50 No 1,890 (821)

2Q 2006

1,820,000 12.50 No 1,911 (781)

3Q 2006

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|           |       |                  |
|-----------|-------|------------------|
| 1,840,000 | 12.50 | No 1,932 (1,348) |
| 4Q 2006   |       |                  |
| 1,840,000 | 12.50 | No 1,932 (2,408) |
| 1Q 2007   |       |                  |
| 1,800,000 | 12.50 | No 1,890 (3,559) |
| 2Q 2007   |       |                  |
| 1,820,000 | 12.50 | No 1,911 (1,285) |
| 3Q 2007   |       |                  |
| 1,840,000 | 12.50 | No 1,932 (1,423) |
| 4Q 2007   |       |                  |
| 1,840,000 | 12.50 | No 1,932 (2,371) |
| 1Q 2008   |       |                  |
| 1,820,000 | 12.50 | No 1,911 (3,754) |
| 2Q 2008   |       |                  |
| 1,820,000 | 12.50 | No 1,911 (893)   |
| 3Q 2008   |       |                  |
| 1,840,000 | 12.50 | No 1,932 (1,043) |
| 4Q 2008   |       |                  |
| 1,840,000 | 12.50 | No 1,932 (1,775) |

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|                                  | Volume      | Weighted-Average<br>Fixed Price<br>to be<br>Received<br>(Paid) | Weighted<br>Average<br>Put<br>Fixed<br>Price | Weighted-Average<br>Call<br>Fixed<br>Price | Weighted-Average<br>Differential | SFAS 133<br>Hedge | Net<br>Premiums<br>Received<br>(\$ in<br>thousands) | Fair<br>Value at<br>December 31,<br>2005<br>(\$ in<br>thousands) |
|----------------------------------|-------------|----------------------------------------------------------------|----------------------------------------------|--------------------------------------------|----------------------------------|-------------------|-----------------------------------------------------|------------------------------------------------------------------|
| <b>Collars:</b>                  |             |                                                                |                                              |                                            |                                  |                   |                                                     |                                                                  |
| 1Q 2006                          | 180,000     |                                                                | 6.00                                         | 9.70                                       |                                  | Yes               |                                                     | (270)                                                            |
| <b>Locked Swaps:</b>             |             |                                                                |                                              |                                            |                                  |                   |                                                     |                                                                  |
| 1Q 2006                          | 6,300,000   |                                                                |                                              |                                            |                                  | No                |                                                     | (7,598)                                                          |
| 2Q 2006                          | 6,370,000   |                                                                |                                              |                                            |                                  | No                |                                                     | (5,199)                                                          |
| 3Q 2006                          | 6,440,000   |                                                                |                                              |                                            |                                  | No                |                                                     | (5,099)                                                          |
| 4Q 2006                          | 6,440,000   |                                                                |                                              |                                            |                                  | No                |                                                     | (4,706)                                                          |
| 1Q 2007                          | 6,300,000   |                                                                |                                              |                                            |                                  | No                |                                                     | (4,789)                                                          |
| 2Q 2007                          | 6,370,000   |                                                                |                                              |                                            |                                  | No                |                                                     | (2,517)                                                          |
| 3Q 2007                          | 6,440,000   |                                                                |                                              |                                            |                                  | No                |                                                     | (2,049)                                                          |
| 4Q 2007                          | 6,440,000   |                                                                |                                              |                                            |                                  | No                |                                                     | (2,272)                                                          |
| <b>Floating-Price Swaps:</b>     |             |                                                                |                                              |                                            |                                  |                   |                                                     |                                                                  |
| 1Q 2006                          | (2,700,000) | (7.96)                                                         |                                              |                                            |                                  | No                |                                                     | 2,607                                                            |
| <b>Total Natural Gas</b>         |             |                                                                |                                              |                                            |                                  |                   | 23,016                                              | (264,142)                                                        |
| <b>Oil (bbls):</b>               |             |                                                                |                                              |                                            |                                  |                   |                                                     |                                                                  |
| <b>Swaps:</b>                    |             |                                                                |                                              |                                            |                                  |                   |                                                     |                                                                  |
| 1Q 2006                          | 900,000     | 60.00                                                          |                                              |                                            |                                  | Yes               |                                                     | (1,739)                                                          |
| 2Q 2006                          | 880,000     | 59.88                                                          |                                              |                                            |                                  | Yes               |                                                     | (2,760)                                                          |
| 3Q 2006                          | 828,000     | 60.16                                                          |                                              |                                            |                                  | Yes               |                                                     | (2,858)                                                          |
| 4Q 2006                          | 828,000     | 59.78                                                          |                                              |                                            |                                  | Yes               |                                                     | (3,415)                                                          |
| 1Q 2007                          | 360,000     | 57.13                                                          |                                              |                                            |                                  | Yes               |                                                     | (2,495)                                                          |
| 2Q 2007                          | 91,000      | 51.04                                                          |                                              |                                            |                                  | Yes               |                                                     | (1,200)                                                          |
| 3Q 2007                          | 92,000      | 50.56                                                          |                                              |                                            |                                  | Yes               |                                                     | (1,233)                                                          |
| 4Q 2007                          | 92,000      | 50.11                                                          |                                              |                                            |                                  | Yes               |                                                     | (1,236)                                                          |
| <b>Cap-Swaps:</b>                |             |                                                                |                                              |                                            |                                  |                   |                                                     |                                                                  |
| 1Q 2006                          | 135,000     | 57.82                                                          | 40.67                                        |                                            |                                  | No                |                                                     | (565)                                                            |
| 2Q 2006                          | 136,500     | 57.82                                                          | 40.67                                        |                                            |                                  | No                |                                                     | (825)                                                            |
| 3Q 2006                          | 138,000     | 57.82                                                          | 40.67                                        |                                            |                                  | No                |                                                     | (1,057)                                                          |
| 4Q 2006                          | 92,000      | 56.53                                                          | 40.00                                        |                                            |                                  | No                |                                                     | (917)                                                            |
| <b>Total Oil</b>                 |             |                                                                |                                              |                                            |                                  |                   |                                                     | (20,300)                                                         |
| <b>Total Natural Gas and Oil</b> |             |                                                                |                                              |                                            |                                  |                   | \$ 23,016                                           | \$ (284,442)                                                     |

We have established the fair value of all derivative instruments using estimates of fair value reported by our counterparties and subsequently evaluated internally using established index prices and other sources. The actual contribution to our future results of operations will be based on the market prices at the time of settlement and may be more or less than the fair value estimates used at December 31, 2005.

Based upon the market prices at December 31, 2005, we expect to transfer approximately \$153.8 million (net of income taxes) of the loss included in the balance in accumulated other comprehensive income to earnings during the next 12 months when the transactions actually occur. All transactions hedged as of December 31, 2005 are expected to mature by December 31, 2009.

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

|                                                                 | 2005         | December 31,<br>2004<br>(\$ in thousands) | 2003        |
|-----------------------------------------------------------------|--------------|-------------------------------------------|-------------|
| Fair value of contracts outstanding, as of January 1            | \$ 38,350    | \$ (44,988)                               | \$ (14,533) |
| Change in fair value of contracts during the period             | (771,076)    | (69,927)                                  | (31,078)    |
| Contracts realized or otherwise settled during the period       | 401,684      | 154,901                                   | 17,389      |
| Fair value of new contracts when entered into during the period | (614,772)    | (5,369)                                   | (16,766)    |
| Fair value of contracts when closed during the period           |              | 3,733                                     |             |
| Fair value of contracts outstanding, as of December 31          | \$ (945,814) | \$ 38,350                                 | \$ (44,988) |

The change in the fair value of our derivative instruments since January 1, 2005 resulted mainly from an increase in oil and natural gas prices. Derivative instruments reflected as current in the consolidated balance sheet represent the estimated fair value of derivative instrument settlements scheduled to occur over the subsequent twelve-month period based on market prices for oil and gas as of the consolidated balance sheet date. The derivative settlement amounts are not due and payable until the month in which the related underlying hedged transaction occurs.

We assumed certain liabilities related to open derivative positions in connection with the CNR acquisition. In accordance with SFAS 141, these derivative positions were recorded at fair value in the purchase price allocation as a liability of \$592 million. The recognition of the derivative liability and other assumed liabilities resulted in an increase in the total purchase price which is allocated to the assets acquired. Because of this accounting treatment, only cash settlements for changes in fair value subsequent to the acquisition date for the derivative positions assumed will result in adjustments to our oil and gas revenues upon settlement. For example, if the fair value of the derivative positions assumed do not change then upon the sale of the underlying production and corresponding settlement of the derivative positions, cash would be paid to the counterparties and there would be no adjustment to oil and gas revenues related to the derivative positions. If, however, the actual sales price is different from the price assumed in the original fair value calculation, the difference would be reflected as either a decrease or increase in oil and gas revenues, depending upon whether the sales price was higher or lower, respectively, than the prices assumed in the original fair value calculation. For accounting purposes, the net effect of these acquired hedges is that we have hedged the production volumes listed below market prices on the date of our acquisition of CNR.

Pursuant to Statement of Financial Accounting Standards No. 149, *Amendment of SFAS 133 on Derivative Instruments and Hedging Activities*, the derivative instruments assumed in connection with the CNR acquisition are deemed to contain a significant financing element and all cash flows associated with these positions will be reported as financing activity in the statement of cash flows for the periods in which settlement occurs.

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The following details the CNR derivatives we have assumed:

|                             | Volume     | Weighted-Average<br>Fixed<br>Price to be<br>Received<br>(Paid) | Weighted<br>Average<br>Put<br>Fixed<br>Price | Weighted-Average<br>Call Fixed<br>Price | SFAS 133<br>Hedge | Fair<br>Value at<br>December 31,<br>2005<br>(\$ in<br>thousands) |
|-----------------------------|------------|----------------------------------------------------------------|----------------------------------------------|-----------------------------------------|-------------------|------------------------------------------------------------------|
| <b>Natural Gas (mmbtu):</b> |            |                                                                |                                              |                                         |                   |                                                                  |
| Swaps:                      |            |                                                                |                                              |                                         |                   |                                                                  |
| 1Q 2006                     | 7,872,500  | 4.91                                                           |                                              |                                         | Yes               | (50,693)                                                         |
| 2Q 2006                     | 10,510,500 | 4.86                                                           |                                              |                                         | Yes               | (56,501)                                                         |
| 3Q 2006                     | 10,626,000 | 4.86                                                           |                                              |                                         | Yes               | (57,355)                                                         |
| 4Q 2006                     | 10,626,000 | 4.86                                                           |                                              |                                         | Yes               | (62,483)                                                         |
| 1Q 2007                     | 10,350,000 | 4.82                                                           |                                              |                                         | Yes               | (68,401)                                                         |
| 2Q 2007                     | 10,465,000 | 4.82                                                           |                                              |                                         | Yes               | (46,158)                                                         |
| 3Q 2007                     | 10,580,000 | 4.82                                                           |                                              |                                         | Yes               | (46,442)                                                         |
| 4Q 2007                     | 10,580,000 | 4.82                                                           |                                              |                                         | Yes               | (51,557)                                                         |
| 1Q 2008                     | 9,555,000  | 4.68                                                           |                                              |                                         | Yes               | (53,954)                                                         |
| 2Q 2008                     | 9,555,000  | 4.68                                                           |                                              |                                         | Yes               | (33,892)                                                         |
| 3Q 2008                     | 9,660,000  | 4.68                                                           |                                              |                                         | Yes               | (33,999)                                                         |
| 4Q 2008                     | 9,660,000  | 4.66                                                           |                                              |                                         | Yes               | (38,487)                                                         |
| 1Q 2009                     | 4,500,000  | 5.18                                                           |                                              |                                         | Yes               | (18,772)                                                         |
| 2Q 2009                     | 4,550,000  | 5.18                                                           |                                              |                                         | Yes               | (10,450)                                                         |
| 3Q 2009                     | 4,600,000  | 5.18                                                           |                                              |                                         | Yes               | (10,508)                                                         |
| 4Q 2009                     | 4,600,000  | 5.18                                                           |                                              |                                         | Yes               | (12,616)                                                         |
| <b>Total</b>                |            |                                                                |                                              |                                         |                   | (652,268)                                                        |
| Collars:                    |            |                                                                |                                              |                                         |                   |                                                                  |
| 1Q 2009                     | 900,000    |                                                                | 4.50                                         | 6.00                                    | Yes               | (3,380)                                                          |
| 2Q 2009                     | 910,000    |                                                                | 4.50                                         | 6.00                                    | Yes               | (1,754)                                                          |
| 3Q 2009                     | 920,000    |                                                                | 4.50                                         | 6.00                                    | Yes               | (1,773)                                                          |
| 4Q 2009                     | 920,000    |                                                                | 4.50                                         | 6.00                                    | Yes               | (2,197)                                                          |
| <b>Total</b>                |            |                                                                |                                              |                                         |                   | (9,104)                                                          |
| <b>Total Natural Gas</b>    |            |                                                                |                                              |                                         |                   | \$ (661,372)                                                     |

In connection with the November 14, 2005 acquisition of Columbia Natural Resources, LLC ( CNR ), Chesapeake assumed obligations under forward gas sales agreements with Mahonia II Limited (Mahonia) to deliver a total of 8.9 bcf of natural gas to Mahonia through February 2006. As of December 31, 2005, the remaining 4.25 bcf of gas scheduled to be delivered under this contract has been recorded as a \$60.9 million current accrued liability, based on the fair value of the delivery commitment at the date of acquisition.

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### Interest Rate Risk

The table below presents principal cash flows and related weighted average interest rates by expected maturity dates. As of December 31, 2005, the fair value of the fixed-rate long-term debt has been estimated based on quoted market prices.

|                               | 2006 | 2007 | 2008 | 2009 | 2010 | Years of Maturity<br>Thereafter<br>(\$ in millions) | Total      | Fair Value |
|-------------------------------|------|------|------|------|------|-----------------------------------------------------|------------|------------|
| <b>Liabilities:</b>           |      |      |      |      |      |                                                     |            |            |
| Long-term debt fixed-rate (a) | \$   | \$   | \$   | \$   | \$   | \$ 5,524.7                                          | \$ 5,524.7 | \$ 5,582.4 |
| Average interest rate         |      |      |      |      |      | 6.3%                                                | 6.3%       | 6.3%       |
| Long-term debt variable rate  | \$   | \$   | \$   | \$   | \$   | \$ 72.0                                             | \$ 72.0    | \$ 72.0    |
| Average interest rate         |      |      |      |      |      | 7.3%                                                | 7.3%       | 7.3%       |

(a) This amount does not include the discount included in long-term debt of (\$95.6) million and the discount for interest rate swaps of (\$11.3) million.

Changes in interest rates affect the amount of interest we earn on our cash, cash equivalents and short-term investments and the interest rate we pay on borrowings under our revolving bank credit facility. All of our other long-term indebtedness is fixed rate and therefore does not expose us to the risk of earnings or cash flow loss due to changes in market interest rates. However, changes in interest rates do affect the fair value of our debt.

### Interest Rate Derivatives

We use interest rate derivatives to mitigate our exposure to the volatility in interest rates. For interest rate derivative instruments designated as fair value hedges (in accordance with SFAS 133), changes in fair value of interest rate derivatives are recorded on the consolidated balance sheets as assets (liabilities) and the debt's carrying value amount is adjusted by the change in the fair value of the debt subsequent to the initiation of the derivative. Any resulting differences are recorded currently as ineffectiveness in the consolidated statements of operations as an adjustment to interest expense. Changes in the fair value of derivative instruments not qualifying as fair value hedges are recorded currently as adjustments to interest expense.

As of December 31, 2005, the following interest rate swaps were used to convert a portion of our long-term fixed-rate debt to floating-rate debt were outstanding:

| Term                         | Notional<br>Amount | Fixed<br>Rate | Floating Rate                         | Fair Value<br>Gain (Loss)<br>(\$ in thousands) |
|------------------------------|--------------------|---------------|---------------------------------------|------------------------------------------------|
| September 2004 - August 2012 | \$ 75,000,000      | 9.000%        | 6 month LIBOR plus 452 basis points   | \$ (2,734)                                     |
| July 2005 - January 2015     | \$ 150,000,000     | 7.750%        | 6 month LIBOR plus 289 basis points   | \$ (5,133)                                     |
| July 2005 - June 2014        | \$ 150,000,000     | 7.500%        | 6 month LIBOR plus 282 basis points   | \$ (5,327)                                     |
| September 2005 - August 2014 | \$ 250,000,000     | 7.000%        | 6 month LIBOR plus 205.5 basis points | \$ (5,004)                                     |
| October 2005 - June 2015     | \$ 200,000,000     | 6.375%        | 6 month LIBOR plus 112 basis points   | \$ (1,344)                                     |
| October 2005 - January 2018  | \$ 250,000,000     | 6.250%        | 6 month LIBOR plus 99 basis points    | \$ (3,240)                                     |
| October 2005 - January 2016  | \$ 200,000,000     | 6.625%        | 6 month LIBOR plus 129 basis points   | \$ 282                                         |

In January 2006, we closed the interest rate swap on our 6.625% Senior Notes for \$1.0 million. Subsequent to December 31, 2005, we entered into the following interest rate swaps (which qualify as fair value hedges) to convert a portion of our long-term fixed-rate debt to floating-rate debt:

| Term | Notional | Floating Rate |
|------|----------|---------------|
|------|----------|---------------|

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|              |              | Amount         |                                       |
|--------------|--------------|----------------|---------------------------------------|
| January 2006 | January 2016 | \$ 250,000,000 | 6 month LIBOR plus 129 basis points   |
| March 2006   | January 2016 | \$ 250,000,000 | 6 month LIBOR plus 120 basis points   |
| March 2006   | August 2017  | \$ 250,000,000 | 6 month LIBOR plus 125.5 basis points |

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In 2005, we closed various interest rate swaps for gains totaling \$7.1 million. These interest rate swaps were designated as fair value hedges, and the settlement amounts received will be amortized as a reduction to realized interest expense over the remaining terms of the related senior notes.

In March 2004, Chesapeake entered into an interest rate swap which required Chesapeake to pay a fixed rate of 8.68% while the counterparty paid Chesapeake a floating rate of six month LIBOR plus 0.75% on a notional amount of \$142.7 million. On March 15, 2005, we elected to terminate the interest rate swap and paid \$31.8 million to the counterparty.

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**ITEM 8. *Financial Statements and Supplementary Data***

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**CHESAPEAKE ENERGY CORPORATION**

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**MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING**

It is the responsibility of the management of Chesapeake Energy Corporation to establish and maintain adequate internal control over financial reporting (as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934). Management utilized the Committee of Sponsoring Organizations of the Treadway Commission's *Internal Control - Integrated Framework* (COSO framework) in conducting the required assessment of effectiveness of the Company's internal control over financial reporting.

Our evaluation of and conclusion on the effectiveness of internal control over financial reporting excludes Columbia Energy Resources, LLC, which we acquired in a purchase business combination on November 14, 2005. The acquisition of Columbia Energy Resources, LLC accounted for approximately twenty percent of our total assets at December 31, 2005, and contributed approximately two percent of our total revenue in fiscal 2005. See Note 13 for additional information regarding the acquisition.

Management has performed an assessment of the effectiveness of the Company's internal control over financial reporting and has determined the Company's internal control over financial reporting was effective as of December 31, 2005.

Our management's assessment of the effectiveness of the Company's internal control over financial reporting as of December 31, 2005 has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in its report which appears herein.

Aubrey K. McClendon

Chairman and Chief Executive Officer

Marcus C. Rowland

Executive Vice President and Chief Financial Officer

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Shareholders

of Chesapeake Energy Corporation:

We have completed integrated audits of Chesapeake Energy Corporation's 2005 and 2004 consolidated financial statements and of its internal control over financial reporting as of December 31, 2005, and an audit of its 2003 consolidated financial statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Our opinions, based on our audits, are presented below.

***Consolidated financial statements and financial statement schedule***

In our opinion, the consolidated financial statements listed in the accompanying index present fairly, in all material respects, the financial position of Chesapeake Energy Corporation and its subsidiaries at December 31, 2005 and 2004, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2005 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the accompanying index presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit of financial statements includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 12 to the consolidated financial statements, effective January 1, 2003, the Company changed the manner in which it accounts for asset retirement obligations.

***Internal control over financial reporting***

Also, in our opinion, management's assessment, included in Management's Report on Internal Control Over Financial Reporting appearing under Item 8, that the Company maintained effective internal control over financial reporting as of December 31, 2005 based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), is fairly stated, in all material respects, based on those criteria. Furthermore, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control - Integrated Framework* issued by the COSO. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on management's assessment and on the effectiveness of the Company's internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

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A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

As described in Management's Report on Internal Control Over Financial Reporting, management has excluded Columbia Energy Resources, LLC from its assessment of internal control over financial reporting as of December 31, 2005 because it was acquired by the Company in a purchase business combination in November 2005. We have also excluded Columbia Energy Resources, LLC from our audit of internal control over financial reporting. Columbia Energy Resources, LLC is a wholly-owned subsidiary whose total assets and total revenues represent twenty percent and two percent, respectively, of the related consolidated financial statement amounts as of and for the year ended December 31, 2005.

PricewaterhouseCoopers LLP

Oklahoma City, Oklahoma

March 13, 2006

**Table of Contents****CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS**

|                                                                                                | December 31,      |              |
|------------------------------------------------------------------------------------------------|-------------------|--------------|
|                                                                                                | 2005              | 2004         |
|                                                                                                | (\$ in thousands) |              |
| ASSETS                                                                                         |                   |              |
| CURRENT ASSETS:                                                                                |                   |              |
| Cash and cash equivalents                                                                      | \$ 60,027         | \$ 6,896     |
| Accounts receivable:                                                                           |                   |              |
| Oil and gas sales                                                                              | 615,382           | 347,081      |
| Joint interest, net of allowances of \$4,904,000 and \$4,648,000, respectively                 | 84,765            | 68,220       |
| Related parties                                                                                | 12,839            | 8,286        |
| Other                                                                                          | 78,208            | 35,781       |
| Deferred income tax asset                                                                      | 234,592           | 18,068       |
| Short-term derivative instruments                                                              | 10,503            | 51,061       |
| Inventory and other                                                                            | 87,081            | 32,147       |
| Total Current Assets                                                                           | 1,183,397         | 567,540      |
| PROPERTY AND EQUIPMENT:                                                                        |                   |              |
| Oil and gas properties, at cost based on full-cost accounting:                                 |                   |              |
| Evaluated oil and gas properties                                                               | 15,880,919        | 9,451,413    |
| Unevaluated properties                                                                         | 1,739,095         | 761,785      |
| Less: accumulated depreciation, depletion and amortization of oil and gas properties           | (3,945,703)       | (3,057,742)  |
| Total oil and gas properties, at cost based on full-cost accounting                            | 13,674,311        | 7,155,456    |
| Other property and equipment                                                                   | 750,083           | 324,495      |
| Drilling rigs                                                                                  | 116,133           | 49,375       |
| Less: accumulated depreciation and amortization of other property, equipment and drilling rigs | (128,640)         | (84,942)     |
| Total Property and Equipment                                                                   | 14,411,887        | 7,444,384    |
| OTHER ASSETS:                                                                                  |                   |              |
| Investment in Pioneer Drilling Company                                                         | 138,095           | 65,950       |
| Other investments                                                                              | 159,348           | 26,793       |
| Long-term derivative instruments                                                               | 78,860            | 44,169       |
| Other assets                                                                                   | 146,875           | 95,673       |
| Total Other Assets                                                                             | 523,178           | 232,585      |
| TOTAL ASSETS                                                                                   | \$ 16,118,462     | \$ 8,244,509 |

**Table of Contents****CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS (Continued)**

|                                                                                                                                                                                                                              | December 31,<br>2005                      2004<br>(\$ in thousands) |            |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------|------------|
| LIABILITIES AND STOCKHOLDERS EQUITY                                                                                                                                                                                          |                                                                     |            |
| CURRENT LIABILITIES:                                                                                                                                                                                                         |                                                                     |            |
| Accounts payable                                                                                                                                                                                                             | \$ 516,792                                                          | \$ 367,176 |
| Short-term derivative instruments                                                                                                                                                                                            | 577,681                                                             | 91,414     |
| Other accrued liabilities                                                                                                                                                                                                    | 364,501                                                             | 222,029    |
| Revenues and royalties due others                                                                                                                                                                                            | 394,693                                                             | 216,820    |
| Accrued interest                                                                                                                                                                                                             | 110,421                                                             | 66,514     |
| Total Current Liabilities                                                                                                                                                                                                    | 1,964,088                                                           | 963,953    |
| LONG-TERM LIABILITIES:                                                                                                                                                                                                       |                                                                     |            |
| Long-term debt, net                                                                                                                                                                                                          | 5,489,742                                                           | 3,075,109  |
| Deferred income tax liability                                                                                                                                                                                                | 1,804,978                                                           | 933,873    |
| Asset retirement obligation                                                                                                                                                                                                  | 156,593                                                             | 73,718     |
| Long-term derivative instruments                                                                                                                                                                                             | 479,996                                                             | 1,296      |
| Revenues and royalties due others                                                                                                                                                                                            | 22,585                                                              | 17,007     |
| Other liabilities                                                                                                                                                                                                            | 26,157                                                              | 16,670     |
| Total Long-Term Liabilities                                                                                                                                                                                                  | 7,980,051                                                           | 4,117,673  |
| CONTINGENCIES AND COMMITMENTS (Note 4)                                                                                                                                                                                       |                                                                     |            |
| STOCKHOLDERS EQUITY:                                                                                                                                                                                                         |                                                                     |            |
| Preferred Stock, \$.01 par value, 20,000,000 shares authorized:                                                                                                                                                              |                                                                     |            |
| 6.00% cumulative convertible preferred stock, 99,310 and 103,110 shares issued and outstanding as of December 31, 2005 and 2004, respectively, entitled in liquidation to \$4,965,500 and \$5,155,500                        | 4,966                                                               | 5,156      |
| 5.00% cumulative convertible preferred stock (Series 2003), 1,025,946 and 1,725,000 shares issued and outstanding as of December 31, 2005 and 2004, respectively, entitled in liquidation to \$102,594,600 and \$172,500,000 | 102,595                                                             | 172,500    |
| 4.125% cumulative convertible preferred stock, 89,060 and 313,250 shares issued and outstanding as of December 31, 2005 and 2004, respectively, entitled in liquidation to \$89,060,000 and \$313,250,000                    | 89,060                                                              | 313,250    |
| 5.00% cumulative convertible preferred stock (Series 2005), 4,600,000 and 0 shares issued and outstanding as of December 31, 2005 and 2004, respectively, entitled in liquidation to \$460,000,000                           | 460,000                                                             |            |
| 4.50% cumulative convertible preferred stock, 3,450,000 and 0 shares issued and outstanding as of December 31, 2005 and 2004, respectively, entitled in liquidation to \$345,000,000                                         | 345,000                                                             |            |
| 5.00% cumulative convertible preferred stock (Series 2005B), 5,750,000 and 0 shares issued and outstanding as of December 31, 2005 and 2004, respectively, entitled in liquidation to \$575,000,000                          | 575,000                                                             |            |
| Common Stock, \$.01 par value, 500,000,000 shares authorized, 375,510,521 and 316,940,784 shares issued December 31, 2005 and 2004, respectively                                                                             | 3,755                                                               | 3,169      |
| Paid-in capital                                                                                                                                                                                                              | 3,803,312                                                           | 2,440,105  |
| Retained earnings                                                                                                                                                                                                            | 1,100,841                                                           | 262,987    |
| Accumulated other comprehensive income (loss), net of tax of \$112,071,000 and (\$11,489,000), respectively                                                                                                                  | (194,972)                                                           | 20,425     |
| Unearned compensation                                                                                                                                                                                                        | (89,242)                                                            | (32,618)   |
| Less: treasury stock, at cost; 5,320,816 and 5,072,121 common shares as of December 31, 2005 and 2004, respectively                                                                                                          | (25,992)                                                            | (22,091)   |
| Total Stockholders Equity                                                                                                                                                                                                    | 6,174,323                                                           | 3,162,883  |

|                                                  |                      |                     |
|--------------------------------------------------|----------------------|---------------------|
| <b>TOTAL LIABILITIES AND STOCKHOLDERS EQUITY</b> | <b>\$ 16,118,462</b> | <b>\$ 8,244,509</b> |
|--------------------------------------------------|----------------------|---------------------|

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

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**Table of Contents****CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF OPERATIONS**

|                                                                                   | Years Ended December 31,                 |              |              |
|-----------------------------------------------------------------------------------|------------------------------------------|--------------|--------------|
|                                                                                   | 2005                                     | 2004         | 2003         |
|                                                                                   | (\$ in thousands, except per share data) |              |              |
| <b>REVENUES:</b>                                                                  |                                          |              |              |
| Oil and gas sales                                                                 | \$ 3,272,585                             | \$ 1,936,176 | \$ 1,296,822 |
| Oil and gas marketing sales                                                       | 1,392,705                                | 773,092      | 420,610      |
| Total Revenues                                                                    | 4,665,290                                | 2,709,268    | 1,717,432    |
| <b>OPERATING COSTS:</b>                                                           |                                          |              |              |
| Production expenses                                                               | 316,956                                  | 204,821      | 137,583      |
| Production taxes                                                                  | 207,898                                  | 103,931      | 77,893       |
| General and administrative expenses                                               | 64,272                                   | 37,045       | 23,753       |
| Oil and gas marketing expenses                                                    | 1,358,003                                | 755,314      | 410,288      |
| Oil and gas depreciation, depletion and amortization                              | 894,035                                  | 582,137      | 369,465      |
| Depreciation and amortization of other assets                                     | 50,966                                   | 29,185       | 16,793       |
| Provision for legal settlements                                                   |                                          | 4,500        | 6,402        |
| Total Operating Costs                                                             | 2,892,130                                | 1,716,933    | 1,042,177    |
| <b>INCOME FROM OPERATIONS</b>                                                     | 1,773,160                                | 992,335      | 675,255      |
| <b>OTHER INCOME (EXPENSE):</b>                                                    |                                          |              |              |
| Interest and other income                                                         | 10,452                                   | 4,476        | 2,827        |
| Interest expense                                                                  | (219,800)                                | (167,328)    | (154,356)    |
| Loss on repurchases or exchanges of Chesapeake debt                               | (70,419)                                 | (24,557)     | (20,759)     |
| Loss on investment in Seven Seas Petroleum, Inc.                                  |                                          |              | (2,015)      |
| Total Other Income (Expense)                                                      | (279,767)                                | (187,409)    | (174,303)    |
| <b>INCOME BEFORE INCOME TAXES AND CUMULATIVE EFFECT OF ACCOUNTING CHANGE</b>      | 1,493,393                                | 804,926      | 500,952      |
| <b>INCOME TAX EXPENSE:</b>                                                        |                                          |              |              |
| Current                                                                           |                                          |              | 5,000        |
| Deferred                                                                          | 545,091                                  | 289,771      | 185,360      |
| Total Income Tax Expense                                                          | 545,091                                  | 289,771      | 190,360      |
| <b>NET INCOME BEFORE CUMULATIVE EFFECT OF ACCOUNTING CHANGE</b>                   | 948,302                                  | 515,155      | 310,592      |
| <b>CUMULATIVE EFFECT OF ACCOUNTING CHANGE, NET OF INCOME TAXES OF \$1,464,000</b> |                                          |              | 2,389        |
| <b>NET INCOME</b>                                                                 | 948,302                                  | 515,155      | 312,981      |
| <b>PREFERRED STOCK DIVIDENDS</b>                                                  | (41,813)                                 | (39,506)     | (22,469)     |
| <b>LOSS ON CONVERSION/EXCHANGE OF PREFERRED STOCK</b>                             | (26,874)                                 | (36,678)     |              |
| <b>NET INCOME AVAILABLE TO COMMON SHAREHOLDERS</b>                                | \$ 879,615                               | \$ 438,971   | \$ 290,512   |
| <b>EARNINGS PER COMMON SHARE BASIC:</b>                                           |                                          |              |              |
| Income before cumulative effect of accounting change                              | \$ 2.73                                  | \$ 1.73      | \$ 1.36      |
| Cumulative effect of accounting change                                            |                                          |              | 0.02         |
|                                                                                   | \$ 2.73                                  | \$ 1.73      | \$ 1.38      |

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## EARNINGS PER COMMON SHARE ASSUMING DILUTION:

|                                                      |    |      |    |      |    |      |
|------------------------------------------------------|----|------|----|------|----|------|
| Income before cumulative effect of accounting change | \$ | 2.51 | \$ | 1.53 | \$ | 1.20 |
| Cumulative effect of accounting change               |    |      |    |      |    | 0.01 |

|  |    |      |    |      |    |      |
|--|----|------|----|------|----|------|
|  | \$ | 2.51 | \$ | 1.53 | \$ | 1.21 |
|--|----|------|----|------|----|------|

|                                         |    |       |    |       |    |       |
|-----------------------------------------|----|-------|----|-------|----|-------|
| CASH DIVIDEND DECLARED PER COMMON SHARE | \$ | 0.195 | \$ | 0.170 | \$ | 0.135 |
|-----------------------------------------|----|-------|----|-------|----|-------|

## WEIGHTED AVERAGE COMMON AND COMMON EQUIVALENT SHARES OUTSTANDING (in thousands):

|       |         |         |         |
|-------|---------|---------|---------|
| Basic | 322,034 | 253,212 | 211,203 |
|-------|---------|---------|---------|

|                   |         |         |         |
|-------------------|---------|---------|---------|
| Assuming dilution | 366,683 | 305,718 | 258,567 |
|-------------------|---------|---------|---------|

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

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**Table of Contents****CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS**

|                                                                                                        | 2005        | Years Ended December 31,<br>2004<br>(\$ in thousands) | 2003        |
|--------------------------------------------------------------------------------------------------------|-------------|-------------------------------------------------------|-------------|
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                                           |             |                                                       |             |
| <b>NET INCOME</b>                                                                                      | \$ 948,302  | \$ 515,155                                            | \$ 312,981  |
| <b>ADJUSTMENTS TO RECONCILE NET INCOME TO CASH PROVIDED BY OPERATING ACTIVITIES:</b>                   |             |                                                       |             |
| Depreciation, depletion, and amortization                                                              | 935,965     | 605,593                                               | 382,004     |
| Deferred income taxes                                                                                  | 544,891     | 289,532                                               | 186,664     |
| Loss on repurchases or exchanges of Chesapeake debt                                                    | 70,419      | 24,557                                                | 20,759      |
| Premiums paid for repurchasing of senior notes                                                         | (59,893)    | (16,281)                                              | (6,695)     |
| Amortization of loan costs and bond discount                                                           | 14,784      | 10,275                                                | 5,861       |
| Unrealized (gains) losses on derivatives                                                               | (42,722)    | (35,549)                                              | (3,992)     |
| Stock-based compensation                                                                               | 15,343      | 4,828                                                 |             |
| Cumulative effect of accounting change                                                                 |             |                                                       | (3,853)     |
| Loss on investment in Seven Seas                                                                       |             |                                                       | 2,015       |
| Other                                                                                                  | (1,362)     | 4,412                                                 | 1,490       |
| (Increase) decrease in accounts receivable                                                             | (204,860)   | (152,590)                                             | (72,683)    |
| (Increase) decrease in inventory and other assets                                                      | (66,979)    | (9,481)                                               | (10,971)    |
| Increase (decrease) in accounts payable, accrued liabilities and other                                 | 92,215      | 97,635                                                | 86,861      |
| Increase (decrease) in current and non-current revenues and royalties due others                       | 160,785     | 94,188                                                | 38,466      |
| Cash provided by operating activities                                                                  | 2,406,888   | 1,432,274                                             | 938,907     |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                                           |             |                                                       |             |
| Acquisitions of oil and gas companies, proved properties and unproved properties, net of cash acquired | (3,925,473) | (1,914,746)                                           | (1,261,275) |
| Exploration and development of oil and gas properties                                                  | (2,371,854) | (1,276,341)                                           | (727,231)   |
| Additions to buildings and other fixed assets                                                          | (417,470)   | (126,707)                                             | (71,454)    |
| Additions to investments                                                                               | (135,013)   | (36,962)                                              | (30,750)    |
| Additions to drilling rig equipment                                                                    | (66,758)    | (23,093)                                              | (1,221)     |
| Deposits for acquisitions                                                                              | (35,000)    | (16,250)                                              | (13,250)    |
| Divestitures of oil and gas properties                                                                 | 9,769       | 12,048                                                | 22,156      |
| Sale of non-oil and gas assets and investments                                                         | 20,422      | 860                                                   | 5,799       |
| Other                                                                                                  | (1)         | (13)                                                  | 9           |
| Cash used in investing activities                                                                      | (6,921,378) | (3,381,204)                                           | (2,077,217) |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                                           |             |                                                       |             |
| Proceeds from long-term borrowings                                                                     | 5,682,000   | 2,160,000                                             | 738,000     |
| Payments on long-term borrowings                                                                       | (5,765,116) | (2,101,000)                                           | (738,000)   |
| Cash received from issuance of senior notes, net of offering costs                                     | 2,924,636   | 1,165,975                                             | 485,445     |
| Proceeds from issuance of preferred stock, net of offering costs                                       | 1,341,529   | 304,936                                               | 390,365     |
| Proceeds from issuance of common stock, net of offering costs                                          | 985,782     | 624,187                                               | 177,427     |
| Cash paid to purchase or exchange senior notes                                                         | (565,868)   | (248,434)                                             | (106,379)   |
| Cash paid for common stock dividends                                                                   | (60,528)    | (38,902)                                              | (27,253)    |
| Cash paid for preferred stock dividends                                                                | (31,480)    | (40,907)                                              | (20,916)    |
| Cash paid for financing cost of credit facilities                                                      | (4,672)     | (9,175)                                               | (2,474)     |
| Cash paid for treasury stock and preferred stock                                                       | (4,000)     |                                                       | (2,109)     |
| Derivative settlements                                                                                 | (11,642)    |                                                       |             |
| Net increase in outstanding payments in excess of cash balance                                         | 61,171      | 88,348                                                | 28,315      |

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|                                                           |           |           |           |
|-----------------------------------------------------------|-----------|-----------|-----------|
| Other financing costs                                     | (5,803)   | (1,770)   | (496)     |
| Cash received from exercise of stock options and warrants | 21,612    | 11,987    | 9,329     |
| Cash provided by financing activities                     | 4,567,621 | 1,915,245 | 931,254   |
| Net increase (decrease) in cash and cash equivalents      | 53,131    | (33,685)  | (207,056) |
| Cash and cash equivalents, beginning of period            | 6,896     | 40,581    | 247,637   |
| Cash and cash equivalents, end of period                  | \$ 60,027 | \$ 6,896  | \$ 40,581 |

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

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**Table of Contents****CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)**

|                                                                               | Years Ended December 31, |            |            |
|-------------------------------------------------------------------------------|--------------------------|------------|------------|
|                                                                               | 2005                     | 2004       | 2003       |
|                                                                               | (\$ in thousands)        |            |            |
| <b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION OF CASH PAYMENTS FOR:</b> |                          |            |            |
| Interest, net of capitalized interest                                         | \$ 175,416               | \$ 134,000 | \$ 137,146 |
| Income taxes, net of refunds received                                         | \$ 200                   | \$ 239     | \$ 5,160   |
| <b>SUPPLEMENTAL SCHEDULE OF NON-CASH INVESTING AND FINANCING ACTIVITIES:</b>  |                          |            |            |

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

In 2005, holders of our 6.0% cumulative convertible preferred stock converted 3,800 shares into 18,468 shares of common stock at a conversion price of \$10.287 per share.

In 2005, holders of our 4.125% and 5.0% (Series 2003) cumulative convertible preferred stock exchanged 224,190 and 699,054 shares, respectively, for 14,321,881 and 4,362,720 shares, respectively, of common stock in privately negotiated exchanges.

In 2005, Chesapeake acquired Columbia Energy Resources, LLC and its subsidiaries including Columbia Natural Resources, LLC ( CNR ) for a total consideration of \$3.02 billion, consisting of \$2.2 billion of cash and derivative liabilities, prepaid sales agreements and other liabilities of \$0.8 billion. See further discussion regarding the CNR acquisition in Note 13 of the notes to our consolidated financial statements.

In 2004, we completed a public exchange offer in which we retired \$458.5 million of our 8.125% Senior Notes due 2011 and \$10.8 million of accrued interest and issued \$72.8 million of our 7.75% Senior Notes due 2015 and \$2.8 million of accrued interest and \$433.5 million of our 6.875% Senior Notes due 2016 and \$4.1 million of accrued interest.

In 2004, we issued an additional \$37.0 million of our 6.875% Senior Notes due 2016 and \$0.5 million of accrued interest in exchange for \$24.3 million of our 8.125% Senior Notes due 2011 and \$0.7 million of accrued interest and \$9.1 million of our 7.75% Senior Notes due 2015 and \$0.1 million of accrued interest in four private exchange transactions.

In 2004, holders of our 6.75% cumulative convertible preferred stock converted 2,998,000 shares into 19,467,482 shares of common stock (at a conversion price of \$7.70 per share).

In 2004, holders of our 6.0% cumulative convertible preferred stock exchanged 600,000 shares for 3,225,000 shares of common stock and 3,896,890 shares for 20,754,817 shares of common stock in a privately negotiated exchange and a public exchange offer, respectively.

In 2004, Chesapeake acquired Hallwood Energy Corporation for a total consideration of \$292.0 million, consisting of \$223.5 million of cash and short-term notes payable of \$60.0 million.

In 2003, we issued \$86.7 million of our 7.75% Senior Notes due 2015, \$63.8 million of our 7.50% Senior Notes due 2013 and accrued interest of \$1.0 million in exchange for \$71.7 million of our 8.125% Senior Notes due 2011, \$40.2 million of our 8.375% Senior Notes due 2008, \$32.0 million of our 8.5% Senior Notes due 2012 and \$2.2 million of accrued interest, pursuant to privately negotiated transactions. The \$71.7 million of our 8.125% Senior Notes, \$40.2 million of our 8.375% Senior Notes and \$32.0 million of our 8.5% Senior Notes were retired upon receipt.

As of December 31, 2005, 2004 and 2003, dividends payable on our common and preferred stock were \$37.9 million, \$19.4 million and \$15.7 million, respectively.

In 2005, 2004 and 2003 oil and gas properties were adjusted by \$251.7 million, \$463.9 million and (\$4.9) million, respectively, for net tax liabilities related to acquisitions.

During 2005, 2004 and 2003, \$27.3 million, \$29.7 million, and \$18.1 million, respectively, of additions to oil and gas properties were recorded as an increase to accrued exploration and development costs.

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We recorded non-cash asset additions to net oil and gas properties of \$76.8 million, \$20.2 million and \$45.7 million in 2005, 2004 and 2003, respectively, for asset retirement obligations.

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

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**Table of Contents****CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY**

|                                                                                                   | Years Ended December 31, |            |            |
|---------------------------------------------------------------------------------------------------|--------------------------|------------|------------|
|                                                                                                   | 2005                     | 2004       | 2003       |
|                                                                                                   | (\$ in thousands)        |            |            |
| <b>PREFERRED STOCK:</b>                                                                           |                          |            |            |
| Balance, beginning of period                                                                      | \$ 490,906               | \$ 552,400 | \$ 149,900 |
| Issuance of 6.00% cumulative convertible preferred stock                                          |                          |            | 230,000    |
| Issuance of 5.00% cumulative convertible preferred stock (Series 2003)                            |                          |            | 172,500    |
| Issuance of 4.125% cumulative convertible preferred stock                                         |                          | 313,250    |            |
| Issuance of 5.00% cumulative convertible preferred stock (Series 2005)                            | 460,000                  |            |            |
| Issuance of 4.50% cumulative convertible preferred stock                                          | 345,000                  |            |            |
| Issuance of 5.00% cumulative convertible preferred stock (Series 2005B)                           | 575,000                  |            |            |
| Exchange of common stock for 224,190 shares of 4.125% preferred stock                             | (224,190)                |            |            |
| Exchange of common stock for 699,054 shares of 5.00% preferred stock (Series 2003)                | (69,905)                 |            |            |
| Exchange of common stock for 2,998,000 shares of 6.75% preferred stock                            |                          | (149,900)  |            |
| Exchange of common stock for 3,800, 4,496,890 and 0 shares of 6.00% preferred stock, respectively | (190)                    | (224,844)  |            |
| Balance, end of period                                                                            | 1,576,621                | 490,906    | 552,400    |
| <b>COMMON STOCK:</b>                                                                              |                          |            |            |
| Balance, beginning of period                                                                      | 3,169                    | 2,218      | 1,949      |
| Issuance of 32,200,000, 46,000,000 and 23,000,000 shares of common stock, respectively            | 322                      | 460        | 230        |
| Exchange of 18,703,069, 43,447,299 and 0 shares of common stock for preferred stock               | 187                      | 435        |            |
| Exercise of stock options and warrants                                                            | 40                       | 29         | 39         |
| Restricted stock grants                                                                           | 37                       | 27         |            |
| Balance, end of period                                                                            | 3,755                    | 3,169      | 2,218      |
| <b>PAID-IN CAPITAL:</b>                                                                           |                          |            |            |
| Balance, beginning of period                                                                      | 2,440,105                | 1,389,212  | 1,205,554  |
| Issuance of common stock                                                                          | 1,024,282                | 649,520    | 186,070    |
| Exchange of 18,703,069, 43,447,299 and 0 shares of common stock for preferred stock, respectively | 294,098                  | 374,310    |            |
| Equity-based compensation                                                                         | 82,144                   | 41,485     | 2,292      |
| Offering expenses                                                                                 | (77,293)                 | (34,297)   | (21,139)   |
| Exercise of stock options and warrants                                                            | 21,573                   | 11,958     | 9,290      |
| Tax benefit from exercise of stock options and restricted stock                                   | 18,506                   | 9,135      | 7,145      |
| Preferred stock conversion/exchange expenses                                                      | (103)                    | (1,218)    |            |
| Balance, end of period                                                                            | 3,803,312                | 2,440,105  | 1,389,212  |
| <b>RETAINED EARNINGS (DEFICIT):</b>                                                               |                          |            |            |
| Balance, beginning of period                                                                      | 262,987                  | (168,617)  | (426,085)  |
| Net income                                                                                        | 948,302                  | 515,155    | 312,981    |
| Dividends on common stock                                                                         | (64,830)                 | (45,229)   | (29,128)   |
| Dividends on preferred stock                                                                      | (45,618)                 | (38,322)   | (26,385)   |
| Balance, end of period                                                                            | 1,100,841                | 262,987    | (168,617)  |
| <b>ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS):</b>                                             |                          |            |            |
| Balance, beginning of period                                                                      | 20,425                   | (20,312)   | (3,461)    |
| Gain (loss) on hedging activity                                                                   | (266,312)                | 15,946     | (16,851)   |
| Unrealized gain on marketable securities                                                          | 50,915                   | 24,791     |            |
| Balance, end of period                                                                            | (194,972)                | 20,425     | (20,312)   |

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**UNEARNED COMPENSATION:**

|                                       |          |          |
|---------------------------------------|----------|----------|
| Balance, beginning of period          | (32,618) |          |
| Restricted stock granted              | (79,979) | (38,949) |
| Amortization of unearned compensation | 23,355   | 6,331    |

|                        |          |          |
|------------------------|----------|----------|
| Balance, end of period | (89,242) | (32,618) |
|------------------------|----------|----------|

**TREASURY STOCK COMMON:**

|                                                                           |          |          |          |
|---------------------------------------------------------------------------|----------|----------|----------|
| Balance, beginning of period                                              | (22,091) | (22,091) | (19,982) |
| Purchase of 257,220, 0 and 279,042 shares of treasury stock, respectively | (4,000)  |          | (2,109)  |
| 401(k) make-up plan distribution of 8,525 shares                          | 99       |          |          |

|                        |          |          |          |
|------------------------|----------|----------|----------|
| Balance, end of period | (25,992) | (22,091) | (22,091) |
|------------------------|----------|----------|----------|

|                                  |              |              |              |
|----------------------------------|--------------|--------------|--------------|
| <b>TOTAL STOCKHOLDERS EQUITY</b> | \$ 6,174,323 | \$ 3,162,883 | \$ 1,732,810 |
|----------------------------------|--------------|--------------|--------------|

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

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**Table of Contents****CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

|                                                                                                                                                              | <b>Years Ended December 31,</b> |             |             |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------|-------------|-------------|
|                                                                                                                                                              | <b>2005</b>                     | <b>2004</b> | <b>2003</b> |
|                                                                                                                                                              | <b>(\$ in thousands)</b>        |             |             |
| Net Income                                                                                                                                                   | \$ 948,302                      | \$ 515,155  | \$ 312,981  |
| Other comprehensive income (loss), net of income tax:                                                                                                        |                                 |             |             |
| Change in fair value of derivative instruments, net of income taxes of (\$317,772,000), (\$44,463,000) and (\$15,272,000), respectively                      | (552,837)                       | (79,046)    | (24,917)    |
| Reclassification of (gain) loss on settled contracts, net of income taxes of \$136,841,000, \$50,480,000 and \$1,448,000, respectively                       | 238,066                         | 89,743      | 2,363       |
| Ineffective portion of derivatives qualifying for cash flow hedge accounting, net of income taxes of \$27,850,000, \$2,953,000 and \$3,495,000, respectively | 48,452                          | 5,249       | 5,703       |
| Unrealized gain on marketable securities, net of income taxes of \$29,266,000, \$13,945,000 and \$0, respectively                                            | 50,915                          | 24,791      |             |
| Other adjustments, net of income taxes of \$3,000                                                                                                            | 6                               |             |             |
| Comprehensive income                                                                                                                                         | \$ 732,904                      | \$ 555,892  | \$ 296,130  |

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

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### **CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES**

#### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

##### **1. Basis of Presentation and Summary of Significant Accounting Policies**

###### *Description of Company*

Chesapeake Energy Corporation ( Chesapeake or the company ) is an oil and natural gas 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 and the marketing of natural gas and oil for other working interest owners in properties we operate. Our properties are located in Oklahoma, Texas, Arkansas, Louisiana, Kansas, Montana, Colorado, North Dakota, New Mexico, West Virginia, Kentucky, Ohio, New York, Maryland, Michigan, Pennsylvania, Tennessee and Virginia.

###### *Principles of Consolidation*

The accompanying consolidated financial statements of Chesapeake include the accounts of our direct and indirect wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated. Investments in companies and partnerships which give us significant influence, but not control, over the investee are accounted for using the equity method. Other investments are generally carried at cost.

###### *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, Chesapeake considers investments in all highly liquid instruments with original maturities of three months or less at date of purchase to be cash equivalents.

###### *Inventory*

Inventory, which is included in current assets, includes tubular goods and other lease and well equipment which we plan to utilize in our ongoing exploration and development activities and is carried at the lower of cost or market using the specific identification method. Oil inventory in tanks is carried at the lower of the estimated cost to produce or market value. Purchased gas inventory is recorded at the lower of weighted average cost or market.

###### *Oil and Gas Properties*

Chesapeake follows the full-cost method of accounting under which all costs associated with property acquisition, exploration and development activities are capitalized. We capitalize internal costs that can be directly identified with our acquisition, exploration and development activities and do 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. As of December 31, 2005, approximately 78% of our proved reserves were evaluated by independent petroleum engineers, with the balance evaluated by our internal reservoir engineers. In addition, our internal engineers evaluate all properties on an annual basis. The average composite rates used for depreciation, depletion and amortization were \$1.91 per equivalent mcfe in 2005, \$1.61 per equivalent mcfe in 2004, and \$1.38 per equivalent mcfe in 2003.



**Table of Contents****CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Proceeds from the sale of properties are accounted for as reductions of 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. No income is recognized in connection with contractual services provided by Chesapeake to other interest owners on properties in which we hold an economic interest.

The costs of unproved properties are excluded from amortization until the properties are evaluated. We review all of our unevaluated properties quarterly to determine whether or not and to what extent proved reserves have been assigned to the properties and otherwise if impairment has occurred. Unevaluated properties are grouped by major prospect area where individual property costs are not significant and are assessed individually when individual costs are significant.

We review the carrying value of our 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, may 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.

We account for seismic costs in accordance with Rule 4-10 of Regulation S-X. Specifically, rule 4-10 requires that all companies that use the full cost method capitalize exploration costs as part of their oil and gas properties (i.e., full cost pool). Exploration costs may be incurred both before acquiring the related property and after acquiring the property. Further, exploration costs include, among other things, geographical and geophysical studies and salaries and other expenses of geologists, geophysical crews, and others conducting those studies. Such costs are capitalized as incurred.

Seismic 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 properties. The company reviews its unproved properties and associated seismic costs quarterly in order to ascertain whether impairment has incurred. To the extent that seismic costs cannot be directly associated with specific unevaluated properties, they are included in the amortization base as incurred.

*Other Property and Equipment and Drilling Rigs*

Other property and equipment consists primarily of gas gathering and processing facilities, drilling rigs, vehicles, land, buildings and improvements, office equipment, and software. Land purchases are made in order to build additional office space at our Oklahoma City headquarters and field offices. 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 a straight-line basis. A summary of other property and equipment and the useful lives are as follows:

|                                                 | December 31,      |            | Useful Life |    |
|-------------------------------------------------|-------------------|------------|-------------|----|
|                                                 | 2005              | 2004       |             |    |
|                                                 | (\$ in thousands) |            | (in years)  |    |
| Land                                            | \$ 74,466         | \$ 24,153  |             |    |
| Buildings and improvements                      | 156,110           | 105,516    | 15          | 39 |
| Gathering, processing and compression equipment | 406,408           | 112,888    | 7           | 20 |
| Other fixtures and equipment                    | 113,099           | 81,938     | 2           | 7  |
| Drilling rigs                                   | 116,133           | 49,375     | 15          |    |
| Total                                           | \$ 866,216        | \$ 373,870 |             |    |



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**CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES**

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

*Investments*

Investments in securities are accounted for under the equity method in circumstances where we are deemed to exercise significant influence over the operating and investing policies of the investee. Under the equity method, we recognize our share of the investee's earnings in our consolidated statements of operations. Investments in securities not accounted for under the equity method are accounted for under the cost method. Investments in marketable equity securities accounted for under the cost method have been designated as available for sale and, as such, are recorded at fair value. We have no investments which are required to be consolidated pursuant to the terms of FASB Interpretation No. (FIN) 46, *Consolidation of Variable Interest Entities*.

Included in investments at December 31, 2005 are equity securities totaling \$297.4 million. At December 31, 2005, investments accounted for under the equity method totaled \$57.8 million and investments accounted for under the cost method totaled \$239.6 million. Included in the investments accounted for under the cost method are an investment in the common stock of Pioneer Drilling Company (AMEX:PDC) reported at a fair market value of \$138.1 million (cost basis of \$42.7 million) and an investment in the common stock of Gastar Exploration Ltd. (AMEX:GST) reported at a fair market value of \$98.4 million (cost basis of \$76.0 million). The fair market value of our investments in Pioneer Drilling Company and Gastar Exploration Ltd. at December 31, 2005 are based upon the closing price of their common stock (\$17.93 per share and \$3.63 per share, respectively).

*Capitalized Interest*

During 2005, 2004 and 2003, interest of approximately \$79.0 million, \$36.2 million and \$13.0 million, respectively, was capitalized on significant investments in unproved properties that were not being currently depreciated, depleted or amortized and on which exploration activities were in progress. Interest is capitalized using the weighted average interest rate on our outstanding borrowings.

*Accounts Payable and Accrued Liabilities*

Included in accounts payable at December 31, 2005 and 2004, respectively, are liabilities of approximately \$177.8 million and \$116.7 million representing the amount by which checks issued, but not yet presented to our banks for collection, exceeded balances in applicable bank accounts. Other accrued liabilities include \$88.3 million and \$61.0 million of accrued drilling costs as of December 31, 2005 and 2004, respectively.

*Debt Issue Costs*

Included in other assets are costs associated with the issuance of our senior notes and costs associated with our revolving bank credit facility. The remaining unamortized debt issue costs at December 31, 2005 and 2004 totaled \$92.2 million and \$54.4 million, respectively, and are being amortized over the life of the senior notes or revolving credit facility.

*Asset Retirement Obligations*

Effective January 1, 2003, Chesapeake adopted Statement of Financial Accounting Standards (SFAS) No. 143, *Accounting for Asset Retirement Obligation*. This statement applies to obligations associated with the retirement of tangible long-lived assets that result from the acquisition, construction and development of the assets.

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**CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES**

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

SFAS 143 requires that the fair value of a liability for a retirement obligation be recognized in the period in which the liability is incurred. For oil and gas properties, this is the period in which an oil or gas well is acquired or drilled. The asset retirement obligation is capitalized as part of the carrying amount of our oil and gas properties at its discounted fair value. The liability is then accreted each period until the liability is settled or the well is sold, at which time the liability is reversed.

*Revenue Recognition*

*Oil and Natural Gas Sales.* Revenue from the sale of oil and natural gas is recognized when title passes, net of royalties.

*Gas Imbalances.* We follow the sales method of accounting for our gas revenue whereby we recognize sales revenue on all gas sold to our purchasers, regardless of whether the sales are proportionate to our ownership in the property. An asset or a liability is recognized to the extent that we have an imbalance in excess of the remaining gas reserves on the underlying properties. The gas imbalance net position at December 31, 2005 and 2004 was a liability of \$4.5 million and \$4.4 million, respectively.

*Marketing Sales.* Chesapeake takes title to the natural gas it purchases from other working interest owners in operated wells and arranges for transportation and delivers the natural gas to third parties, at which time revenues are recorded. Chesapeake's results of operations related to its oil and gas marketing activities are presented on a gross basis, because we act as a principal rather than an agent. All significant intercompany accounts and transactions have been eliminated.

*Hedging*

From time to time, Chesapeake uses commodity price and financial risk management instruments to mitigate our exposure to price fluctuations in oil and natural gas transactions and interest rates. Recognized gains and losses on derivative contracts are reported as a component of the related transaction. Results of oil and gas derivative transactions are reflected in oil and gas sales and results of interest rate hedging transactions are reflected in interest expense. The changes in fair value of derivative instruments not qualifying for designation as either cash flow or fair value hedges that occur prior to maturity are reported currently in the consolidated statement of operations as unrealized gains (losses) within oil and gas sales or interest expense. Cash flows from derivative instruments are classified in the same category within the statement of cash flows as the items being hedged, or on a basis consistent with the nature of the instrument.

We have established the fair value of all derivative instruments using estimates determined by our counterparties and subsequently evaluated internally using established index prices and other sources. These values are based upon, among other things, futures prices, volatility, time to maturity and credit risk. The values we report in our financial statements change as these estimates are revised to reflect actual results, changes in market conditions or other factors.

Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*, establishes accounting and reporting standards requiring that derivative instruments (including certain derivative instruments embedded in other contracts) be recorded at fair value and included in the consolidated balance sheet as assets or liabilities. The accounting for changes in the fair value of a derivative instrument depends on the intended use of the derivative and the resulting designation, which is established at the inception of a derivative. For derivative instruments designated as cash flow hedges, changes in fair value, to the extent the hedge is effective, are recognized in other comprehensive income until the hedged item is recognized in earnings. Any change in the fair value resulting from ineffectiveness, as defined by SFAS 133, is recognized immediately

**Table of Contents****CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

in oil and gas sales. For derivative instruments designated as fair value hedges (in accordance with SFAS 133), changes in fair value, as well as the offsetting changes in the estimated fair value of the hedged item attributable to the hedged risk, are recognized currently in earnings. Differences between the changes in the fair values of the hedged item and the derivative instrument, if any, represent gains or losses on ineffectiveness and are reflected currently in interest expense. Hedge effectiveness is measured at least quarterly based on the relative changes in fair value between the derivative contract and the hedged item over time. Changes in fair value of contracts that do not qualify as hedges or are not designated as hedges are also recognized currently in earnings.

*Stock Options*

Chesapeake has elected to follow APB No. 25, *Accounting for Stock Issued to Employees*, and related interpretations in accounting for its employee and director stock options. Under APB No. 25, compensation expense is recognized for the difference between the option exercise price and market value on the measurement date. The original issuance of stock options has not resulted in the recognition of compensation expense because the exercise price of the stock options granted under the plans has equaled the market price of the underlying stock on the date of grant. Pursuant to FASB Interpretation No. 44 (FIN 44), which addresses the accounting consequence of various modifications to the terms of a previously granted fixed-price stock option, we recognized stock-based compensation expense in the consolidated statements of operations of \$3.9 million, \$0.6 million and \$0.9 million in 2005, 2004 and 2003, respectively. Of the \$3.9 million recognized in 2005, \$1.2 million was capitalized to oil and gas properties.

Pro forma information regarding net income and earnings per share is required by Statement of Financial Accounting Standards No. 123, *Stock-based Compensation* and has been determined as if we had accounted for our employee and director 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 2005, 2004 and 2003, respectively: interest rates (zero-coupon U.S. government issues with a remaining life equal to the expected term of the options) ranging from 2.24% to 4.35%, dividend yields ranging from 0.52% to 1.53%, and volatility factors of the expected market price of our common stock ranging from 0.29 to 0.46. We used a weighted-average expected life of the options of five years for each of 2005, 2004 and 2003.

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

|                                                                     | Years Ended December 31,                    |            |            |
|---------------------------------------------------------------------|---------------------------------------------|------------|------------|
|                                                                     | 2005                                        | 2004       | 2003       |
|                                                                     | (\$ in thousands, except per share amounts) |            |            |
| Net Income:                                                         |                                             |            |            |
| As reported                                                         | \$ 948,302                                  | \$ 515,155 | \$ 312,981 |
| Stock-based compensation expense included in net income, net of tax | 9,743                                       | 3,090      | 586        |
| Pro forma compensation expense, net of tax                          | (18,028)                                    | (14,289)   | (11,604)   |
| Pro forma                                                           | \$ 940,017                                  | \$ 503,956 | \$ 301,963 |
| Basic earnings per common share:                                    |                                             |            |            |
| As reported                                                         | \$ 2.73                                     | \$ 1.73    | \$ 1.38    |
| Pro forma                                                           | \$ 2.71                                     | \$ 1.69    | \$ 1.32    |
| Diluted earnings per common share:                                  |                                             |            |            |
| As reported                                                         | \$ 2.51                                     | \$ 1.53    | \$ 1.21    |
| Pro forma                                                           | \$ 2.48                                     | \$ 1.49    | \$ 1.17    |

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**CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES**

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

For purposes of the pro forma disclosures, the estimated fair value of the options is amortized to expense over the option vesting period, which is four years for employee options.

In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 123(R), *Share-Based Payment*, which revised the accounting for stock-based compensation under SFAS 123. This statement establishes standards for the accounting of transactions in which an entity exchanges its equity instruments for goods or services. SFAS 123(R) requires a public entity to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. That cost will be recognized over the period during which an employee is required to provide services in exchange for the award. The fair value of employee stock options will be estimated using option-pricing models. Excess tax benefits will be recognized as an addition to paid-in capital. Cash retained as a result of those excess tax benefits will be presented in the statement of cash flows as financing cash inflows. The write-off of deferred tax assets relating to unrealized tax benefits associated with recognized compensation cost will be recognized as income tax expense unless there are excess tax benefits from previous awards remaining in paid-in capital to which it can be offset. This statement is effective as of the beginning of the first annual reporting period that begins after June 15, 2005. Chesapeake will implement SFAS 123(R) in the first quarter of 2006 utilizing the modified prospective method, with the Black-Scholes option pricing model continuing to be used to value the stock options as of the grant date. Based on the stock options outstanding and unvested at December 31, 2005 and our current intention to limit future awards of stock options, we do not believe the requirement to expense stock options under SFAS No. 123 (R) will have a significant impact on future results of operations. Chesapeake began issuing shares of restricted common stock to employees in 2004 and to directors in 2005.

*Reclassifications*

Certain reclassifications have been made to the consolidated financial statements for 2004 and 2003 to conform to the presentation used for the 2005 consolidated financial statements.

**2. Net Income Per Share**

Statement of Financial Accounting Standards No. 128, *Earnings Per Share (EPS)*, requires presentation of basic and diluted earnings per share, as defined, on the face of the statements of operations for all entities with complex capital structures. SFAS 128 requires a reconciliation of the numerator and denominator of the basic and diluted EPS computations.

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

For the years ended December 31, 2005, 2004 and 2003, outstanding options to purchase 0.1 million, 0.1 million and 1.9 million shares of common stock at a weighted-average exercise price of \$29.85, \$23.82 and \$11.15, respectively, were antidilutive because the exercise prices of the options were greater than the average market price of the common stock.

For the year ended December 31, 2005, diluted shares do not include the common stock equivalent of the 4.125% preferred stock (convertible into 8,610,708 shares) as the effect was antidilutive, and the preferred stock adjustment to net income does not include \$28.9 million of dividends and loss on conversion/exchange related to these preferred shares.

For the year ended December 31, 2004, diluted shares do not include the common stock equivalent of the 6% preferred stock outstanding prior to conversion (convertible into 21,339,375 shares) as the effect was antidilutive and the preferred stock dividend adjustment to net income does not include \$12.2 million of dividends related to these preferred shares.

**Table of Contents****CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

For the year ended December 31, 2003, outstanding warrants to purchase 0.4 million shares of common stock at a weighted-average exercise price of \$14.55 were antidilutive because the exercise price of the warrants was greater than the average market price of the common stock.

Emerging Issues Task Force (EITF) Issue 04-8, *The Effect of Contingently Convertible Instruments on Diluted Earnings Per Share*, which was issued in September 2004, provides guidance on when the dilutive effect of contingently convertible securities with a market price trigger should be included in diluted EPS. EITF 04-8 states that these securities should be included in the diluted EPS computation regardless of whether the market price trigger has been met. The guidance in EITF 04-8 is effective for all periods ending after December 15, 2004 and has been applied retrospectively by restating previously reported EPS. Accordingly, effective December 15, 2004, the company has assumed the conversion of the 4.125% convertible preferred shares issued in 2004 (if dilutive) for purposes of determining EPS assuming dilution.

A reconciliation for the years ended December 31, 2005, 2004 and 2003 is as follows:

|                                                                                                                             | Income      | Shares        | Per Share |
|-----------------------------------------------------------------------------------------------------------------------------|-------------|---------------|-----------|
|                                                                                                                             | (Numerator) | (Denominator) | Amount    |
| (in thousands, except per share data)                                                                                       |             |               |           |
| For the Year ended December 31, 2005:                                                                                       |             |               |           |
| Basic EPS:                                                                                                                  |             |               |           |
| Income available to common shareholders                                                                                     | \$ 879,615  | 322,034       | \$ 2.73   |
| Effect of Dilutive Securities                                                                                               |             |               |           |
| Assumed conversion as of the beginning of the period of preferred shares outstanding during the period:                     |             |               |           |
| Common shares assumed issued for 4.125% convertible preferred stock                                                         |             | 5,349         |           |
| Common shares assumed issued for 4.50% convertible preferred stock                                                          |             | 2,332         |           |
| Common shares assumed issued for 5.00% (Series 2003) convertible preferred stock                                            |             | 6,254         |           |
| Common shares assumed issued for 5.00% (Series 2005) convertible preferred stock                                            |             | 12,532        |           |
| Common shares assumed issued for 5.00% (Series 2005B) convertible preferred stock                                           |             | 2,177         |           |
| Common shares assumed issued for 6.00% convertible preferred stock                                                          |             | 483           |           |
| Common stock equivalent of preferred stock outstanding prior to conversion, 5.00% (Series 2003) convertible preferred stock |             | 3,024         |           |
| Common stock equivalent of preferred stock outstanding prior to conversion, 6.00% convertible preferred stock               |             | 12            |           |
| Preferred stock dividends                                                                                                   | 36,278      |               |           |
| Loss on redemption of preferred stock                                                                                       | 3,519       |               |           |
| Employee stock options                                                                                                      |             | 10,861        |           |
| Restricted stock                                                                                                            |             | 1,614         |           |
| Warrants assumed in Gothic acquisition                                                                                      |             | 11            |           |
| Diluted EPS Income available to common shareholders and assumed conversions                                                 | \$ 919,412  | 366,683       | \$ 2.51   |



**Table of Contents****CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

|                                                                                                               | Income      | Shares        | Per Share |
|---------------------------------------------------------------------------------------------------------------|-------------|---------------|-----------|
|                                                                                                               | (Numerator) | (Denominator) | Amount    |
| (in thousands, except per share data)                                                                         |             |               |           |
| For the Year ended December 31, 2004:                                                                         |             |               |           |
| Basic EPS:                                                                                                    |             |               |           |
| Income available to common shareholders                                                                       | \$ 438,971  | 253,212       | \$ 1.73   |
| Effect of Dilutive Securities                                                                                 |             |               |           |
| Assumed conversion as of the beginning of the period of preferred shares outstanding during the period:       |             |               |           |
| Common shares assumed issued for 4.125% convertible preferred stock                                           |             | 14,200        |           |
| Common shares assumed issued for 5.00% (Series 2003) convertible preferred stock                              |             | 10,516        |           |
| Common shares assumed issued for 6.00% convertible preferred stock                                            |             | 501           |           |
| Common shares assumed issued for 6.75% convertible preferred stock                                            |             | 16,971        |           |
| Preferred stock dividends                                                                                     | 27,290      |               |           |
| Employee stock options                                                                                        |             | 10,097        |           |
| Restricted stock                                                                                              |             | 203           |           |
| Warrants assumed in Gothic acquisition                                                                        |             | 18            |           |
| Diluted EPS Income available to common shareholders and assumed conversions                                   | \$ 466,261  | 305,718       | \$ 1.53   |
| For the Year Ended December 31, 2003:                                                                         |             |               |           |
| Income before cumulative effect of accounting change, net of tax                                              | \$ 310,592  |               |           |
| Preferred stock dividends                                                                                     | (22,469)    |               |           |
| Basic EPS:                                                                                                    |             |               |           |
| Income available to common shareholders before cumulative effect of accounting change, net of tax             | \$ 288,123  | 211,203       | \$ 1.36   |
| Effect of Dilutive Securities                                                                                 |             |               |           |
| Assumed conversion as of the beginning of the period of preferred shares outstanding during the period:       |             |               |           |
| Common shares assumed issued for 5.00% (Series 2003) convertible preferred stock                              |             | 1,441         |           |
| Common shares assumed issued for 6.00% convertible preferred stock                                            |             | 18,499        |           |
| Common shares assumed issued for 6.75% convertible preferred stock                                            |             | 19,467        |           |
| Preferred stock dividends                                                                                     | 22,469      |               |           |
| Employee stock options                                                                                        |             | 7,957         |           |
| Diluted EPS Income available to common shareholders before cumulative effect of accounting change, net of tax | \$ 310,592  | 258,567       | \$ 1.20   |

**Table of Contents****CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****3. Senior Notes and Revolving Bank Credit Facility**

Our long-term debt consisted of the following at December 31, 2005 and 2004:

|                                                        | December 31,      |              |
|--------------------------------------------------------|-------------------|--------------|
|                                                        | 2005              | 2004         |
|                                                        | (\$ in thousands) |              |
| 7.5% Senior Notes due 2013                             | \$ 363,823        | \$ 363,823   |
| 7.0% Senior Notes due 2014                             | 300,000           | 300,000      |
| 7.5% Senior Notes due 2014                             | 300,000           | 300,000      |
| 7.75% Senior Notes due 2015                            | 300,408           | 300,408      |
| 6.375% Senior Notes due 2015                           | 600,000           | 600,000      |
| 6.625% Senior Notes due 2016                           | 600,000           |              |
| 6.875% Senior Notes due 2016                           | 670,437           | 670,437      |
| 6.5% Senior Notes due 2017                             | 600,000           |              |
| 6.25% Senior Notes due 2018                            | 600,000           |              |
| 6.875% Senior Notes due 2020                           | 500,000           |              |
| 2.75% Contingent Convertible Senior Notes due 2035 (a) | 690,000           |              |
| 8.375% Senior Notes due 2008                           |                   | 18,990       |
| 8.125% Senior Notes due 2011                           |                   | 245,407      |
| 9.0% Senior Notes due 2012                             |                   | 300,000      |
| Revolving bank credit facility                         | 72,000            | 59,000       |
| Discount on senior notes                               | (95,577)          | (84,924)     |
| Premium (discount) for interest rate derivatives (b)   | (11,349)          | 1,968        |
| Total notes payable and long-term debt                 | \$ 5,489,742      | \$ 3,075,109 |

(a) The holders of the 2.75% Contingent Convertible Senior Notes due 2035 may require us to repurchase all or a portion of these notes on November 15, 2015, 2020, 2025 and 2030 at 100% of the principal amount of the notes.

(b) See Note 10 for further discussion related to these instruments.

During the past three years, we have repurchased or exchanged Chesapeake debt and incurred losses in connection with these transactions. The following table shows the losses related to these transactions for 2005, 2004 and 2003, respectively (\$ in millions):

|                                              | Notes    | Loss on Repurchases/Exchanges |           |         |
|----------------------------------------------|----------|-------------------------------|-----------|---------|
|                                              | Retired  | Premium                       | Other (a) | Total   |
| <b>For the Year Ended December 31, 2005:</b> |          |                               |           |         |
| 8.375% Senior Notes due 2008                 | \$ 19.0  | \$ 1.2                        | \$ 0.1    | \$ 1.3  |
| 8.125% Senior Notes due 2011                 | 245.4    | 17.3                          | 4.4       | 21.7    |
| 9.0% Senior Notes due 2012                   | 300.0    | 41.4                          | 6.0       | 47.4    |
|                                              | \$ 564.4 | \$ 59.9                       | \$ 10.5   | \$ 70.4 |
| <b>For the Year Ended December 31, 2004:</b> |          |                               |           |         |
| 8.375% Senior Notes due 2008                 | \$ 190.8 | \$ 16.1                       | \$ 1.5    | \$ 17.6 |

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|                              |          |         |        |         |
|------------------------------|----------|---------|--------|---------|
| 8.5% Senior Notes due 2012   | 4.3      | 0.2     | 0.7    | 0.9     |
| 8.125% Senior Notes due 2011 | 482.8    |         | 6.0    | 6.0     |
|                              | \$ 677.9 | \$ 16.3 | \$ 8.2 | \$ 24.5 |

**For the Year Ended December 31, 2003:**

|                            |          |        |            |         |
|----------------------------|----------|--------|------------|---------|
| 8.5% Senior Notes due 2012 | \$ 106.4 | \$ 6.7 | \$ 14.1(b) | \$ 20.8 |
|----------------------------|----------|--------|------------|---------|

- 
- (a) Includes the write-off of unamortized discounts, deferred charges, transaction costs and derivative charges as described below.  
(b) Includes a \$12.0 million loss that was recognized based on the hedging relationship between the notes and an associated interest rate derivative.

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**CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES**

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

In 2003 and 2004, we completed financing transactions that extended the maturity and lowered the interest rate of our outstanding senior notes. This was accomplished by issuing new senior notes with lower interest rates and extended maturity dates in exchange for existing senior notes. For accounting purposes, the notes exchanged were determined to have substantially similar terms based on their associated future cash flows. Accordingly, unless otherwise noted, these exchanges resulted in no gain or loss being recorded on our consolidated statements of operations.

In January and February of 2004, we issued \$37.0 million of our 6.875% Senior Notes due 2016 in exchange for \$24.3 million of our 8.125% Senior Notes due 2011 and \$9.1 million of our 7.75% Senior Notes due 2015 in four private exchange transactions. In January 2004, we completed a public exchange offer in which we retired \$458.5 million of our 8.125% Senior Notes due 2011 and issued \$72.8 million of our 7.75% Senior Notes due 2015 and \$433.5 million of our 6.875% Senior Notes due 2016. In connection with this exchange, we recorded a pre-tax charge of \$6.0 million, consisting of a \$5.7 million underwriter's fee and \$0.3 million in other transaction costs. In October 2003, we issued \$63.8 million of our 7.50% Senior Notes due 2013 and \$23.7 million of our 7.75% Senior Notes due 2015 in exchange for \$71.7 million of our 8.125% Senior Notes due 2011 and \$12.3 million of our 8.375% Senior Notes due 2008 pursuant to a privately negotiated transaction. In August 2003, we issued \$33.5 million of our 7.75% Senior Notes due 2015 in exchange for \$32.0 million of our 8.5% Senior Notes due 2012 pursuant to a privately negotiated transaction. In July 2003, we issued \$29.5 million of our 7.75% Senior Notes due 2015 in exchange for \$27.9 million of our 8.375% Senior Notes pursuant to a privately negotiated transaction.

The senior note indentures permit us to redeem the senior notes at any time at specified make-whole or redemption prices. The indentures (issued before July 2005) contain covenants limiting our ability and our restricted subsidiaries' ability to incur additional indebtedness; pay dividends on our capital stock or redeem, repurchase or retire our capital stock or subordinated indebtedness; make investments and other restricted payments; incur liens; engage in transactions with affiliates; sell assets; and consolidate, merge or transfer assets.

Chesapeake is a holding company and owns no operating assets and has no significant operations independent of its subsidiaries. Our obligations under our outstanding senior notes have been fully and unconditionally guaranteed, on a joint and several basis, by all of our domestic wholly owned subsidiaries.

As of February 2006, we have a \$2.0 billion syndicated revolving bank credit facility which matures in February 2011. As of December 31, 2005, we had \$72 million of outstanding borrowings under our facility and utilized \$53 million of the facility for various letters of credit. Borrowings under our facility are collateralized by certain producing oil and gas properties and bear interest at either (i) the greater of the reference rate of Union Bank of California, N.A. or the federal funds effective rate plus 0.50% or (ii) the London Interbank Offered Rate (LIBOR), at our option, plus a margin that varies from 0.875% to 1.50% according to our senior unsecured long-term debt ratings. The collateral value and borrowing base are determined periodically. The unused portion of the facility is subject to an annual commitment fee that also varies from 0.125% to 0.30% according to our senior unsecured long-term debt ratings. Currently, the annual commitment fee rate is 0.25%. Interest is payable quarterly or, if LIBOR applies, it may be payable at more frequent intervals.

The credit facility agreement contains various covenants and restrictive provisions which govern our ability to incur additional indebtedness, purchase or redeem our capital stock, make investments or loans, and create liens. The credit facility agreement requires us to maintain an indebtedness to total capitalization ratio (as defined) not to exceed 0.65 to 1 and an indebtedness to EBITDA ratio (as defined) not to exceed 3.5 to 1. At December 31, 2005, our indebtedness to total capitalization ratio was 0.48 to 1 and our indebtedness to EBITDA ratio was 2.34 to 1. If we should fail to perform our obligations under these and other covenants, the revolving

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### **CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES**

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

credit commitment could be terminated and any outstanding borrowings under the facility could be declared immediately due and payable. Such acceleration, if involving a principal amount of \$10 million (\$50 million in the case of our senior notes issued after 2004), would constitute an event of default under our senior note indentures which could in turn result in the acceleration of a significant portion of our senior note indebtedness. The credit facility agreement also has cross default provisions that apply to other indebtedness we may have with an outstanding principal amount in excess of \$75 million.

Our subsidiaries, Chesapeake Exploration Limited Partnership and Chesapeake Appalachia, L.L.C., are the borrowers under our revolving bank credit facility. The facility is fully and unconditionally guaranteed, on a joint and several basis, by Chesapeake and all of our other domestic wholly owned subsidiaries.

#### **4. Contingencies and Commitments**

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

*Employment Agreements with Officers.* Currently, Chesapeake has employment agreements with its chief executive officer, chief operating officer, chief financial officer and various other senior management personnel, which provide for annual base salaries, bonus compensation and various benefits. The agreements provide for the continuation of salary and benefits for varying terms in the event of termination of employment without cause. The agreement with the chief executive officer has a term of five years commencing July 1, 2005. The term of the agreement is automatically extended for one additional year on each January 31 unless the company provides 30 days notice of non-extension. The agreements with the chief operating officer, chief financial officer and other senior managers expire on September 30, 2006. The company's employment agreements with the executive officers provide for payments in the event of a change in control. The chief executive officer is entitled to receive a payment in the amount of three times his base compensation and three-times the value of the prior year's benefits, plus a tax gross-up payment, any stock-based awards held by the chief executive officer will immediately become 100% vested, and any unexercised options will not terminate as a result of his termination of employment. The company will also provide him office space and secretarial and accounting support for a period of 12 months after a change of control. The chief operating officer, chief financial officer and other officers are each entitled to receive a payment in the amount of two times his or her base compensation plus bonuses paid during the prior year. See further discussion regarding the resignation of our former chief operating officer in Note 16 of the notes to our consolidated financial statements.

*Environmental Risk.* Due to the nature of the oil and gas business, Chesapeake and its subsidiaries are exposed to possible environmental risks. Chesapeake has implemented various policies and procedures to avoid environmental contamination and risks from environmental contamination. Chesapeake conducts periodic reviews, on a company-wide basis, to identify changes in our environmental risk profile. These reviews evaluate whether there is a probable liability, its amount, and the likelihood that the liability will be incurred. The amount of any potential liability is determined by considering, among other matters, incremental direct costs of any likely remediation and the proportionate cost of employees who are expected to devote a significant amount of time directly to any possible remediation effort. We manage our exposure to environmental liabilities on properties to be acquired by identifying existing problems and assessing the potential liability. Depending on the extent of an identified environmental problem, Chesapeake may exclude a property from the acquisition, require the seller to remediate the property to our satisfaction, or agree to assume liability for the remediation of the property. Chesapeake has historically not experienced any significant environmental liability, and is not aware of any potential material environmental issues or claims at December 31, 2005.

**Table of Contents****CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

*Leases.* Chesapeake has entered into various operating leases for office space and equipment. Future minimum lease payments required as of December 31, 2005 related to these operating leases are as follows (\$ in thousands):

|              |                  |
|--------------|------------------|
| 2006         | \$ 4,124         |
| 2007         | 3,473            |
| 2008         | 2,837            |
| 2009         | 2,204            |
| 2010         | 419              |
| After 2010   | 702              |
| <b>Total</b> | <b>\$ 13,759</b> |

Rent expense, including short-term rentals, for the years ended December 31, 2005, 2004 and 2003 was \$29.8 million, \$17.9 million and \$13.1 million, respectively.

*Transportation Contracts.* In connection with the November 14, 2005 acquisition of Columbia Natural Resources, LLC, Chesapeake assumed various firm pipeline transportation service agreements with expiration dates ranging from one to 94 years. Under the terms of these contracts, we are obligated to pay demand charges as set forth in the transporter's Federal Energy Regulatory Commission (FERC) gas tariff. In exchange, the company will receive rights to flow natural gas production through pipelines located in highly competitive markets. The aggregate amount of such required demand payments as of December 31, 2005 are as follows (in thousands):

|              |                   |
|--------------|-------------------|
| 2006         | \$ 7,406          |
| 2007         | 3,331             |
| 2008         | 2,972             |
| 2009         | 2,525             |
| 2010         | 1,076             |
| After 2010   | 95,467            |
| <b>Total</b> | <b>\$ 112,777</b> |

In addition, the company is required to pay additional amounts depending on actual quantities shipped under the agreement. The company's total payments under the agreement were \$1.4 million in 2005.

*Drilling Contracts.* We have contracts with various drilling contractors to use 36 drilling rigs in 2006 with terms of one to three years. Minimum future commitments as of December 31, 2005 are as follows (in thousands):

|            |            |
|------------|------------|
| 2006       | \$ 153,321 |
| 2007       | 98,375     |
| 2008       | 62,697     |
| 2009       | 8,818      |
| After 2009 |            |

Total

\$ 323,211

Chesapeake's wholly owned subsidiary, Nomac Drilling Corporation, as of December 31, 2005, had contracted to acquire 26 rigs to be constructed during 2006. The total cost of the rigs is estimated to be approximately \$227 million.

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**Table of Contents****CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Additionally through Nomac Drilling Corporation, as of December 31, 2005, we had agreed to acquire 13 drilling rigs and related assets from Martex Drilling Company, L.L.P., a privately-held drilling contractor with operations in East Texas and North Louisiana, for \$150 million, which was completed in February 2006.

*Other.* On December 23, 2005, Chesapeake and a leading investment bank entered into an agreement to lend Mountain Drilling Company up to \$25 million each. The agreement matures on December 31, 2009. There were no outstanding borrowings under this agreement at December 31, 2005.

In connection with the CNR acquisition, Chesapeake assumed obligations under forward gas sales agreements to deliver natural gas through February 2006. As of December 31, 2005, the remaining 4.25 bcf of gas scheduled to be delivered under this contract was recorded as a \$60.9 million current accrued liability, based on the fair value of the delivery commitment at the date of acquisition.

As of December 31, 2005, Chesapeake had agreed to acquire oil and natural gas assets located in its Barnett Shale, South Texas, Permian Basin, Mid-Continent and East Texas regions from private companies for an aggregate purchase price of approximately \$700 million in cash.

As of December 31, 2005, we had agreed to acquire a privately held Oklahoma-based trucking company for \$48 million. This acquisition closed in January 2006.

As of December 31, 2005, we had agreed to acquire office buildings in Oklahoma City for \$35.5 million. These acquisitions closed in January 2006.

**5. Income Taxes**

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

|              | Years Ended December 31, |                   |                      |
|--------------|--------------------------|-------------------|----------------------|
|              | 2005                     | 2004              | 2003                 |
|              | (\$ in thousands)        |                   |                      |
| Current      | \$                       | \$                | \$ 5,000             |
| Deferred     | 545,091                  | 289,771           | 186,824              |
| <b>Total</b> | <b>\$ 545,091</b>        | <b>\$ 289,771</b> | <b>\$ 191,824(a)</b> |

(a) Includes \$1,464,000 of tax expense related to the cumulative effect of a change in accounting principle.

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

|                                                | Years Ended December 31, |            |            |
|------------------------------------------------|--------------------------|------------|------------|
|                                                | 2005                     | 2004       | 2003       |
|                                                | (\$ in thousands)        |            |            |
| Computed expected federal income tax provision | \$ 522,688               | \$ 281,724 | \$ 176,682 |
| State income taxes and other                   | 22,608                   | 8,230      | 10,968     |
| Change in valuation allowance                  |                          |            | 4,364      |
| Tax percentage depletion                       | (205)                    | (183)      | (190)      |



|            |            |            |
|------------|------------|------------|
| \$ 545,091 | \$ 289,771 | \$ 191,824 |
|------------|------------|------------|

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**Table of Contents****CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

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:

|                                              | <b>Years Ended December 31,</b> |                |
|----------------------------------------------|---------------------------------|----------------|
|                                              | <b>2005</b>                     | <b>2004</b>    |
|                                              | <b>(\$ in thousands)</b>        |                |
| Deferred tax liabilities:                    |                                 |                |
| Oil and gas properties                       | \$ (2,227,960)                  | \$ (1,121,776) |
| Other property and equipment                 | (26,679)                        | (18,128)       |
| Derivative instruments                       |                                 | (10,798)       |
| Investments                                  | (42,211)                        | (5,944)        |
| Deferred tax liabilities                     | \$ (2,296,850)                  | \$ (1,156,646) |
| Deferred tax assets:                         |                                 |                |
| Net operating loss carryforwards             | \$ 246,857                      | \$ 199,897     |
| Asset retirement obligation                  | 59,525                          | 26,907         |
| Derivative instruments                       | 358,660                         |                |
| Accrued liabilities                          | 30,648                          | 1,643          |
| Percentage depletion carryforwards           | 4,603                           | 3,801          |
| Alternative minimum tax credits              | 5,298                           | 5,344          |
| Other                                        | 20,873                          | 3,249          |
| Deferred tax assets                          | \$ 726,464                      | \$ 240,841     |
| Total deferred tax asset (liability)         | \$ (1,570,386)(a)               | \$ (915,805)   |
| Reflected in accompanying balance sheets as: |                                 |                |
| Current deferred income tax asset            | \$ 234,592                      | \$ 18,068      |
| Non-current deferred income tax liability    | (1,804,978)                     | (933,873)      |
|                                              | \$ (1,570,386)                  | \$ (915,805)   |

- (a) In addition to the income tax expense of \$545.1 million, activity during 2005 includes a net liability of \$251.7 million related to acquisitions, a benefit of \$153.1 million related to derivative instruments, a liability of \$29.6 million related to investments, a benefit of \$18.5 million related to stock-based compensation, and a benefit of \$0.2 million related to other miscellaneous items. These items were not recorded as part of the provision for income taxes.

SFAS 109 requires that we record a valuation allowance when it is more likely than not that some portion or all of deferred tax assets will not be realized. During 2004, we determined that it was more likely than not that \$6.8 million of the deferred tax assets related to Louisiana net operating losses, upon which we had previously recorded a valuation allowance, would be realized due to the acquisitions occurring in 2004. The recognition of the deferred tax asset was included as a component of the acquisition of the properties and was not reflected as a reduction of the 2004 provision for income tax.

As of December 31, 2005, we classified \$234.6 million of deferred tax assets as current that were attributable to the current portion of derivative liabilities and other current temporary differences. As of December 31, 2004, we classified \$18.1 million of deferred tax assets as current that were attributable to the current portion of derivative liabilities and other current temporary differences.

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**Table of Contents****CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

At December 31, 2005, Chesapeake had federal income tax net operating loss (NOL) carryforwards of approximately \$564.5 million. Additionally, we had \$169.6 million of alternative minimum tax (AMT) NOL carryforwards available as a deduction against future AMT income and approximately \$12.3 million of percentage depletion carryforwards. The NOL carryforwards expire from 2012 through 2025. The value of these carryforwards depends on the ability of Chesapeake to generate taxable income. In addition, for AMT purposes, only 90% of AMT income in any given year may be offset by AMT NOLs. A summary of our NOLs follows:

|                   | NOL<br>(\$ in thousands) | AMT NOL           |
|-------------------|--------------------------|-------------------|
| Expiration Date:  |                          |                   |
| December 31, 2012 | \$ 171,588               | \$                |
| December 31, 2018 | 42,187                   |                   |
| December 31, 2019 | 145,855                  | 57,414            |
| December 31, 2020 | 5,155                    | 1,393             |
| December 31, 2021 | 15,370                   | 5,313             |
| December 31, 2022 | 50,410                   | 25,299            |
| December 31, 2023 | 65,273                   | 37,648            |
| December 31, 2024 | 60,349                   | 40,062            |
| December 31, 2025 | 8,264                    | 2,506             |
| <b>Total</b>      | <b>\$ 564,451</b>        | <b>\$ 169,635</b> |

The ability of Chesapeake to utilize NOL carryforwards to reduce future federal taxable income and federal income tax of Chesapeake is subject to various limitations under the Internal Revenue Code of 1986, as amended. The utilization of such carryforwards may be limited upon the occurrence of certain ownership changes, including the issuance or exercise of rights to acquire stock, the purchase or sale of stock by 5% stockholders, as defined in the Treasury regulations, and the offering of stock by us during any three-year period resulting in an aggregate change of more than 50% in the beneficial ownership of Chesapeake.

In the event of an ownership change (as defined for income tax purposes), Section 382 of the Code imposes an annual limitation on the amount of a corporation's taxable income that can be offset by these carryforwards. The limitation is generally equal to the product of (i) the fair market value of the equity of the company multiplied by (ii) a percentage approximately equivalent to the yield on long-term tax exempt bonds during the month in which an ownership change occurs. In addition, the limitation is increased if there are recognized built-in gains during any post-change year, but only to the extent of any net unrealized built-in gains (as defined in the Code) inherent in the assets sold. Certain NOLs acquired through various acquisitions are also subject to limitations.

The following table summarizes our net operating losses as of December 31, 2005 and any related limitations:

|                        | Total      | Limited<br>(\$ in thousands) | Annual<br>Limitation |
|------------------------|------------|------------------------------|----------------------|
| Net operating loss     | \$ 564,451 | \$ 49,284                    | \$ 27,754            |
| AMT net operating loss | \$ 169,635 | \$ 11,220                    | \$ 6,652             |

Although no assurances can be made, we do not believe that an ownership change has occurred as of December 31, 2005. Future equity transactions by Chesapeake or by 5% stockholders (including relatively small transactions and transactions beyond our control) could cause an ownership change and therefore a limitation on the annual utilization of NOLs.

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### **CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES**

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

##### **6. Related Party Transactions**

As of December 31, 2005, we had accrued accounts receivable from our two co-founders, CEO Aubrey K. McClendon and former COO Tom L. Ward, of \$6.4 million and \$6.4 million, respectively, representing joint interest billings from December 2005 which were invoiced and paid in January 2006. Since Chesapeake was founded in 1989, Messrs. McClendon and Ward have acquired small working interests in certain of our oil and gas properties by participating in our drilling activities. Joint interest billings to them are settled in cash immediately upon delivery of a monthly joint interest billing.

Under the Founder Well Participation Program, approved by our shareholders in June 2005, Messrs. McClendon and Ward may elect to participate in all or none of the wells drilled by or on behalf of Chesapeake, but they are not allowed to participate only in selected wells. A participation election is required to be received by the Compensation Committee of Chesapeake's Board of Directors 30 days prior to the start of each calendar year. Their participation is permitted only under the terms outlined in the Founder Well Participation Program, which, among other things, limits their individual participation to a maximum working interest of 2.5% in a well and prohibits participation in situations where Chesapeake's working interest would be reduced below 12.5% as a result of their participation. In addition, the company is reimbursed for the cost of its leasehold acquired by Messrs. McClendon and Ward as a result of their well participation. As a result of the resignation of Mr. Ward on February 10, 2006, his participation in the Founder Well Participation Program will expire on August 10, 2006, which is also the expiration date of non-competition covenants applicable to Mr. Ward.

As disclosed in Note 8, in 2005, Chesapeake had revenues of \$851.4 million from oil and gas sales to Eagle Energy Partners I, L.P., an affiliated entity.

During 2005, 2004 and 2003, we paid legal fees of \$1.2 million, \$1.1 million and \$2.1 million, respectively, for legal services provided by a law firm of which a former director is a member.

##### **7. Employee Benefit Plans**

We maintain two qualified 401(k) profit sharing plans, the Chesapeake Energy Corporation Savings and Incentive Stock Bonus Plan, which is open to employees of Chesapeake and all our subsidiaries except Nomac Drilling Corporation, and the Nomac Drilling 401(k) Plan, which is open to employees of Nomac Drilling Corporation. Eligible employees may elect to defer voluntary contributions to the plans, subject to plan limits and those set by the Internal Revenue Service. Chesapeake matches contributions to the Chesapeake Savings and Incentive Stock Bonus Plan dollar for dollar with Chesapeake common stock purchased in the open market for up to 15% of an employee's annual compensation. The company contributed \$10.0 million, \$6.9 million and \$4.0 million to this plan during 2005, 2004 and 2003, respectively. The company matched contributions to the Nomac Drilling 401(k) Plan dollar for dollar with Chesapeake common stock purchased in the open market for up to 8% of the participating employee's annual compensation during 2005. Prior to 2005, the matching contribution to the Nomac plan was 6%. The company contributed \$0.4 million, \$0.2 million and \$0.1 million to this plan in 2005, 2004 and 2003, respectively.

In November 2005, Chesapeake acquired Columbia Natural Resources, LLC., which sponsors the Columbia Natural Resources, LLC 401(k) Plan. Chesapeake's 401(k) plan was amended effective January 1, 2006 to honor previous service by employees with CNR and predecessor companies. Employees that were offered employment with Chesapeake effective January 1, 2006 are eligible to participate in Chesapeake's 401(k) plan. This group of employees includes employees in the Charleston, WV headquarters office as well as exempt, administrative field employees. Existing assets of these participants are scheduled for transfer to the Chesapeake plan on March 1, 2006. All non-administrative field employees, including union employees, are excluded from participation in the

**Table of Contents****CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Chesapeake plan and will continue participation in the existing CNR plan. This plan will remain active and will be adopted by the new employer entity, Chesapeake Appalachia, L.L.C.

In January 2003, we established a 401(k) make-up plan and a deferred compensation plan, both of which are nonqualified deferred compensation plans. To be eligible to participate in the 401(k) make-up plan during 2004 and 2003, an employee had to receive annual compensation (base salary and bonus combined) of at least \$90,000, have a minimum of five years of service as a company employee and have made the maximum contribution allowable under the 401(k) plan. The company matched employee contributions to the 401(k) make-up plan in Chesapeake common stock dollar for dollar for up to 15% of the employee's annual compensation. In December 2004, Chesapeake amended the 401(k) make-up plan and the deferred compensation plan in response to the American Jobs Creation Act of 2004, which set out new guidelines for such plans. The compensation eligibility threshold (base salary and bonus combined) for the 401(k) make-up plan was adjusted to \$95,000 in 2005 to correspond with the IRS annual limitations. Effective January 1, 2006, the compensation eligibility threshold (base salary and bonus combined) for the 401(k) make-up plan was increased to \$100,000. We contributed \$1.6 million, \$1.4 million and \$1.2 million to the 401(k) make-up plan during 2005, 2004 and 2003, respectively.

Non-employee directors and employees with at least one year of service receiving an annual base salary of at least \$100,000 during the 12 months prior to the enrollment date were eligible to participate in the deferred compensation plan in 2003 and 2004. In 2005, the annual base salary compensation limit required for eligibility in the deferred compensation plan was reduced to \$95,000. Non-employee directors are able to defer up to 100% of director fees. The maximum compensation that can be deferred under all company deferred compensation plans, including the Chesapeake 401(k) plan, has been increased to a total of 75% of base salary and 100% of performance bonus. Chesapeake made no matching or other contributions to the deferred compensation plan, although the plan permits the company to make discretionary contributions.

Any assets placed in trust by Chesapeake to fund future obligations of the 401(k) make-up plan and the deferred compensation plan are subject to the claims of creditors in the event of insolvency or bankruptcy, and participants are general creditors of the company as to their deferred compensation in the plans.

Chesapeake maintains no post-employment benefit plans except those sponsored by CNR. CNR employees who elected to accept employment with Chesapeake effective January 1, 2006 are no longer eligible to participate in the CNR post-employment benefit plans. As of December 31, 2005, a total of 193 employees remained eligible for these plans. The CNR benefit plans provide health care and life insurance benefits to eligible employees upon retirement. We account for these benefits on an accrual basis. As of December 31, 2005, the company had accrued \$2.6 million in accumulated post-employment benefit liability.

**8. Major Customers and Segment Information**

Sales to individual customers constituting 10% or more of total revenues were as follows:

| Year Ended December 31, | Customer                      | Percent of        |                |
|-------------------------|-------------------------------|-------------------|----------------|
|                         |                               | Amount            | Total Revenues |
|                         |                               | (\$ in thousands) |                |
| 2005                    | Eagle Energy Partners I, L.P. | \$ 851,420        | 18%            |
| 2004                    | Eagle Energy Partners I, L.P. | \$ 467,387        | 17%            |
| 2003                    | Reliant Energy Services       | \$ 189,140        | 11%            |
| 2003                    | Duke Energy Field Services    | \$ 163,329        | 10%            |

In September 2003, Chesapeake invested \$5.8 million in Eagle Energy Partners I, L.P. and received a 25% limited partnership interest. Through additional investments totaling \$3.4 million, Chesapeake has increased its





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**CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES**

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

limited partner ownership interest to approximately 33% as of December 31, 2005. Chesapeake accounts for its investment in Eagle Energy Partners I, L.P. under the equity method of accounting in accordance with APB 18. In October 2005, Chesapeake purchased a fixed volume of gas in storage from Eagle Energy Partners I, L.P. for approximately \$29 million. Along with the gas storage purchased, Chesapeake assumed hedging contracts which Eagle had previously negotiated covering the gas in storage. These hedges have scheduled maturities beginning in December 2005 and ending in March 2006. Eagle Energy has agreed to periodically purchase the gas in storage from Chesapeake at market prices plus a premium of \$0.1125 per mcf beginning in December 2005 and ending in March 2006. As of December 31, 2005, the remaining gas storage had a market value of \$29.6 million and the assumed hedges had a market value of (\$6.7) million.

In accordance with SFAS 131, *Disclosures about Segments of an Enterprise and Related Information*, we have identified two reportable operating segments. These segments are managed separately because of the nature of their products and services. Chesapeake's two reportable segments are the exploration and production segment and the marketing segment. Based upon the growth of the company's drilling rig operations in 2005, drilling operations have been presented in Other for all years presented. These operations previously had been considered a part of the exploration and production segment.

The exploration and production segment is responsible for finding and producing natural gas and crude oil. The marketing segment is responsible for gathering, processing, transporting and selling natural gas and crude oil primarily from Chesapeake operated wells.

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Management evaluates the performance of our segments based upon income before income taxes and cumulative effect of accounting change. Revenues from the marketing segment's sale of oil and gas related to Chesapeake's ownership interests are reflected as exploration and production revenues. Such amounts totaled \$2,395.9 million, \$1,349.1 million and \$875.3 million for 2005, 2004 and 2003, respectively. Revenues and associated expenses from the drilling of oil and gas wells on Chesapeake-operated properties generally are eliminated and included as part of the carrying value of our oil and gas properties. The following tables present selected financial information for Chesapeake according to our operating segments:

| <b>For the Year Ended December 31, 2005:</b> | <b>Exploration and<br/>Production</b> | <b>Marketing</b>  | <b>Other<br/>Operations<br/>(\$ in thousands)</b> | <b>Intercompany<br/>Eliminations</b> | <b>Consolidated<br/>Total</b> |
|----------------------------------------------|---------------------------------------|-------------------|---------------------------------------------------|--------------------------------------|-------------------------------|
| Revenues                                     | \$ 3,272,585                          | \$ 3,788,653      | \$ 60,755                                         | \$ (2,456,703)                       | \$ 4,665,290                  |
| Intersegment revenues                        |                                       | (2,395,948)       | (60,755)                                          | 2,456,703                            |                               |
| Total Revenues                               | 3,272,585                             | 1,392,705         |                                                   |                                      | 4,665,290                     |
| Depreciation, depletion and amortization     | 939,904                               | 5,097             | 5,897                                             | (5,897)                              | 945,001                       |
| Interest and other income                    | 9,684                                 | 523               | 299                                               | (54)                                 | 10,452                        |
| Interest expense                             | 219,800                               |                   |                                                   |                                      | 219,800                       |
| Other expense                                | 70,419                                |                   |                                                   |                                      | 70,419                        |
| <b>INCOME BEFORE INCOME TAXES</b>            | <b>\$ 1,466,652</b>                   | <b>\$ 26,496</b>  | <b>\$ 10,089</b>                                  | <b>\$ (9,844)</b>                    | <b>\$ 1,493,393</b>           |
| <b>TOTAL ASSETS</b>                          | <b>\$ 15,123,840</b>                  | <b>\$ 688,747</b> | <b>\$ 305,875</b>                                 | <b>\$</b>                            | <b>\$ 16,118,462</b>          |
| <b>CAPITAL EXPENDITURES</b>                  | <b>\$ 7,696,400</b>                   | <b>\$ 132,817</b> | <b>\$ 69,945</b>                                  | <b>\$</b>                            | <b>\$ 7,899,162</b>           |
| <b>For the Year Ended December 31, 2004:</b> |                                       |                   |                                                   |                                      |                               |
| Revenues                                     | \$ 1,936,176                          | \$ 2,122,235      | \$ 22,864                                         | \$ (1,372,007)                       | \$ 2,709,268                  |
| Intersegment revenues                        |                                       | (1,349,143)       | (22,864)                                          | 1,372,007                            |                               |
| Total Revenues                               | 1,936,176                             | 773,092           |                                                   |                                      | 2,709,268                     |
| Depreciation, depletion and amortization     | 602,894                               | 8,428             | 3,775                                             | (3,775)                              | 611,322                       |
| Interest and other income                    | 3,944                                 | 532               | 240                                               | (240)                                | 4,476                         |
| Interest expense                             | 167,328                               |                   |                                                   |                                      | 167,328                       |
| Other expense                                | 24,557                                |                   |                                                   |                                      | 24,557                        |
| <b>INCOME BEFORE INCOME TAXES</b>            | <b>\$ 801,583</b>                     | <b>\$ 3,343</b>   | <b>\$ (1,995)</b>                                 | <b>\$ 1,995</b>                      | <b>\$ 804,926</b>             |
| <b>TOTAL ASSETS</b>                          | <b>\$ 7,810,772</b>                   | <b>\$ 318,246</b> | <b>\$ 115,491</b>                                 | <b>\$</b>                            | <b>\$ 8,244,509</b>           |
| <b>CAPITAL EXPENDITURES</b>                  | <b>\$ 3,845,851</b>                   | <b>\$ 42,462</b>  | <b>\$ 23,957</b>                                  | <b>\$</b>                            | <b>\$ 3,912,270</b>           |
| <b>For the Year Ended December 31, 2003:</b> |                                       |                   |                                                   |                                      |                               |
| Revenues                                     | \$ 1,296,822                          | \$ 1,295,872      | \$ 15,652                                         | \$ (890,914)                         | \$ 1,717,432                  |
| Intersegment revenues                        |                                       | (875,262)         | (15,652)                                          | 890,914                              |                               |
| Total Revenues                               | 1,296,822                             | 420,610           |                                                   |                                      | 1,717,432                     |
| Depreciation, depletion and amortization     | 383,065                               | 3,193             | 3,485                                             | (3,485)                              | 386,258                       |
| Interest and other income                    | 1,673                                 | 1,154             | 29                                                | (29)                                 | 2,827                         |
| Interest expense                             | 154,345                               | 11                |                                                   |                                      | 154,356                       |
| Other expense                                | 22,774                                |                   |                                                   |                                      | 22,774                        |
| <b>INCOME BEFORE INCOME TAXES</b>            | <b>\$ 496,133</b>                     | <b>\$ 4,819</b>   | <b>\$ (1,996)</b>                                 | <b>\$ 1,996</b>                      | <b>\$ 500,952</b>             |
| <b>TOTAL ASSETS</b>                          | <b>\$ 4,340,673</b>                   | <b>\$ 195,733</b> | <b>\$ 35,885</b>                                  | <b>\$</b>                            | <b>\$ 4,572,291</b>           |

|                             |              |           |          |              |
|-----------------------------|--------------|-----------|----------|--------------|
| <b>CAPITAL EXPENDITURES</b> | \$ 2,084,896 | \$ 27,265 | \$ 1,206 | \$ 2,113,367 |
|-----------------------------|--------------|-----------|----------|--------------|

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**Table of Contents****CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****9. Stockholders Equity, Restricted Stock and Stock Options**

The following is a summary of the changes in our common shares outstanding for 2005, 2004 and 2003:

|                                       | 2005          | 2004 | 2003 |
|---------------------------------------|---------------|------|------|
|                                       | (in millions) |      |      |
| Shares outstanding, beginning of year | 317           | 222  | 195  |
| Stock option and warrant exercises    | 4             | 3    | 4    |
| Restricted stock issuances            | 4             | 3    |      |
| Preferred stock conversions           | 19            | 43   |      |
| Common stock issuances                | 32            | 46   | 23   |
| Shares outstanding, end of year       | 376           | 317  | 222  |

The following is a summary of the changes in our preferred shares outstanding for 2005, 2004 and 2003:

|                                         | 6.75%       | 6.00%       | 5%<br>(2003) | 4.125%    | 5%<br>(2005) | 4.50%     | 5% (2005B) |
|-----------------------------------------|-------------|-------------|--------------|-----------|--------------|-----------|------------|
| Shares outstanding, 1/1/05              |             | 103,110     | 1,725,000    | 313,250   |              |           |            |
| Preferred stock issuances               |             |             |              |           | 4,600,000    | 3,450,000 | 5,750,000  |
| Conversion of preferred                 |             | (3,800)     |              |           |              |           |            |
| Exchanges of preferred for common stock |             |             | (699,054)    | (224,190) |              |           |            |
| Shares outstanding, 12/31/05            |             | 99,310      | 1,025,946    | 89,060    | 4,600,000    | 3,450,000 | 5,750,000  |
| Shares outstanding, 1/1/04              | 2,998,000   | 4,600,000   | 1,725,000    |           |              |           |            |
| Preferred stock issuances               |             |             |              | 313,250   |              |           |            |
| Conversion by holder                    | (960,000)   |             |              |           |              |           |            |
| Mandatory conversion                    | (2,038,000) |             |              |           |              |           |            |
| Exchange of preferred for common stock  |             | (600,000)   |              |           |              |           |            |
| Registered exchange offer               |             | (3,896,890) |              |           |              |           |            |
| Shares outstanding, 12/31/04            |             | 103,110     | 1,725,000    | 313,250   |              |           |            |
| Shares outstanding, 1/1/03              | 2,998,000   |             |              |           |              |           |            |
| Preferred stock issuances               |             | 4,600,000   | 1,725,000    |           |              |           |            |
| Shares outstanding, 12/31/03            | 2,998,000   | 4,600,000   | 1,725,000    |           |              |           |            |

In connection with the exchanges noted above, we recorded a loss of \$26.9 million in 2005 and \$36.7 million in 2004 in the consolidated statements of operations. In general, the loss is equal to the excess of the fair value of all common stock exchanged over the fair value of the securities issuable pursuant to the original conversion terms of the preferred stock.

In 2005, holders of our 6.00% cumulative convertible preferred stock converted 3,800 shares into 18,468 shares of our common stock.

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In 2005, holders of our 5.00% (Series 2003) cumulative convertible preferred stock converted 699,054 shares into 4,362,720 shares of our common stock.

In 2005, holders of our 4.125% cumulative convertible preferred stock converted 224,190 shares into 14,321,881 shares of our common stock.

In April 2005, we issued 4,600,000 shares of 5.00% (Series 2005) cumulative convertible preferred stock, par value \$0.01 per share and liquidation preference \$100 per share, in a private offering, all of which were

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**CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES**

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

outstanding as of December 31, 2005. The net proceeds from the offering were \$447.2 million. Each share of preferred stock is convertible, at the holder's option at any time, initially into approximately 3.8811 shares of our common stock based on an initial conversion price of \$25.766 per share, subject to specified adjustments. At December 31, 2005, 17,853,060 shares of our common stock were reserved for issuance upon conversion. The preferred stock is subject to mandatory conversion, at our option, on or after April 15, 2010 (1) at the same rate if the market price of the common stock equals or exceeds 130% of the conversion price, or \$33.50, for a specified time period and (2) at the lower of the conversion price and the then current market price of common stock if there are less than 250,000 shares of preferred stock outstanding at the time. Annual cumulative cash dividends of \$5.00 per share are payable quarterly on the fifteenth day of each January, April, July and October.

In September 2005, we issued 3,450,000 shares of 4.50% cumulative convertible preferred stock, par value of \$0.01 per share and liquidation preference \$100 per share, in a public offering, all of which were outstanding as of December 31, 2005. The net proceeds from the offering were \$335.2 million. Each share of preferred stock is convertible, at the holder's option at any time, initially into approximately 2.2639 shares of our common stock based on an initial conversion price of \$44.172 per share, subject to specified adjustments. At December 31, 2005, 7,810,455 shares of our common stock were reserved for issuance upon conversion. The preferred stock is subject to mandatory conversion, at our option, on or after September 15, 2010 (1) at the same rate if the market price of the common stock equals or exceeds 130% of the conversion price, or \$57.42, for a specified time period and (2) at the lower of the conversion price and the then current market price of common stock if there are less than 250,000 shares of preferred stock outstanding at the time. Annual cumulative cash dividends of \$4.50 per share are payable quarterly on the fifteenth day of each March, June, September and December.

In September 2005, we issued 9,200,000 shares of Chesapeake common stock at \$32.72 per share in a public offering for net proceeds of \$289.4 million.

In November 2005, we issued 5,750,000 shares of 5.00% (Series 2005B) cumulative convertible preferred stock, par value of \$0.01 per share and liquidation preference \$100 per share, in a private offering, all of which were outstanding as of December 31, 2005. The net proceeds from the offering were \$559.1 million. Each share of preferred stock is convertible, at the holder's option at any time, initially into approximately 2.5595 shares of our common stock based on an initial conversion price of \$39.07 per share, subject to specified adjustments. At December 31, 2005, 14,717,125 shares of our common stock were reserved for issuance upon conversion. The preferred stock is subject to mandatory conversion, at our option, on or after November 15, 2010 (1) at the same rate if the market price of the common stock equals or exceeds 130% of the conversion price, or \$50.79, for a specified time period and (2) at the lower of the conversion price and the then current market price of common stock if there are less than 250,000 shares of preferred stock outstanding at the time. Annual cumulative cash dividends of \$5.00 per share are payable quarterly on the fifteenth day of each February, May, August and November.

In December 2005, we issued 23,000,000 shares of Chesapeake common stock at \$31.46 per share in a public offering for net proceeds of \$696.4 million.

In 2004, holders of our 6.75% cumulative convertible preferred stock converted 2,998,000 shares into 19,467,482 shares of common stock (at a conversion price of \$7.70 per share).

In 2004, a holder of our 6.0% cumulative convertible preferred stock exchanged 600,000 shares for 3,225,000 shares of common stock in a privately negotiated transaction, and holders exchanged 3,896,890 shares of such preferred stock for 20,754,817 shares of common stock in a public exchange offer.

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**CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES**

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

In August 2004, we issued 23,000,000 shares of Chesapeake common stock at \$14.75 per share in a public offering for net proceeds of \$326.2 million.

In March and April 2004, we issued 313,250 shares of 4.125% cumulative convertible preferred stock, par value \$.01 per share and liquidation preference \$1,000 per share, in a private offering, 89,060 shares of which were outstanding as of December 31, 2005. The net proceeds from the offering were \$304.9 million. Each share of preferred stock is convertible initially into 60.0555 shares of common stock (which is calculated using an initial conversion price of \$16.65 per share of common stock), subject to adjustment upon the occurrence of certain events. A holder's right to convert will arise only when (i) the closing sale price of our common stock reaches or exceeds 130% of the conversion price for a specified period of time; (ii) the trading price of the preferred stock falls below 98% of the product of the closing sale price of our common stock and the conversion price for a specified period of time; or (iii) upon the occurrence of certain corporate transactions. At December 31, 2005, 5,348,542 shares of our common stock were reserved for issuance upon conversion. The preferred stock is subject to mandatory conversion, at our option, on or after March 15, 2009 (1) at the same rate if the market price of the common stock equals or exceeds 130% of the conversion price, or \$21.65, for a specified time period and (2) at the lower of the conversion price and the then current market price of common stock if there are less than 25,000 shares of preferred stock outstanding at the time. Annual cumulative cash dividends of \$41.25 per share are payable quarterly on the fifteenth day of each March, June, September and December.

In January 2004, we issued 23,000,000 shares of Chesapeake common stock at \$13.51 per share in a public offering for net proceeds of \$298.1 million.

In November 2003, we issued 1,725,000 shares of 5.00% (Series 2003) cumulative convertible preferred stock, par value \$.01 per share and liquidation preference \$100 per share, in a public offering, 1,025,946 of which were outstanding as of December 31, 2005. The net proceeds from the offering were \$167.6 million. Each preferred share is convertible at any time at the option of the holder into 6.0962 shares of common stock, subject to adjustment. At December 31, 2005, 6,254,372 shares of our common stock were reserved for issuance upon conversion. The conversion rate is based on an initial conversion price of \$16.40 per common share plus cash in lieu of fractional shares. The preferred stock is subject to mandatory conversion, at our option, (1) on or after November 18, 2006 at the same rate, if the market price of the common stock equals or exceeds 130% of the conversion price, or \$21.32, for a specified time period and (2) on or after November 18, 2008, at the lower of the conversion price and the then current market price of common stock if there are less than 250,000 shares of preferred stock outstanding at the time. Annual cumulative cash dividends of \$5.00 per share are payable quarterly on the fifteenth day of each February, May, August and November.

In March 2003, we issued 23,000,000 shares of Chesapeake common stock at \$8.10 per share in a public offering for net proceeds of \$177.4 million.

In March 2003, we issued 4,600,000 shares of 6.00% cumulative convertible preferred stock, par value \$.01 per share and liquidation preference \$50 per share, in a private offering, 99,310 shares of which were outstanding as of December 31, 2005. The net proceeds from the offering were \$222.8 million. Each preferred share is convertible at any time at the option of the holder into 4.8605 shares of common stock, subject to adjustment. At December 31, 2005, 482,696 shares of common stock were reserved for issuance upon conversion. The conversion rate is based on an initial conversion price of \$10.287 per common share plus cash in lieu of fractional shares. The preferred stock is subject to mandatory conversion at our option, (1) on or after March 20, 2006 at the same rate if the market price of the common stock equals or exceeds 130% of the conversion price, or \$13.37, at the time and (2) on or after March 20, 2008 at the lower of the conversion price and the then current market price of the common stock if there are less than 250,000 shares of preferred stock outstanding at the time.

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**CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES**

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

Annual cumulative cash dividends of \$3.00 per share are payable quarterly on the fifteenth day of March, June, September and December.

*Restricted Stock*

During 2005 and 2004, Chesapeake issued 3.9 million shares and 2.7 million shares, respectively, of restricted common stock to directors and employees. The total value of restricted shares granted is recorded as unearned compensation in stockholders' equity based on the fair market value of the shares on the date of grant. This value is amortized over the vesting period, which is four years from the date of grant. To the extent amortization of compensation cost relates to employees directly involved in acquisition, exploration and development activities, such amounts are capitalized to oil and gas properties. Amounts not capitalized to oil and gas properties are recognized in general and administrative expense. Chesapeake recognized amortization of compensation cost related to restricted stock totaling \$23.3 million and \$6.3 million during 2005 and 2004. Of these amounts, \$12.6 million and \$4.2 million were reflected in general and administrative expense with the remaining \$10.7 million and \$2.1 million capitalized to oil and gas properties. As of December 31, 2005 and 2004, the unamortized balance of unearned compensation recorded as a reduction of stockholders' equity was \$89.2 million and \$32.6 million.

The vesting of certain restricted stock grants results in state and federal income tax benefits related to the difference between the market price of the common stock at the date of vesting and the date of grant. During 2005, we recognized a tax benefit of \$2.0 million, which was recorded as an adjustment to additional paid-in capital and deferred income taxes with respect to such benefits.

*Stock-Based Compensation Plans*

Under Chesapeake's Long Term Incentive Plan, restricted stock, stock options, stock appreciation rights, performance shares and other stock awards may be awarded to employees, directors and consultants of Chesapeake. Subject to any adjustments as provided by the plan, the aggregate number of shares which may be issued and sold may not exceed 3,000,000 shares. The maximum period for exercise of an option or stock appreciation right may not be more than ten years from the date of grant and the exercise price may not be less than the fair market value of the shares underlying the option or stock appreciation right on the date of grant. Awards granted under the plan become vested at dates or upon the satisfaction of certain performance or other criteria determined by a committee of the board of directors. No awards may be granted under this plan after September 30, 2014. This plan has been approved by our shareholders. Stock options to purchase 150,000 and 50,000 shares of our common stock were issued to our directors from this plan in 2005 and 2004, respectively. In addition, 62,500 shares of restricted stock were issued to our directors from this plan in 2005. As of December 31, 2005, there were 2.7 million shares remaining available for issuance under the plan.

Under Chesapeake's 2003 Stock Incentive Plan, restricted stock and incentive and nonqualified stock options to purchase our common stock may be awarded to employees and consultants of Chesapeake. Subject to any adjustments as provided by the plan, the aggregate number of shares which may be issued and sold may not exceed 10,000,000 shares. The maximum period for exercise of an option may not be more than ten years from the date of grant and the exercise price may not be less than the fair market value of the shares underlying the option on the date of grant. Restricted stock and options granted become vested at dates determined by a committee of the board of directors. No awards may be granted under this plan after April 14, 2013. This plan has been approved by our shareholders. There were 3.9 million restricted shares, net of forfeitures, issued during 2005 from this plan. As of December 31, 2005, there were 3.7 million shares remaining available for issuance under the plan.



**Table of Contents****CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Under Chesapeake's 2003 Stock Award Plan for Non-Employee Directors, 10,000 shares of Chesapeake's common stock will be awarded to each newly appointed non-employee director on his or her first day of service. Subject to any adjustments as provided by the plan, the aggregate number of shares which may be issued may not exceed 50,000 shares. This plan was not required to be approved by our shareholders. In 2005, 10,000 shares of common stock were awarded to a new director from this plan. As of December 31, 2005, there are 30,000 shares remaining available for issuance under this plan.

Under Chesapeake's 2002 Non-Employee Director Stock Option Plan and 1992 Nonstatutory Stock Option Plan, we granted nonqualified options to purchase our common stock to members of our board of directors who are not Chesapeake employees. Subject to any adjustments provided for in the plans, the 2002 plan and the 1992 plan covered a maximum of 500,000 shares and 3,132,000 shares, respectively. No shares remained available for option grants under the plans as of December 31, 2005. The 1992 plan terminated in December 2002 and the 2002 plan terminated in June 2005. Pursuant to a formula award provision in the plans, each non-employee director received a quarterly grant of a ten-year immediately exercisable option to purchase shares of common stock at an exercise price equal to the fair market value of the shares on the date of grant. Both plans were approved by our shareholders.

In addition to the plans described above, we have stock options outstanding to employees under a number of employee stock option plans which are described below. These plans were terminated in June 2005 (with the exception of the 1994 Plan which expired in October 2004) and therefore no shares remain available for stock option grants under the plans. Beginning in 2004, stock-based compensation awards to employees have been made in the form of restricted stock from the 2003 Stock Incentive Plan.

| Name of Plan                                       | Eligible Participants     | Type of                    |                                                   | Shareholder     |
|----------------------------------------------------|---------------------------|----------------------------|---------------------------------------------------|-----------------|
|                                                    |                           | Options                    | Shares Covered                                    |                 |
| 2002 and 2001 Stock Option Plans                   | Employees and consultants | Incentive and nonqualified | 3,000,000/ 3,200,000                              | Approved<br>Yes |
| 2001 and 2000 Executive Officer Stock Option Plans | Executive officers        | Nonqualified               | 4,000,000/<br>2,500,000<br>(treasury shares only) | No              |
| 2002 and 2001 Nonqualified Stock Option Plans      | Employees and consultants | Nonqualified               | 4,000,000/<br>3,000,000                           | No              |
| 2000 Employee and 1999 Stock Option Plans          | Employees and consultants | Nonqualified               | 3,000,000 (each plan)                             | No              |
| 1996 and 1994 Stock Option Plans                   | Employees and consultants | Incentive and nonqualified | 6,000,000/<br>4,886,910                           | Yes             |

Each of these plans provided that the maximum period for exercise of an option may not be more than ten years from the date of grant and the exercise price may not be less than the fair market value of the shares underlying the options on the date of grant; provided, however, nonqualified stock options not exceeding 10% of the options issuable under each of the plans (except the 1996 and 1994 Stock Option Plans) could have been granted at an exercise price which was not less than 85% of the grant date fair market value. The 1996 Stock Option Plan did not limit the amount of nonqualified stock options that could be granted with an exercise price of at least 85% of the fair market value of the shares underlying the options on the date of grant. The 1994 Stock Option Plan, which terminated in October 2004, did not permit options with an exercise price below the fair market value of the shares underlying the options on the date of grant. Options granted under all these plans become exercisable at dates determined by a committee of the board of directors.

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A summary of our stock option activity and related information follows:

|                                             | 2005          |                | Years Ended December 31,<br>2004 |                | 2003          |                |
|---------------------------------------------|---------------|----------------|----------------------------------|----------------|---------------|----------------|
|                                             | Weighted-Avg. |                | Weighted-Avg.                    |                | Weighted-Avg. |                |
|                                             | Options       | Exercise Price | Options                          | Exercise Price | Options       | Exercise Price |
| Outstanding beginning of period             | 24,228,464    | \$ 6.00        | 27,233,285                       | \$ 5.78        | 24,576,775    | \$ 4.40        |
| Granted                                     | 177,500       | 18.67          | 347,250                          | 14.23          | 7,168,623     | 8.98           |
| Exercised                                   | (4,032,180)   | 5.78           | (3,219,877)                      | 4.94           | (4,262,915)   | 3.04           |
| Canceled/forfeited                          | (117,771)     | 8.51           | (132,194)                        | 8.21           | (249,198)     | 8.51           |
| Outstanding end of period                   | 20,256,013    | \$ 6.14        | 24,228,464                       | \$ 6.00        | 27,233,285    | \$ 5.78        |
| Exercisable end of period                   | 15,960,440    | \$ 5.57        | 15,441,511                       | \$ 5.06        | 12,131,098    | \$ 4.26        |
| Shares authorized for future grants         | 6,452,444     |                | 8,392,285                        |                | 11,018,225    |                |
| Fair value of options granted during period | \$ 6.21       |                | \$ 4.66                          |                | \$ 3.36       |                |

The following table summarizes information about stock options outstanding at December 31, 2005:

| Range of Exercise Prices |            | Outstanding Options<br>Weighted-Avg.<br>Remaining Contractual Life |                              | Options Exercisable<br>Weighted-Avg.<br>Exercise Price |                              |
|--------------------------|------------|--------------------------------------------------------------------|------------------------------|--------------------------------------------------------|------------------------------|
| Number Outstanding       |            |                                                                    | Weighted-Avg. Exercise Price | Number Exercisable                                     | Weighted-Avg. Exercise Price |
| \$ 0.94 \$ 1.13          | 2,381,599  | 2.89                                                               | \$ 1.08                      | 2,381,599                                              | \$ 1.08                      |
| 1.38 4.00                | 2,183,302  | 4.17                                                               | 3.26                         | 2,183,302                                              | 3.26                         |
| 4.06 4.06                | 2,058      | 2.46                                                               | 4.06                         | 2,058                                                  | 4.06                         |
| 5.20 5.20                | 2,714,939  | 6.56                                                               | 5.20                         | 1,836,849                                              | 5.20                         |
| 5.35 5.96                | 1,812,027  | 4.90                                                               | 5.57                         | 1,787,912                                              | 5.56                         |
| 6.11 6.11                | 4,777,753  | 5.75                                                               | 6.11                         | 4,776,816                                              | 6.11                         |
| 6.13 7.74                | 252,771    | 5.78                                                               | 6.91                         | 222,673                                                | 6.87                         |
| 7.80 7.80                | 2,739,115  | 7.02                                                               | 7.80                         | 1,124,867                                              | 7.80                         |
| 7.86 10.01               | 258,106    | 6.63                                                               | 8.48                         | 184,345                                                | 8.55                         |
| 10.08 30.63              | 3,134,343  | 7.74                                                               | 11.46                        | 1,460,019                                              | 12.78                        |
| \$ 0.94 \$30.63          | 20,256,013 | 5.72                                                               | \$ 6.14                      | 15,960,440                                             | \$ 5.57                      |

The exercise of certain stock options results in state and federal income tax benefits to us related to the difference between the market price of the common stock at the date of disposition and the option price. During 2005, 2004 and 2003, we recognized tax benefits of \$16.5 million, \$9.1 million and \$7.1 million, which were recorded as adjustments to additional paid-in capital and deferred income taxes with respect to such benefits.

*Shareholder Rights Plan*

Chesapeake maintains a shareholder rights plan designed to deter coercive or unfair takeover tactics, to prevent a person or group from gaining control of Chesapeake without offering fair value to all shareholders and to deter other abusive takeover tactics which are not in the best interest of shareholders.

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**CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES**

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

Under the terms of the plan, each share of common stock is accompanied by one right, which given certain acquisition and business combination criteria, entitles the shareholder to purchase from Chesapeake one one-thousandth of a newly issued share of Series A preferred stock at a price of \$25.00, subject to adjustment by Chesapeake.

The rights become exercisable 10 days after Chesapeake learns that an acquiring person (as defined in the plan) has acquired 15% or more of the outstanding common stock of Chesapeake or 10 business days after the commencement of a tender offer which would result in a person owning 15% or more of such shares. Chesapeake may redeem the rights for \$0.01 per right within ten days following the time Chesapeake learns that a person has become an acquiring person. The rights will expire on July 27, 2008, unless redeemed earlier by Chesapeake.

**10. Financial Instruments and Hedging Activities**

*Oil and Gas Hedging Activities*

Our results of operations and operating cash flows are impacted by changes in market prices for oil and gas. To mitigate a portion of the exposure to adverse market changes, we have entered into various derivative instruments. As of December 31, 2005, our oil and gas derivative instruments were comprised of swaps, cap-swaps, basis protection swaps, call options and collars. These instruments allow us to predict with greater certainty the effective oil and gas prices to be received for our hedged production. Although derivatives often fail to achieve 100% effectiveness for accounting purposes, we believe our derivative instruments continue to be highly effective in achieving the risk management objectives for which they were intended.

For swap instruments, Chesapeake receives a fixed price for the hedged commodity and pays a floating market price to the counterparty. The fixed-price payment and the floating-price payment are netted, resulting in a net amount due to or from the counterparty.

For cap-swaps, Chesapeake receives a fixed price and pays a floating market price. The fixed price received by Chesapeake includes a premium in exchange for a cap limiting the counterparty's exposure. In other words, there is no limit to Chesapeake's exposure but there is a limit to the downside exposure of the counterparty.

Basis protection swaps are arrangements that guarantee a price differential for oil or gas from a specified delivery point. Chesapeake receives a payment from the counterparty if the price differential is greater than the stated terms of the contract and pays the counterparty if the price differential is less than the stated terms of the contract.

For call options, Chesapeake receives a cash premium from the counterparty in exchange for the sale of a call option. If the market price exceeds the fixed price of the call option, then Chesapeake pays the counterparty such excess. If the market price settles below the fixed price of the call option, no payment is due from Chesapeake.

Collars contain a fixed floor price (put) and ceiling price (call). If the market price exceeds the call strike price or falls below the put strike price, Chesapeake receives the fixed price and pays the market price. If the market price is between the call and the put strike price, no payments are due from either party.

Chesapeake enters into counter-swaps from time to time for the purpose of locking-in the value of a swap. Under the counter-swap, Chesapeake receives a floating price for the hedged commodity and pays a fixed price to the counterparty. The counter-swap is 100% effective in locking-in the value of a swap since subsequent changes in the market value of the swap are entirely offset by subsequent changes in the market value of the

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counter-swap. We refer to this locked-in value as a locked swap. At the time Chesapeake enters into a counter-swap, Chesapeake removes the original swap's designation as a cash flow hedge and classifies the original swap as a non-qualifying hedge under SFAS 133. The reason for this new designation is that collectively the swap and the counter-swap no longer hedge the exposure to variability in expected future cash flows. Instead, the swap and counter-swap effectively lock-in a specific gain (or loss) that will be unaffected by subsequent variability in oil and gas prices. Any locked-in gain or loss is recorded in accumulated other comprehensive income and reclassified to oil and gas sales in the month of related production.

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

Chesapeake enters into derivatives from time to time for the purpose of converting a fixed price gas sales contract to a floating price. We refer to these contracts as floating-price swaps. For a floating-price swap, Chesapeake receives a floating market price from the counterparty and pays a fixed price.

In accordance with FIN No. 39, to the extent that a legal right of setoff exists, Chesapeake nets the value of its derivative arrangements with the same counterparty in the accompanying consolidated balance sheets.

Chesapeake enters into basis protection swaps for the purpose of locking-in a price differential for oil or gas from a specified delivery point. We currently have basis protection swaps covering four different delivery points which correspond to the actual prices we receive for much of our gas production. By entering into these basis protection swaps, we have effectively reduced our exposure to market changes in future gas price differentials. As of December 31, 2005, the fair value of our basis protection swaps was \$307.3 million. Currently, our basis protection swaps cover approximately 24% of our anticipated gas production in 2006, 24% in 2007, 20% in 2008 and 14% in 2009.

Gains or losses from derivative transactions are reflected as adjustments to oil and gas sales on the consolidated statements of operations. Realized gains (losses) included in oil and gas sales were (\$401.7) million, (\$154.9) million and (\$17.4) million in 2005, 2004 and 2003, respectively. Pursuant to SFAS 133, certain derivatives do not qualify for designation as cash flow hedges. Changes in the fair value of these non-qualifying derivatives that occur prior to their maturity (i.e., temporary fluctuations in value) are reported currently in the consolidated statements of operations as unrealized gains (losses) within oil and gas sales. Unrealized gains (losses) included in oil and gas sales were \$41.1 million, \$40.9 million and \$10.5 million, in 2005, 2004 and 2003, respectively.

Following provisions of SFAS 133, changes in the fair value of derivative instruments designated as cash flow hedges, to the extent they are effective in offsetting cash flows attributable to the hedged risk, are recorded in other comprehensive income until the hedged item is recognized in earnings. Any change in fair value resulting from ineffectiveness is recognized currently in oil and gas sales as unrealized gains (losses). We recorded a gain (loss) on ineffectiveness of (\$76.3) million, (\$8.2) million and (\$9.2) million in 2005, 2004 and 2003, respectively.

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The estimated fair values of our oil and gas derivative instruments (including derivatives acquired from CNR) as of December 31, 2005 and 2004 are provided below. The associated carrying values of these instruments are equal to the estimated fair values.

|                                  | <b>December 31,</b>      |             |
|----------------------------------|--------------------------|-------------|
|                                  | <b>2005</b>              | <b>2004</b> |
|                                  | <b>(\$ in thousands)</b> |             |
| Derivative assets (liabilities): |                          |             |
| Fixed-price gas swaps            | \$ (1,047,094)           | \$ 57,073   |
| Gas basis protection swaps       | 307,308                  | 122,287     |
| Fixed-price gas cap-swaps        | (161,056)                | (48,761)    |
| Fixed-price gas counter-swaps    | 37,785                   | 4,654       |
| Gas call options (a)             | (21,461)                 | (5,793)     |
| Fixed-price gas collars          | (9,374)                  | (5,573)     |
| Fixed-price gas locked swaps     | (34,229)                 | (77,299)    |
| Floating-price gas swaps         | 2,607                    |             |
| Fixed-price oil swaps            | (16,936)                 |             |
| Fixed-price oil cap-swaps        | (3,364)                  | (8,238)     |
| Estimated fair value             | \$ (945,814)             | \$ 38,350   |

(a) After adjusting for the remaining \$23.0 million and \$3.2 million premium paid to Chesapeake by the counterparty, the cumulative unrealized gain (loss) related to these call options as of December 31, 2005 and 2004 was \$1.6 million and (\$2.6) million, respectively. Based upon the market prices at December 31, 2005, we expect to transfer approximately \$153.8 million (net of income taxes) of the loss included in the balance in accumulated other comprehensive income to earnings during the next 12 months when the transactions actually close. All transactions hedged as of December 31, 2005 are expected to mature by December 31, 2009.

We have two secured hedging facilities, each of which permits us to enter into cash-settled natural gas and oil commodity transactions, valued by the counterparty, for up to \$500 million. The scheduled maturity date for these facilities is May 2010. Outstanding transactions under each facility are collateralized by certain of our oil and gas properties that do not secure any of our other obligations. One of the hedging facilities is subject to an annual fee of 0.30% of the maximum total capacity, and each of them has a 1.0% exposure fee, which is assessed quarterly on the average of the daily negative fair market value amounts, if any, during the quarter. As of December 31, 2005, the fair market value of the natural gas and oil hedging transactions was a liability of \$92.9 million under one of the facilities and a liability of \$10.9 million under the other facility. The hedging facilities contain the standard representations and default provisions that are typical of such agreements. As of March 10, 2006, the fair market value of the same transactions was an asset of approximately \$100 million and \$400 million, respectively. The agreements also contain various restrictive provisions which govern the aggregate gas and oil production volumes that we are permitted to hedge under all of our agreements at any one time.

We assumed certain liabilities related to open derivative positions in connection with the CNR acquisition. In accordance with SFAS 141, these derivative positions were recorded at fair value in the purchase price allocation as a liability of \$592 million. The recognition of the derivative liability and other assumed liabilities resulted in an increase in the total purchase price which is allocated to the assets acquired. Because of this accounting treatment, only cash settlements for changes in fair value subsequent to the acquisition date for the derivative positions assumed will result in adjustments to our oil and gas revenues upon settlement. For example, if the fair value of the derivative positions assumed do not change then upon the sale of the underlying



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

production and corresponding settlement of the derivative positions, cash would be paid to the counterparties and there would be no adjustment to oil and gas revenues related to the derivative positions. If, however, the actual sales price is different from the price assumed in the original fair value calculation, the difference would be reflected as either a decrease or increase in oil and gas revenues, depending upon whether the sales price was higher or lower, respectively, than the prices assumed in the original fair value calculation. For accounting purposes, the net effect of these acquired hedges is that we have hedged the production volumes listed below market prices on the date of our acquisition of CNR.

Pursuant to Statement of Financial Accounting Standards No. 149, *Amendment of SFAS 133 on Derivative Instruments and Hedging Activities*, the derivative instruments assumed in connection with the CNR acquisition are deemed to contain a significant financing element and all cash flows associated with these positions will be reported as financing activity in the statement of cash flows for the periods in which settlement occurs.

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The following details the CNR derivatives we have assumed:

|                             |            | Weighted-<br>Average<br><br>Fixed<br>Price to be<br>Received (Paid) | Weighted<br>Average<br>Put<br>Fixed<br>Price | Weighted-<br>Average<br>Call<br><br>Fixed<br>Price | SFAS 133<br>Hedge | Fair<br><br>Value at<br>December 31,<br>2005<br><br>(\$ in<br>thousands) |
|-----------------------------|------------|---------------------------------------------------------------------|----------------------------------------------|----------------------------------------------------|-------------------|--------------------------------------------------------------------------|
|                             | Volume     |                                                                     |                                              |                                                    |                   |                                                                          |
| <b>Natural Gas (mmbtu):</b> |            |                                                                     |                                              |                                                    |                   |                                                                          |
| Swaps:                      |            |                                                                     |                                              |                                                    |                   |                                                                          |
| 1Q 2006                     | 7,872,500  | 4.91                                                                |                                              |                                                    | Yes               | (50,693)                                                                 |
| 2Q 2006                     | 10,510,500 | 4.86                                                                |                                              |                                                    | Yes               | (56,501)                                                                 |
| 3Q 2006                     | 10,626,000 | 4.86                                                                |                                              |                                                    | Yes               | (57,355)                                                                 |
| 4Q 2006                     | 10,626,000 | 4.86                                                                |                                              |                                                    | Yes               | (62,483)                                                                 |
| 1Q 2007                     | 10,350,000 | 4.82                                                                |                                              |                                                    | Yes               | (68,401)                                                                 |
| 2Q 2007                     | 10,465,000 | 4.82                                                                |                                              |                                                    | Yes               | (46,158)                                                                 |
| 3Q 2007                     | 10,580,000 | 4.82                                                                |                                              |                                                    | Yes               | (46,442)                                                                 |
| 4Q 2007                     | 10,580,000 | 4.82                                                                |                                              |                                                    | Yes               | (51,557)                                                                 |
| 1Q 2008                     | 9,555,000  | 4.68                                                                |                                              |                                                    | Yes               | (53,954)                                                                 |
| 2Q 2008                     | 9,555,000  | 4.68                                                                |                                              |                                                    | Yes               | (33,892)                                                                 |
| 3Q 2008                     | 9,660,000  | 4.68                                                                |                                              |                                                    | Yes               | (33,999)                                                                 |
| 4Q 2008                     | 9,660,000  | 4.66                                                                |                                              |                                                    | Yes               | (38,487)                                                                 |
| 1Q 2009                     | 4,500,000  | 5.18                                                                |                                              |                                                    | Yes               | (18,772)                                                                 |
| 2Q 2009                     | 4,550,000  | 5.18                                                                |                                              |                                                    | Yes               | (10,450)                                                                 |
| 3Q 2009                     | 4,600,000  | 5.18                                                                |                                              |                                                    | Yes               | (10,508)                                                                 |
| 4Q 2009                     | 4,600,000  | 5.18                                                                |                                              |                                                    | Yes               | (12,616)                                                                 |
| <b>Total</b>                |            |                                                                     |                                              |                                                    |                   | (652,268)                                                                |
| Collars:                    |            |                                                                     |                                              |                                                    |                   |                                                                          |
| 1Q 2009                     | 900,000    |                                                                     | 4.50                                         | 6.00                                               | Yes               | (3,380)                                                                  |
| 2Q 2009                     | 910,000    |                                                                     | 4.50                                         | 6.00                                               | Yes               | (1,754)                                                                  |
| 3Q 2009                     | 920,000    |                                                                     | 4.50                                         | 6.00                                               | Yes               | (1,773)                                                                  |
| 4Q 2009                     | 920,000    |                                                                     | 4.50                                         | 6.00                                               | Yes               | (2,197)                                                                  |
| <b>Total</b>                |            |                                                                     |                                              |                                                    |                   | (9,104)                                                                  |
| <b>Total Natural Gas</b>    |            |                                                                     |                                              |                                                    |                   | \$ (661,372)                                                             |

*Interest Rate Derivatives*

We utilize hedging strategies to manage our exposure to changes in interest rates. To the extent interest rate swaps have been designated as fair value hedges, changes in the fair value of the derivative instrument and the corresponding debt are reflected as adjustments to interest expense in the corresponding months covered by the derivative agreement. Changes in the fair value of derivative instruments not qualifying as fair value hedges are recorded currently as adjustments to interest expense.

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As of December 31, 2005, the following interest rate swaps were used to convert a portion of our long-term fixed-rate debt to floating-rate debt were outstanding:

|                |              | Notional       | Fixed  |                                       | Fair Value                       |
|----------------|--------------|----------------|--------|---------------------------------------|----------------------------------|
| Term           |              | Amount         | Rate   | Floating Rate                         | Gain (Loss)<br>(\$ in thousands) |
| September 2004 | August 2012  | \$ 75,000,000  | 9.000% | 6 month LIBOR plus 452 basis points   | \$ (2,734)                       |
| July 2005      | January 2015 | \$ 150,000,000 | 7.750% | 6 month LIBOR plus 289 basis points   | \$ (5,133)                       |
| July 2005      | June 2014    | \$ 150,000,000 | 7.500% | 6 month LIBOR plus 282 basis points   | \$ (5,327)                       |
| September 2005 | August 2014  | \$ 250,000,000 | 7.000% | 6 month LIBOR plus 205.5 basis points | \$ (5,004)                       |
| October 2005   | June 2015    | \$ 200,000,000 | 6.375% | 6 month LIBOR plus 112 basis points   | \$ (1,344)                       |
| October 2005   | January 2018 | \$ 250,000,000 | 6.250% | 6 month LIBOR plus 99 basis points    | \$ (3,240)                       |
| October 2005   | January 2016 | \$ 200,000,000 | 6.625% | 6 month LIBOR plus 129 basis points   | \$ 282                           |

In January 2006, we closed the interest rate swap on our 6.625% Senior Notes for \$1.0 million. Subsequent to December 31, 2005, we entered into the following interest rate swaps (which qualify as fair value hedges) to convert a portion of our long-term fixed-rate debt to floating-rate debt:

|              |              | Notional       | Fixed  |                                       |
|--------------|--------------|----------------|--------|---------------------------------------|
| Term         |              | Amount         | Rate   | Floating Rate                         |
| January 2006 | January 2016 | \$ 250,000,000 | 6.625% | 6 month LIBOR plus 129 basis points   |
| March 2006   | January 2016 | \$ 250,000,000 | 6.875% | 6 month LIBOR plus 120 basis points   |
| March 2006   | August 2017  | \$ 250,000,000 | 6.500% | 6 month LIBOR plus 125.5 basis points |

In 2005, we closed various interest rate swaps for gains totaling \$7.1 million respectively. These interest rate swaps were designated as fair value hedges, and the settlement amounts received will be amortized as a reduction to realized interest expense over the remaining terms of the related senior notes.

In March 2004, Chesapeake entered into an interest rate swap which required Chesapeake to pay a fixed rate of 8.68% while the counterparty paid Chesapeake a floating rate of six month LIBOR plus 0.75% on a notional amount of \$142.7 million. On March 15, 2005, we elected to terminate the interest rate swap and paid \$31.8 million to the counterparty.

*Fair Value of Financial Instruments*

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

The carrying values of items comprising current assets and current liabilities approximate fair values due to the short-term maturities of these instruments. We estimate the fair value of our long-term fixed-rate debt using primarily quoted market prices. Our carrying amounts for such debt, excluding discounts or premiums related to interest rate derivatives, at December 31, 2005 and 2004 were \$5.429 billion and \$3.014 billion, respectively, compared to approximate fair values of \$5.582 billion and \$3.281 billion, respectively. The carrying amounts for our convertible preferred stock as of December 31, 2005 and 2004 were \$1.577 billion and \$490.9 million, respectively, compared to approximate fair values of \$1.686 billion and \$533.7 million, respectively.

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**Table of Contents****CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)***Concentration of Credit Risk*

A significant portion of our liquidity is concentrated in derivative instruments that enable us to hedge a portion of our exposure to price volatility from producing oil and natural gas. These arrangements expose us to credit risk from our counterparties. Other financial instruments which potentially subject us to concentrations of credit risk consist principally of investments in equity instruments and accounts receivable. Our accounts receivable are primarily from purchasers of oil and natural gas products and exploration and production companies which own interests in properties we operate. This industry concentration has the potential to impact our overall exposure to credit risk, either positively or negatively, in that our customers may be similarly affected by changes in economic, industry or other conditions. We generally require letters of credit for receivables from customers which are judged to have sub-standard credit, unless the credit risk can otherwise be mitigated.

**11. Supplemental Disclosures About Oil And Gas Producing Activities***Net Capitalized Costs*

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

|                                                           | <b>December 31,</b>      |              |
|-----------------------------------------------------------|--------------------------|--------------|
|                                                           | <b>2005</b>              | <b>2004</b>  |
|                                                           | <b>(\$ in thousands)</b> |              |
| Oil and gas properties:                                   |                          |              |
| Proved                                                    | \$ 15,880,919            | \$ 9,451,413 |
| Unproved                                                  | 1,739,095                | 761,785      |
| Total                                                     | 17,620,014               | 10,213,198   |
| Less accumulated depreciation, depletion and amortization | (3,945,703)              | (3,057,742)  |
| Net capitalized costs                                     | \$ 13,674,311            | \$ 7,155,456 |

Unproved properties not subject to amortization at December 31, 2005 and 2004 consisted mainly of leasehold acquired through corporate and significant oil and gas property acquisitions and through direct purchases of leasehold. We capitalized approximately \$79.0 million, \$36.2 million and \$13.0 million of interest during 2005, 2004 and 2003, respectively, on significant investments in unproved properties that were not yet included in the amortization base of the full-cost pool. We will continue to evaluate our unevaluated properties; however, the timing of the ultimate evaluation and disposition of the properties has not been determined.

**Table of Contents****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:

|                                           | Years Ended December 31, |              |              |
|-------------------------------------------|--------------------------|--------------|--------------|
|                                           | 2005                     | 2004         | 2003         |
|                                           | (\$ in thousands)        |              |              |
| Acquisition of properties:                |                          |              |              |
| Proved properties                         | \$ 3,554,651             | \$ 1,541,920 | \$ 1,110,077 |
| Unproved properties                       | 1,375,675                | 570,495      | 198,394      |
| Deferred income taxes                     | 251,722                  | 463,949      | (4,903)      |
| Total                                     | 5,182,048                | 2,576,364    | 1,303,568    |
| Development costs:                        |                          |              |              |
| Development drilling (a)                  | 1,566,730                | 863,268      | 474,355      |
| Leasehold acquisition costs               | 290,946                  | 110,530      | 84,984       |
| Asset retirement obligation and other (b) | 52,619                   | 41,924       | 54,657       |
| Total                                     | 1,910,295                | 1,015,722    | 613,996      |
| Exploration costs:                        |                          |              |              |
| Exploratory drilling                      | 253,341                  | 128,635      | 103,424      |
| Geological and geophysical costs (c)      | 70,901                   | 55,618       | 42,736       |
| Total                                     | 324,242                  | 184,253      | 146,160      |
| Sales of oil and gas properties           | (9,769)                  | (12,048)     | (22,156)     |
| Total                                     | \$ 7,406,816             | \$ 3,764,291 | \$ 2,041,568 |

(a) Includes capitalized internal cost of \$94.1 million, \$45.4 million and \$30.9 million, respectively.

(b) The 2003 amount includes \$24.1 million of asset retirement costs recorded as a result of implementation of SFAS 143 effective January 1, 2003.

(c) Includes capitalized internal cost of \$8.1 million, \$6.3 million and \$4.6 million, respectively.

*Results of Operations from Oil and Gas Producing Activities (unaudited)*

Chesapeake's results of operations from oil and gas producing activities are presented below for 2005, 2004 and 2003. The following table includes revenues and expenses associated directly with our oil and gas producing activities. It does not include any interest costs or general and administrative costs and, therefore, is not necessarily indicative of the contribution to consolidated net operating results of our oil and gas operations.

|                       | Years Ended December 31, |              |              |
|-----------------------|--------------------------|--------------|--------------|
|                       | 2005                     | 2004         | 2003         |
|                       | (\$ in thousands)        |              |              |
| Oil and gas sales (a) | \$ 3,272,585             | \$ 1,936,176 | \$ 1,296,822 |
| Production expenses   | (316,956)                | (204,821)    | (137,583)    |

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|                                                             |              |            |            |
|-------------------------------------------------------------|--------------|------------|------------|
| Production taxes                                            | (207,898)    | (103,931)  | (77,893)   |
| Depletion and depreciation                                  | (894,035)    | (582,137)  | (369,465)  |
| Imputed income tax provision (b)                            | (676,599)    | (376,303)  | (270,515)  |
| Results of operations from oil and gas producing activities | \$ 1,177,097 | \$ 668,984 | \$ 441,366 |

- 
- (a) Includes \$41.1 million, \$40.9 million and \$10.5 million of unrealized gains (losses) on oil and gas derivatives for the years ended December 31, 2005, 2004 and 2003, respectively.
- (b) The imputed income tax provision is hypothetical (at the effective income tax rate) and determined without regard to our deduction for general and administrative expenses, interest costs and other income tax credits and deductions, nor whether the hypothetical tax provision will be payable.

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**Table of Contents****CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)***Oil and Gas Reserve Quantities (unaudited)*

Independent petroleum engineers and Chesapeake's petroleum engineers have evaluated our proved reserves. The portion of the proved reserves (by volume) evaluated by each for 2005, 2004 and 2003 is presented below.

|                                                                               | Years ended December 31, |      |      |
|-------------------------------------------------------------------------------|--------------------------|------|------|
|                                                                               | 2005                     | 2004 | 2003 |
| Netherland, Sewell & Associates, Inc.                                         | 25%                      | 23%  | 24%  |
| Data and Consulting Services, Division of Schlumberger Technology Corporation | 16                       |      |      |
| Lee Keeling and Associates, Inc.                                              | 15                       | 22   | 16   |
| Ryder Scott Company L.P.                                                      | 12                       | 13   | 34   |
| LaRoche Petroleum Consultants, Ltd.                                           | 8                        | 10   |      |
| H.J. Gruy and Associates, Inc.                                                | 2                        | 6    |      |
| Miller and Lents, Ltd.                                                        |                          | 1    |      |
| Internal petroleum engineers                                                  | 22                       | 25   | 26   |
|                                                                               | 100%                     | 100% | 100% |

The information below on our oil and gas reserves is presented in accordance with regulations prescribed by the Securities and Exchange Commission. Chesapeake emphasizes that reserve estimates are inherently imprecise. Our 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 and occur in the near term 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, i.e., prices and costs as of the date the estimate is made. Reservoirs are considered proved if economic producibility is supported by either actual production or conclusive formation test. The area of a reservoir considered proved includes (a) that portion delineated by drilling and defined by gas-oil and/or oil-water contacts, if any, and (b) the immediately adjoining portions not yet drilled, but which can be reasonably judged as economically productive on the basis of available geological and engineering data. In the absence of information on fluid contacts, the lowest known structural occurrence of hydrocarbons controls the lower proved limit of the reservoir. Reserves which can be produced economically through application of improved recovery techniques (such as fluid injection) are included in the proved classification when successful testing by a pilot project, or the operation of an installed program in the reservoir, provides support for the engineering analysis on which the project or program was based.

Proved developed oil and gas reserves are those expected to be recovered through existing wells with existing equipment and operating methods. Additional oil and gas expected to be obtained through the application of fluid injection or other improved recovery techniques for supplementing the natural forces and mechanisms of primary recovery should be included as proved developed reserves only after testing by a pilot project or after the operation of an installed program has confirmed through production responses that increased recovery will be achieved.

**Table of Contents****CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Presented below is a summary of changes in estimated reserves of Chesapeake for 2005, 2004 and 2003:

|                                             | <b>Oil</b>    | <b>Gas</b>    | <b>Total</b>   |
|---------------------------------------------|---------------|---------------|----------------|
|                                             | <b>(mbbl)</b> | <b>(mmcf)</b> | <b>(mmcfe)</b> |
| <b>December 31, 2005</b>                    |               |               |                |
| Proved reserves, beginning of period        | 87,960        | 4,373,989     | 4,901,751      |
| Extensions, discoveries and other additions | 12,460        | 930,800       | 1,005,563      |
| Revisions of previous estimates             | (2,123)       | 53,950        | 41,204         |
| Production                                  | (7,698)       | (422,389)     | (468,577)      |
| Sale of reserves-in-place                   | (26)          | (332)         | (486)          |
| Purchase of reserves-in-place               | 12,750        | 1,964,736     | 2,041,235      |
| Proved reserves, end of period              | 103,323       | 6,900,754     | 7,520,690      |
| Proved developed reserves:                  |               |               |                |
| Beginning of period                         | 62,713        | 2,842,141     | 3,218,418      |
| End of period                               | 76,238        | 4,442,270     | 4,899,694      |
| <b>December 31, 2004</b>                    |               |               |                |
| Proved reserves, beginning of period        | 51,422        | 2,860,040     | 3,168,575      |
| Extensions, discoveries and other additions | 7,601         | 771,125       | 816,728        |
| Revisions of previous estimates             | 6,109         | 108,863       | 145,518        |
| Production                                  | (6,764)       | (322,009)     | (362,593)      |
| Sale of reserves-in-place                   | (102)         | (3,329)       | (3,940)        |
| Purchase of reserves-in-place               | 29,694        | 959,299       | 1,137,463      |
| Proved reserves, end of period              | 87,960        | 4,373,989     | 4,901,751      |
| Proved developed reserves:                  |               |               |                |
| Beginning of period                         | 38,442        | 2,121,734     | 2,352,389      |
| End of period                               | 62,713        | 2,842,141     | 3,218,418      |
| <b>December 31, 2003</b>                    |               |               |                |
| Proved reserves, beginning of period        | 37,587        | 1,979,601     | 2,205,125      |
| Extensions, discoveries and other additions | 3,574         | 359,681       | 381,123        |
| Revisions of previous estimates             | 1,329         | 48,388        | 56,365         |
| Production                                  | (4,665)       | (240,366)     | (268,356)      |
| Sale of reserves-in-place                   | (183)         | (9,626)       | (10,723)       |
| Purchase of reserves-in-place               | 13,780        | 722,362       | 805,041        |
| Proved reserves, end of period              | 51,422        | 2,860,040     | 3,168,575      |
| Proved developed reserves:                  |               |               |                |
| Beginning of period                         | 28,111        | 1,458,284     | 1,626,952      |

|               |        |           |           |
|---------------|--------|-----------|-----------|
| End of period | 38,442 | 2,121,734 | 2,352,389 |
|---------------|--------|-----------|-----------|

During 2005, Chesapeake acquired approximately 2.041 tcf of proved reserves through purchases of oil and gas properties for consideration of \$3.806 billion (primarily in 18 separate transactions of greater than \$10 million each). We also sold 0.5 bcf of proved reserves for consideration of approximately \$9.8 million. During 2005, we recorded upward revisions of 41 bcf to the December 31, 2004 estimates of our reserves. Approximately 24 bcf of the upward revisions was caused by higher oil and gas prices at December 31, 2005.

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**CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES**

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

Higher prices extend the economic lives of the underlying oil and gas properties and thereby increase the estimated future reserves. The weighted average oil and gas wellhead prices used in computing our reserves were \$56.41 per bbl and \$8.76 per mcf at December 31, 2005.

During 2004, Chesapeake acquired approximately 1.137 tcf of proved reserves through purchases of oil and gas properties for consideration of \$2.006 billion (primarily in fifteen separate transactions of greater than \$10 million each). We also sold 4 bcf of proved reserves for consideration of approximately \$12.0 million. During 2004, we recorded upward revisions of 146 bcf to the December 31, 2003 estimates of our reserves. Approximately 5 bcf of the upward revisions was caused by higher oil and gas prices at December 31, 2004. Higher prices extend the economic lives of the underlying oil and gas properties and thereby increase the estimated future reserves. The weighted average oil and gas wellhead prices used in computing our reserves were \$39.91 per bbl and \$5.65 per mcf at December 31, 2004.

During 2003, Chesapeake acquired approximately 805 bcf of proved reserves through purchases of oil and gas properties for consideration of \$1.105 billion (primarily in nine separate transactions of greater than \$10 million each). We also sold 11 bcf of proved reserves for consideration of approximately \$22.2 million. During 2003, we recorded upward revisions of 56 bcf to the December 31, 2002 estimates of our reserves. Approximately 11.1 bcf of the upward revisions was caused by higher oil and gas prices at December 31, 2003. Higher prices extend the economic lives of the underlying oil and gas properties and thereby increase the estimated future reserves. The weighted average oil and gas wellhead prices used in computing our reserves were \$30.22 per bbl and \$5.68 per mcf at December 31, 2003.

*Standardized Measure of Discounted Future Net Cash Flows (unaudited)*

Statement of Financial Accounting Standards No. 69 prescribes guidelines for computing a standardized measure of future net cash flows and changes therein relating to estimated proved reserves. Chesapeake 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. Actual future prices and costs may be materially higher or lower than the year-end prices and costs used. 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 our 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 reflect the valuation process.

**Table of Contents****CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The following summary sets forth our future net cash flows relating to proved oil and gas reserves based on the standardized measure prescribed in SFAS 69:

|                                                          | Years Ended December 31, |                  |                  |
|----------------------------------------------------------|--------------------------|------------------|------------------|
|                                                          | 2005                     | 2004             | 2003             |
|                                                          | (\$ in thousands)        |                  |                  |
| Future cash inflows                                      | \$ 66,286,940(a)         | \$ 28,245,336(b) | \$ 17,807,624(c) |
| Future production costs                                  | (14,794,530)             | (6,542,219)      | (3,816,607)      |
| Future development costs                                 | (4,676,287)              | (2,115,511)      | (912,594)        |
| Future income tax provisions                             | (14,856,446)             | (5,663,575)      | (3,827,408)      |
| Future net cash flows                                    | 31,959,677               | 13,924,031       | 9,251,015        |
| Less effect of a 10% discount factor                     | (15,991,766)             | (6,278,492)      | (3,924,262)      |
| Standardized measure of discounted future net cash flows | \$ 15,967,911            | \$ 7,645,539     | \$ 5,326,753     |

(a) Calculated using weighted average prices of \$56.41 per barrel of oil and \$8.76 per mcf of gas.

(b) Calculated using weighted average prices of \$39.91 per barrel of oil and \$5.65 per mcf of gas.

(c) Calculated using weighted average prices of \$30.22 per barrel of oil and \$5.68 per mcf of gas.

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

|                                                                                    | Years Ended December 31, |              |              |
|------------------------------------------------------------------------------------|--------------------------|--------------|--------------|
|                                                                                    | 2005                     | 2004         | 2003         |
|                                                                                    | (\$ in thousands)        |              |              |
| Standardized measure, beginning of period (a)                                      | \$ 7,645,539             | \$ 5,326,753 | \$ 2,833,918 |
| Sales of oil and gas produced, net of production costs (b)                         | (3,108,277)              | (1,741,438)  | (1,088,184)  |
| Net changes in prices and production costs                                         | 3,249,132                | (730,020)    | (2,364)      |
| Extensions and discoveries, net of production and development costs                | 3,144,966                | 1,784,166    | 1,041,108    |
| Changes in future development costs                                                | (151,133)                | 33,284       | 74,719       |
| Development costs incurred during the period that reduced future development costs | 490,902                  | 226,415      | 130,195      |
| Revisions of previous quantity estimates                                           | 122,924                  | 317,518      | 99,927       |
| Purchase of reserves-in-place (c)                                                  | 6,252,030                | 2,580,973    | 2,012,686    |
| Sales of reserves-in-place (c)                                                     | (939)                    | (5,604)      | (827)        |
| Accretion of discount                                                              | 1,050,439                | 733,314      | 371,765      |
| Net change in income taxes                                                         | (4,106,833)              | (852,462)    | (1,122,661)  |
| Changes in production rates and other                                              | 1,379,161                | (27,360)     | 976,471      |
| Standardized measure, end of period (a)                                            | \$ 15,967,911            | \$ 7,645,539 | \$ 5,326,753 |

(a) The discounted amounts related to cash flow hedges that would affect future net cash flows have not been included in any of the periods presented.

(b) Excluding gains (losses) on derivatives.

- (c) In 2003, purchases and sales of reserves are shown net of the 9.9 bcfe which was acquired and immediately sold for \$19 million.

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**Table of Contents****CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****12. Asset Retirement Obligations**

Effective January 1, 2003, Chesapeake adopted SFAS 143, *Accounting for Asset Retirement Obligation*. This statement applies to obligations associated with the retirement of tangible, long-lived assets that result from the acquisition, construction and development of the assets.

The components of the change in our asset retirement obligations are shown below:

|                                                   | <b>Years Ended<br/>December 31,</b> |             |
|---------------------------------------------------|-------------------------------------|-------------|
|                                                   | <b>2005</b>                         | <b>2004</b> |
|                                                   | <b>(\$ in thousands)</b>            |             |
| Asset retirement obligations, beginning of period | \$ 73,718                           | \$ 48,812   |
| Additions                                         | 51,168                              | 21,862      |
| Revisions (a)                                     | 26,731                              |             |
| Settlements and disposals                         | (1,087)                             | (1,613)     |
| Accretion expense                                 | 6,063                               | 4,657       |
| Asset retirement obligations, end of period       | \$ 156,593                          | \$ 73,718   |

(a) Based on increasing service costs, we have revised our asset retirement obligation related to oil and gas wells in 2005.

**13. Acquisitions and Divestitures**

The following table describes acquisitions that we completed in 2005 (\$ in millions):

| <b>Acquisition</b>                       | <b>Location</b>              | <b>Amount</b> |
|------------------------------------------|------------------------------|---------------|
| Columbia Natural Resources, LLC          | Appalachian Basin            | \$ 2,200(a)   |
| BRG Petroleum Corporation                | Mid-Continent and Ark-La-Tex | 325(b)        |
| Laredo Energy II, L.L.C.                 | South Texas                  | 228           |
| Hallwood Energy, III L.P.                | Barnett Shale                | 250(c)        |
| Houston-based oil and gas company        | Texas Gulf Coast/South Texas | 202           |
| Pecos Production Company                 | Permian                      | 198           |
| Laredo II Partners                       | Texas Gulf Coast/South Texas | 139           |
| Corpus Christi-based oil and gas company | Ark-La-Tex                   | 95            |
| Dallas-based oil and gas company         | Ark-La-Tex                   | 85            |
| Midland-based oil and gas company        | Permian                      | 38            |
| Other                                    | Various                      | 372(d)        |
|                                          |                              | \$ 4,132      |

(a) Includes \$175 million related to gathering systems which was allocated to other property and equipment.

(b) We paid \$16.3 million of the purchase amount in 2004.

(c) Includes \$15 million related to gathering systems which was allocated to other property and equipment.

(d)

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In 2005, we paid the remaining \$57 million of the purchase price related to an acquisition transaction with Hallwood Energy Corporation in the fourth quarter of 2004.

During 2005, we recorded approximately \$252 million of deferred tax liability to reflect the tax effect of the cost paid in excess of the tax basis acquired on certain corporate acquisitions.

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**Table of Contents****CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Acquisitions were recorded using the purchase method of accounting and, accordingly, results of operations of these acquired activities and oil and gas properties have been included in Chesapeake's results of operations from the respective closing dates of the acquisitions.

On November 14, 2005, Chesapeake completed its acquisition of Columbia Natural Resources, LLC. (CNR), an Appalachian Basin natural gas producer with properties principally located in West Virginia, Kentucky, Ohio, Pennsylvania and New York. The cash purchase price totaled \$2.2 billion and was allocated based on the fair values of the assets and liabilities acquired at the date of acquisition. The acquisition was accounted for using the purchase method of accounting and has been included in the consolidated financial statements of Chesapeake since the date of acquisition.

The purchase price paid for CNR was allocated as follows (\$ in thousands):

|                                      |                     |
|--------------------------------------|---------------------|
| Current assets                       | \$ 73,637           |
| Evaluated oil and gas properties     | 2,368,726           |
| Unevaluated properties               | 500,000             |
| Other assets                         | 178,431             |
| Current liabilities                  | (185,003)           |
| Derivative liability                 | (591,756)           |
| Asset retirement obligation          | (39,528)            |
| Deferred taxes                       | (3,293)             |
| Credit facility payoff               | (96,116)            |
| Other long-term deferred liabilities | (5,098)             |
| <b>Net cash consideration</b>        | <b>\$ 2,200,000</b> |

The pro forma information below is presented for illustrative purposes only and is based on estimates and assumptions deemed appropriate by Chesapeake. The pro forma information should not be relied upon as an indication of the operating results that Chesapeake would have achieved if the acquisition had occurred at the beginning of each period presented, or of future results that Chesapeake will achieve after the CNR acquisition. The pro forma information for the years ended December 31, 2005 and 2004 reflect the CNR acquisition as if the acquisition occurred on January 1, 2004.

|                                             | <b>Years Ended<br/>December 31,</b>                   |             |
|---------------------------------------------|-------------------------------------------------------|-------------|
|                                             | <b>2005</b>                                           | <b>2004</b> |
|                                             | <b>(\$ in millions, except<br/>per share amounts)</b> |             |
| Revenues                                    | \$ 4,847.4                                            | \$ 2,913.6  |
| Income from continuing operations           | \$ 1,758.5                                            | \$ 979.0    |
| Net income available to common shareholders | \$ 829.9                                              | \$ 390.3    |
| Income per Common Share:                    |                                                       |             |
| Basic                                       | \$ 2.41                                               | \$ 1.41     |
| Diluted                                     | \$ 2.23                                               | \$ 1.28     |

The strategic benefits of the CNR acquisition include the significant addition of land and gas resource inventories to complement Chesapeake's already extensive resource inventories. In addition, the underexplored and unconsolidated Appalachian Basin has very similar characteristics to the Mid-Continent region in which Chesapeake already has a significant stronghold.



**Table of Contents****CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****14. Quarterly Financial Data (unaudited)**

Summarized unaudited quarterly financial data for 2005 and 2004 are as follows (\$ in thousands except per share data):

|                                | March 31,  | June 30,     | Quarters Ended<br>September 30, | December 31, |
|--------------------------------|------------|--------------|---------------------------------|--------------|
|                                | 2005       | 2005         | 2005                            | 2005         |
| Total revenues                 | \$ 783,450 | \$ 1,048,018 | \$ 1,082,843                    | \$ 1,750,979 |
| Gross profit (a)               | 237,537    | 425,463      | 335,634                         | 774,526      |
| Net income                     | 125,010(b) | 193,779(c)   | 176,988(d)                      | 452,525(e)   |
| Net earnings per common share: |            |              |                                 |              |
| Basic                          | \$ 0.39    | \$ 0.58      | \$ 0.46                         | \$ 1.25      |
| Diluted                        | \$ 0.36    | \$ 0.52      | \$ 0.43                         | \$ 1.11      |

  

|                                | March 31,  | June 30,   | Quarters Ended<br>September 30, | December 31, |
|--------------------------------|------------|------------|---------------------------------|--------------|
|                                | 2004       | 2004       | 2004                            | 2004         |
| Total revenues                 | \$ 563,129 | \$ 574,292 | \$ 629,796                      | \$ 942,051   |
| Gross profit (a)               | 228,044    | 179,280    | 199,165                         | 385,846      |
| Net income                     | 112,590(f) | 97,155     | 96,872                          | 208,538(g)   |
| Net earnings per common share: |            |            |                                 |              |
| Basic                          | \$ 0.44    | \$ 0.36    | \$ 0.33                         | \$ 0.59      |
| Diluted                        | \$ 0.38    | \$ 0.30    | \$ 0.29                         | \$ 0.52      |

- (a) Total revenue less operating costs.  
 (b) Includes a pre-tax loss on repurchases and exchanges of debt of \$0.9 million.  
 (c) Includes a pre-tax loss on repurchases and exchanges of debt of \$68.4 million.  
 (d) Includes a pre-tax loss on repurchases and exchanges of debt of \$0.7 million.  
 (e) Includes a pre-tax loss on repurchases and exchanges of debt of \$0.4 million.  
 (f) Includes a pre-tax loss on repurchases and exchanges of debt of \$6.9 million.  
 (g) Includes a pre-tax loss on repurchases and exchanges of debt of \$17.6 million.

**15. Recently Issued Accounting Standards**

The Financial Accounting Standards Board recently issued the following standards which we reviewed to determine the potential impact on our financial statements upon adoption.

In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123(R), *Share-Based Payment*, which revised SFAS 123, *Accounting for Stock-Based Compensation*. This statement establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services. SFAS 123(R) requires a public entity to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. This statement is effective as of the beginning of the first annual reporting period that begins after June 15, 2005. Since the issuance of SFAS 123(R), three FASB Staff Positions (FSPs) have been issued regarding SFAS 123(R): FSP FAS 123(R)-1 *Classification and Measurement of Freestanding Financial Instruments Originally Issued in Exchange for Employee Services under FASB Statement No. 123(R)*, FSP FAS 123(R)-2 *Practical Accommodation to the Application of Grant Date as Defined in FASB Statement No. 123(R)*, and FSP FAS 123(R)-3 *Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards*. These FSPs will be applicable upon the initial adoption of FAS 123(R). The effect of SFAS123(R) is more fully

described in Note 1.

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### **CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES**

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

In March 2005, the FASB issued FASB Interpretation No. (FIN) 47, *Accounting for Conditional Asset Retirement Obligations*. FIN 47 specifies the accounting treatment for conditional asset retirement obligations under the provisions of SFAS 143. FIN 47 is effective no later than the end of the fiscal year ending after December 15, 2005. We adopted this statement effective December 31, 2005. Implementation of FIN 47 did not have a material effect on our financial statements.

In May 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20 and FASB Statement No. 3*. SFAS 154 requires retrospective application to prior period financial statements for changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS 154 also requires that retrospective application of a change in accounting principle be limited to the direct effects of the change. Indirect effects of a change in accounting principle should be recognized in the period of the accounting change. SFAS 154 is effective for accounting changes made in fiscal years beginning after December 15, 2005. The impact of SFAS 154 will depend on the nature and extent of any voluntary accounting changes and correction of errors after the effective date, but we do not currently expect SFAS 154 to have a material impact on our financial statements.

In June 2005, the EITF reached a consensus on Issue No. 04-10, *Determining Whether to Aggregate Operating Segments That Do Not Meet the Quantitative Thresholds*. EITF Issue 04-10 confirmed that operating segments that do not meet the quantitative thresholds can be aggregated only if aggregation is consistent with the objective and basic principles of SFAS 131, *Disclosure about Segments of an Enterprise and Related Information*. The consensus in this issue should be applied for fiscal years ending after September 30, 2005, and the corresponding information for earlier periods, including interim periods, should be restated unless it is impractical to do so. The adoption of EITF Issue 04-10 is not expected to have a material impact on our disclosures.

In September 2005, the Emerging Issues Task Force (EITF) reached a consensus on Issue No. 04-13, *Accounting for Purchases and Sales of Inventory with the Same Counterparty*. EITF Issue 04-13 requires that purchases and sales of inventory with the same counterparty in the same line of business should be accounted for as a single non-monetary exchange, if entered into in contemplation of one another. The consensus is effective for inventory arrangements entered into, modified or renewed in interim or annual reporting periods beginning after March 15, 2006. The adoption of EITF Issue 04-13 is not expected to have a material impact on our financial statements.

#### **16. Subsequent Events**

On January 17, 2006, we announced that we had entered into agreements with private companies to acquire oil and natural gas assets in the Barnett Shale, south Texas, Permian basin, Mid-Continent and East Texas regions for an aggregate purchase price of approximately \$700 million in cash. We have recently closed transactions for approximately \$640 million in cash and expect to close the remaining acquisition by March 31, 2006. The pending acquisition is subject to customary closing conditions and purchase price adjustments.

On January 5, 2006, we acquired a privately-held Oklahoma-based trucking company for \$48 million.

On February 3, 2006, we amended and restated our revolving bank credit facility, increasing the commitments to \$2 billion and extending the maturity date to February 2011.

In February 2006, through our wholly-owned subsidiary Nomac Drilling Corporation, we acquired 13 drilling rigs and related assets from Martex Drilling Company, L.L.P., a privately-held drilling contractor with operations in East Texas and North Louisiana, for \$150 million.

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**CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES**

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

On February 3, 2006, we issued an additional \$500 million of our 6.5% Senior Notes due 2017, in a private placement. Net proceeds from the offering were approximately \$486.6 and were used to repay outstanding borrowings under our revolving bank credit facility, incurred primarily to finance our recent acquisitions.

On February 10, 2006, we sold our investment in Pioneer Drilling Company (AMEX: PDC) common stock for proceeds of \$159 million and a pre-tax gain of \$116 million.

Our President and Chief Operating Officer, Tom L. Ward, resigned as a director, officer and employee of the company effective February 10, 2006. Mr. Ward has agreed to act as a consultant to Chesapeake for a period of six months from the effective date of his resignation, pursuant to a resignation agreement, to assist in the transition of his responsibilities. During the term of his consulting agreement, Mr. Ward will receive no cash compensation but will be provided support staff for personal administrative and accounting services together with access to the company's fractional shares in aircraft in accordance with historical practices. The resignation agreement provides for the immediate vesting of all of Mr. Ward's unvested stock options and restricted stock on February 10, 2006. As a result of such vesting, options to purchase 724,615 shares of Chesapeake's common stock at an average exercise price of \$8.01 per share and 1,291,875 shares of restricted common stock became immediately vested. As a result, the company expects to incur a non-cash after-tax charge of approximately \$31.8 million in the first quarter 2006. Mr. Ward will have until May 10, 2006 to exercise the stock options granted to him by the company.

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**Table of Contents****Schedule II**

**CHESAPEAKE ENERGY CORPORATION**  
**VALUATION AND QUALIFYING ACCOUNTS**  
(\$ in thousands)

| Description                                 | Balance at<br>Beginning<br>of Period | Additions<br>Charged |                                 |                         | Balance at<br>End<br>of Period |
|---------------------------------------------|--------------------------------------|----------------------|---------------------------------|-------------------------|--------------------------------|
|                                             |                                      | To<br>Expense        | Charged<br>To Other<br>Accounts | Deductions              |                                |
| December 31, 2005:                          |                                      |                      |                                 |                         |                                |
| Allowance for doubtful accounts             | \$ 4,648                             | \$ 114               | \$ 142                          | \$                      | \$ 4,904                       |
| Valuation allowance for deferred tax assets | \$                                   | \$                   | \$                              | \$                      | \$                             |
| December 31, 2004:                          |                                      |                      |                                 |                         |                                |
| Allowance for doubtful accounts             | \$ 2,669                             | \$ 975               | \$ 1,004                        | \$                      | \$ 4,648                       |
| Valuation allowance for deferred tax assets | \$ 6,805                             | \$                   | \$                              | \$ 6,805 <sup>(a)</sup> | \$                             |
| December 31, 2003:                          |                                      |                      |                                 |                         |                                |
| Allowance for doubtful accounts             | \$ 1,433                             | \$ 156               | \$ 1,202                        | \$ 122                  | \$ 2,669                       |
| Valuation allowance for deferred tax assets | \$ 2,441                             | \$ 4,364             | \$                              | \$                      | \$ 6,805                       |

- (a) As of December 31, 2004, we determined that it is more likely than not that the \$6.8 million of the net deferred tax assets related to net operating losses generated by Louisiana properties would be realized due to acquisitions which occurred in 2004. Therefore, the \$6.8 million valuation allowance was reversed.

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

Not applicable.

**ITEM 9A. Controls and Procedures**

We maintain disclosure controls and procedures designed to ensure that information required to be disclosed by Chesapeake in reports filed or submitted by it under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms. As of December 31, 2005, we carried out an evaluation, under the supervision and with the participation of Chesapeake management, including Chesapeake's Chief Executive Officer and Chief Financial Officer of the effectiveness of the design and operation of Chesapeake's disclosure controls and procedures pursuant to Securities Exchange Act Rule 13a-15(b). Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective as of December 31, 2005, to ensure that information required to be disclosed by Chesapeake is accumulated and communicated to Chesapeake management, including Chesapeake's Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

**Changes in Internal Controls**

No changes in the company's internal control over financial reporting occurred during the quarter ended December 31, 2005 that have materially affected, or are reasonably likely to materially affect, the company's internal control over financial reporting.

**Management's Report on Internal Control Over Financial Reporting**

Management's report on internal control over financial reporting and the attestation report of our independent registered public accounting firm are included in Item 8 of this report.

**ITEM 9B. Other Information****Unregistered Sales of Equity Securities.**

In 2005 and the first quarter of 2006, Chesapeake entered into unsolicited transactions with holders of our 4.125% Cumulative Convertible Preferred Stock and 5.0% (Series 2003) Cumulative Convertible Preferred Stock to issue shares of our common stock in exchange for the 4.125% and 5.0% (Series 2003) preferred stock. The issuances of the shares of common stock in these transactions were exempt from registration under the Securities Act of 1933 pursuant to Rule 3(a)(9). The following transactions have not been previously reported under Item 3.02 *Unregistered Sales of Equity Securities* of Form 8-K because, in the aggregate, the number of shares of common stock issued is less than 1% of our total common shares outstanding:

|             |             | Preferred | Liquidation  | Common    |
|-------------|-------------|-----------|--------------|-----------|
| Transaction | Preferred   | Shares    | Value of     | Shares    |
| Date        | Series      | Received  | Pref. Shares | Issued    |
| 11/9/2005   | 4.125%      | 26,185    | \$26,185,000 | 1,662,608 |
| 11/9/2005   | 4.125%      | 3,100     | 3,100,000    | 196,833   |
| 11/9/2005   | 4.125%      | 2,000     | 2,000,000    | 126,990   |
| 12/14/2005  | 4.125%      | 1,750     | 1,750,000    | 109,813   |
| 12/20/2005  | 4.125%      | 1,000     | 1,000,000    | 62,842    |
| 12/20/2005  | 4.125%      | 3,000     | 3,000,000    | 188,407   |
| 1/18/2006   | 4.125%      | 1,700     | 1,700,000    | 106,731   |
| 1/19/2006   | 5.0% (2003) | 125,000   | 12,500,000   | 777,655   |
| 1/20/2006   | 4.125%      | 1,050     | 1,050,000    | 65,863    |
| 1/20/2006   | 5.0% (2003) | 18,000    | 1,800,000    | 111,980   |



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|           |             |         |              |           |
|-----------|-------------|---------|--------------|-----------|
| 1/23/2006 | 5.0% (2003) | 40,273  | 4,027,300    | 250,588   |
|           |             | 223,058 | \$58,112,300 | 3,660,310 |

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**PART III**

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

The information called for by this Item 10 is incorporated herein by reference to the definitive Proxy Statement to be filed by Chesapeake pursuant to Regulation 14A of the General Rules and Regulations under the Securities Exchange Act of 1934 not later than April 28, 2006.

**ITEM 11. *Executive Compensation***

The information called for by this Item 11 is incorporated herein by reference to the definitive Proxy Statement to be filed by Chesapeake pursuant to Regulation 14A of the General Rules and Regulations under the Securities Exchange Act of 1934 not later than April 28, 2006.

**ITEM 12. *Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters***

The information called for by this Item 12 is incorporated herein by reference to the definitive Proxy Statement to be filed by Chesapeake pursuant to Regulation 14A of the General Rules and Regulations under the Securities Exchange Act of 1934 not later than April 28, 2006.

**ITEM 13. *Certain Relationships and Related Transactions***

The information called for by this Item 13 is incorporated herein by reference to the definitive Proxy Statement to be filed by Chesapeake pursuant to Regulation 14A of the General Rules and Regulations under the Securities Exchange Act of 1934 not later than April 28, 2006.

**ITEM 14. *Principal Accounting Fees and Services***

The information called for by this Item 14 is incorporated herein by reference to the definitive Proxy Statement to be filed by Chesapeake pursuant to Regulation 14A of the General Rules and Regulations under the Securities Exchange Act of 1934 not later than April 28, 2006.

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**PART IV**

**ITEM 15. Exhibits, Financial Statement Schedules**

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

1. *Financial Statements.* Chesapeake's consolidated financial statements are included in Item 8 of this report. Reference is made to the accompanying Index to Financial Statements.
2. *Financial Statement Schedules.* Schedule II is included in Item 8 of this report with our consolidated financial statements. No other financial statement schedules are applicable or required.
3. *Exhibits.* The following exhibits are filed herewith pursuant to the requirements of Item 601 of Regulation S-K:

| <b>Exhibit Number</b> | <b>Description</b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                 |
|-----------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 3.1.1                 | Chesapeake's Restated Certificate of Incorporation, as amended. Incorporated herein by reference to Exhibit 3.1.1 to Chesapeake's quarterly report on Form 10-Q for the quarter ended March 31, 2005.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                              |
| 3.1.2                 | Certificate of Designation for Series A Junior Participating Preferred Stock, as amended. Incorporated herein by reference to Exhibit 3.1.2 to Chesapeake's quarterly report on Form 10-Q for the quarter ended March 31, 2005.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                    |
| 3.1.3*                | Certificate of Designation of 6% Cumulative Convertible Preferred Stock, as amended.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                               |
| 3.1.4*                | Certificate of Designation of 5% Cumulative Convertible Preferred Stock (Series 2003), as amended.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                 |
| 3.1.5*                | Certificate of Designation of 4.125% Cumulative Convertible Preferred Stock, as amended.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                           |
| 3.1.6                 | Certificate of Designation of 5% Cumulative Convertible Preferred Stock (Series 2005), as amended. Incorporated herein by reference to Exhibit 3.1.6 to Chesapeake's quarterly report on Form 10-Q for the quarter ended March 31, 2005.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                           |
| 3.1.7                 | Certificate of Designation of 4.5% Cumulative Convertible Preferred Stock. Incorporated herein by reference to Exhibit 3.1 to Chesapeake's current report on Form 8-K dated September 13, 2005.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                    |
| 3.1.8                 | Certificate of Designation of 5% Cumulative Convertible Preferred Stock (Series 2005B). Incorporated herein by reference to Exhibit 3.1 to Chesapeake's current report on Form 8-K dated November 7, 2005.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         |
| 3.2                   | Chesapeake's Amended and Restated Bylaws. Incorporated herein by reference to Exhibit 3.2 of Chesapeake's annual report on Form 10-K for the year ended December 31, 2003.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         |
| 4.1                   | Indenture dated as of May 27, 2004 among Chesapeake, as issuer, the subsidiaries signatory thereto, as Subsidiary Guarantors, and the Bank of New York Trust Company, N.A., as Trustee, with respect to 7.5% senior notes due 2014. Incorporated herein by reference to Exhibit 4.1 to Chesapeake's registration statement on Form S-4 (No. 333-116555). First Supplemental Indenture dated as of August 30, 2004. Incorporated herein by reference to Exhibit 4.11.1 to Chesapeake's quarterly report on Form 10-Q for the quarter ended September 30, 2004. Second Supplemental Indenture dated as of September 27, 2004. Incorporated herein by reference to Exhibit 4.11.2 to Chesapeake's quarterly report on Form 10-Q for the quarter ended September 30, 2004. Third Supplemental Indenture dated as of January 31, 2005. Incorporated herein by reference to Exhibit 4.1.1 to Chesapeake's annual report on Form 10-K for the year ended December 31, 2004. Fourth Supplemental Indenture dated as of July 15, 2005. Incorporated herein by reference to Exhibit 4.1.1 to Chesapeake's quarterly report on Form 10-Q for the quarter ended June 30, 2005. |

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| <b>Exhibit Number</b> | <b>Description</b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                               |
|-----------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 4.1.1*                | Fifth Supplemental Indenture dated as of November 14, 2005 to Indenture dated as of May 27, 2004 among Chesapeake, as issuer, its subsidiaries signatory thereto, as Subsidiary Guarantors, and The Bank of New York Trust Company, N.A., as Trustee, with respect to the 7.50% senior notes due 2014.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                           |
| 4.1.2*                | Sixth Supplemental Indenture dated as of February 24, 2006 to Indenture dated as of May 27, 2004 among Chesapeake, as issuer, its subsidiaries signatory thereto, as Subsidiary Guarantors, and The Bank of New York Trust Company, N.A., as Trustee, with respect to the 7.50% senior notes due 2014.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                           |
| 4.2                   | Indenture dated as of August 2, 2004 among Chesapeake, as issuer, the subsidiaries signatory thereto, as Subsidiary Guarantors, and the Bank of New York Trust Company, N.A., as Trustee, with respect to 7.0% senior notes due 2014. Incorporated herein by reference to Exhibit 4.1 to Chesapeake's registration statement on Form S-4 (No. 333-118378). First Supplemental Indenture dated as of August 30, 2004. Incorporated herein by reference to Exhibit 4.12.1 to Chesapeake's quarterly report on Form 10-Q for the quarter ended September 30, 2004. Second Supplemental Indenture dated as of September 27, 2004. Incorporated herein by reference to Exhibit 4.12.2 to Chesapeake's quarterly report on Form 10-Q for the quarter ended September 30, 2004. Third Supplemental Indenture dated as of January 31, 2005. Incorporated herein by reference to Exhibit 4.2.1 to Chesapeake's annual report on Form 10-K for the year ended December 31, 2004. Fourth Supplemental Indenture dated as of July 15, 2005. Incorporated herein by reference to Exhibit 4.2.1 to Chesapeake's quarterly report on Form 10-Q for the quarter ended June 30, 2005.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                             |
| 4.2.1*                | Fifth Supplemental Indenture dated as of November 14, 2005 to Indenture dated as of August 2, 2004 among Chesapeake, as issuer, its subsidiaries signatory thereto, as Subsidiary Guarantors, and The Bank of New York Trust Company, N.A., as Trustee, with respect to the 7.00% senior notes due 2014.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         |
| 4.2.2*                | Sixth Supplemental Indenture dated as of February 24, 2006 to Indenture dated as of August 2, 2004 among Chesapeake, as issuer, its subsidiaries signatory thereto, as Subsidiary Guarantors, and The Bank of New York Trust Company, N.A., as Trustee, with respect to the 7.00% senior notes due 2014.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         |
| 4.3                   | Indenture dated as of December 20, 2002 among Chesapeake, as issuer, the subsidiaries signatory thereto, as Subsidiary Guarantors and The Bank of New York Trust Company, N.A., as Trustee, with respect to our 7.75% Senior Notes due 2015. Incorporated herein by reference to Exhibit 4.5 to Chesapeake's registration statement on Form S-4 (No. 333-102445) First Supplemental Indenture dated as of February 14, 2003. Incorporated herein by reference to Exhibit 4.6.1 to Chesapeake's report on Form 10-K/A for the year ended December 31, 2002. Second Supplemental Indenture dated as of May 1, 2003. Incorporated herein by reference to Exhibit 4.6.1 to Chesapeake's quarterly report on Form 10-Q for the quarter ended March 31, 2003. Third Supplemental Indenture dated as of August 15, 2003. Incorporated herein by reference to Exhibit 4.6.1 to Chesapeake's quarterly report on Form 10-Q for the quarter ended September 30, 2003. Fourth Supplemental Indenture dated as of March 5, 2004. Incorporated herein by reference to Exhibit 4.6.1 to Chesapeake's annual report on Form 10-K for the year ended December 31, 2003. Fifth Supplemental Indenture dated as of August 30, 2004. Incorporated herein by reference to Exhibit 4.6.1 to Chesapeake's quarterly report on Form 10-Q for the quarter ended September 30, 2004. Sixth Supplemental Indenture dated as of September 27, 2004. Incorporated herein by reference to Exhibit 4.6.2 to Chesapeake's quarterly report on Form 10-Q for the quarter ended September 30, 2004. Seventh Supplemental Indenture dated as of January 31, 2005. Incorporated herein by reference to Exhibit 4.6.1 to Chesapeake's annual report on Form 10-K for the year ended December 31, 2004. Eighth Supplemental Indenture dated as of July 15, 2005. Incorporated herein by reference to Exhibit 4.6.1 to Chesapeake's quarterly report on Form 10-Q for the quarter ended June 30, 2005. |

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| <b>Exhibit Number</b> | <b>Description</b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                           |
|-----------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 4.3.1*                | Ninth Supplemental Indenture dated November 14, 2005 to Indenture dated as of December 20, 2002 among Chesapeake, as issuer, its subsidiaries signatory thereto as Subsidiary Guarantors, and The Bank of New York Trust Company, N.A., as Trustee, with respect to 7.75% Senior Notes due 2015.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                             |
| 4.3.2*                | Tenth Supplemental Indenture dated February 24, 2006 to Indenture dated as of December 20, 2002 among Chesapeake, as issuer, its subsidiaries signatory thereto as Subsidiary Guarantors, and The Bank of New York Trust Company, N.A., as Trustee, with respect to 7.75% Senior Notes due 2015.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                             |
| 4.4                   | Agreement to furnish copies of unfiled long-term debt instruments. Incorporated herein by reference to Chesapeake's transition report on Form 10-K for the six months ended December 31, 1997.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                               |
| 4.5                   | Sixth Amended and Restated Credit Agreement, dated as of February 3, 2006, among Chesapeake Energy Corporation, Chesapeake Exploration Limited Partnership and Chesapeake Appalachia, L.L.C., as Co-Borrowers, Union Bank of California, N.A., as Administrative Agent, BNP Paribas, as Syndication Agent, Bank of America, N.A., Calyon New York Branch and SunTrust Bank, as Co-Documentation Agents, and the several lenders from time to time parties thereto. Incorporated herein by reference to Exhibit 4.8 to Chesapeake's current report on Form 8-K dated February 8, 2006.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                        |
| 4.6                   | Indenture dated as of March 5, 2003 among Chesapeake, as issuer, the subsidiaries signatory thereto, as Subsidiary Guarantors and The Bank of New York Trust Company, N.A., as Trustee, with respect to 7.5% Senior Notes due 2013. First Supplemental Indenture dated as of May 1, 2003. Incorporated herein by reference to Exhibit 4.7.1 to Chesapeake's quarterly report on Form 10-Q for the quarter ended March 31, 2003. Second Supplemental Indenture dated as of August 15, 2003. Incorporated herein by reference to Exhibit 4.7.1 to Chesapeake's quarterly report on Form 10-Q for the quarter ended September 30, 2003. Third Supplemental Indenture dated as of March 5, 2004. Incorporated herein by reference to Exhibit 4.9.1 to Chesapeake's annual report on Form 10-K for the year ended December 31, 2003. Fourth Supplemental Indenture dated as of August 30, 2004. Incorporated herein by reference to Exhibit 4.9.1 to Chesapeake's quarterly report on Form 10-Q for the quarter ended September 30, 2004. Fifth Supplemental Indenture dated as of September 27, 2004. Incorporated herein by reference to Exhibit 4.9.2 to Chesapeake's quarterly report on Form 10-Q for the quarter ended September 30, 2004. Sixth Supplemental Indenture dated January 31, 2005. Incorporated herein by reference to Exhibit 4.9.1 to Chesapeake's annual report on Form 10-K for the year ended December 31, 2004. Seventh Supplemental Indenture dated July 15, 2005. Incorporated herein by reference to Exhibit 4.9.1 to Chesapeake's quarterly report on Form 10-Q for the quarter ended June 30, 2005. |
| 4.6.1*                | Eighth Supplemental Indenture dated November 14, 2005 to Indenture dated as of March 5, 2003 among Chesapeake, as issuer, its subsidiaries signatory thereto as Subsidiary Guarantors, and The Bank of New York Trust Company, N.A., as Trustee, with respect to 7.5% Senior Notes due 2013.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                 |
| 4.6.2*                | Ninth Supplemental Indenture dated February 24, 2006 to Indenture dated as of March 5, 2003 among Chesapeake, as issuer, its subsidiaries signatory thereto as Subsidiary Guarantors, and The Bank of New York Trust Company, N.A., as Trustee, with respect to 7.5% Senior Notes due 2013.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                  |
| 4.7                   | Indenture dated as of November 26, 2003 among Chesapeake, as issuer, the subsidiaries signatory thereto, as Subsidiary Guarantors and The Bank of New York Trust Company, N.A., as Trustee, with respect to 6.875% senior notes due 2016. Incorporated herein by reference to Exhibit 4.2 to Chesapeake's registration statement on Form S-4/A (No. 333-110668). First Supplemental Indenture dated as of March 5, 2004. Incorporated herein by reference to Exhibit 4.10.1 to Chesapeake's annual report on Form 10-K for the year ended December 31, 2003. Second Supplemental Indenture dated as of August 30, 2004. Incorporated herein by reference to Exhibit 4.10.1 to Chesapeake's quarterly report on Form 10-Q for the quarter ended September 30, 2004. Third Supplemental Indenture dated as of September 27, 2004. Incorporated herein by reference to Exhibit 4.10.2 to Chesapeake's quarterly report on Form 10-Q for the quarter ended September 30, 2004. Fourth Supplemental Indenture dated as of January 31, 2005. Incorporated herein by reference to Exhibit 4.10.1 to Chesapeake's annual report on Form 10-K for the year ended December 31, 2004. Fifth Supplemental Indenture dated July 15, 2005. Incorporated herein by reference to Exhibit 4.10.1 to Chesapeake's quarterly report on Form 10-Q for the quarter ended June 30, 2005.                                                                                                                                                                                                                                                           |

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| <b>Exhibit Number</b> | <b>Description</b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                    |
|-----------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 4.7.1*                | Sixth Supplemental Indenture dated November 14, 2005 to Indenture dated as of November 26, 2003 among Chesapeake, as issuer, the subsidiaries signatory thereto, as Subsidiary Guarantors, and The Bank of New York Trust Company, N.A., as Trustee, with respect to 6.875% senior notes due 2016.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                    |
| 4.7.2*                | Seventh Supplemental Indenture dated February 24, 2006 to Indenture dated as of November 26, 2003 among Chesapeake, as issuer, the subsidiaries signatory thereto, as Subsidiary Guarantors, and The Bank of New York Trust Company, N.A., as Trustee, with respect to 6.875% senior notes due 2016.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                  |
| 4.8                   | Indenture dated as of December 8, 2004 among Chesapeake, as issuer, the subsidiaries signatory thereto, as Subsidiary Guarantors and The Bank of New York Trust Company, N.A., as Trustee, with respect to 6.375% senior notes due 2015. Incorporated herein by reference to Exhibit 4.1 to Chesapeake's current report on Form 8-K dated December 14, 2004. First Supplemental Indenture dated January 31, 2005. Incorporated herein by reference to Exhibit 4.11.1 to Chesapeake's annual report on Form 10-K for the year ended December 31, 2004. Second Supplemental Indenture dated May 13, 2005. Incorporated herein by reference to Exhibit 4.11.1 to Chesapeake's quarterly report on Form 10-Q for the quarter ended June 30, 2005. Third Supplemental Indenture dated July 15, 2005. Incorporated by reference herein to Exhibit 4.11.2 to Chesapeake's quarterly report on Form 10-Q for the quarter ended June 30, 2005. |
| 4.8.1*                | Fourth Supplemental Indenture dated November 14, 2005 to Indenture dated as of December 8, 2004 among Chesapeake, as issuer, the subsidiaries signatory thereto, as Subsidiary Guarantors, and The Bank of New York Trust Company, N.A., as Trustee, with respect to 6.375% senior notes due 2015.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                    |
| 4.8.2*                | Fifth Supplemental Indenture dated February 24, 2006 to Indenture dated as of December 8, 2004 among Chesapeake, as issuer, the subsidiaries signatory thereto, as Subsidiary Guarantors, and The Bank of New York Trust Company, N.A., as Trustee, with respect to 6.375% senior notes due 2015.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                     |
| 4.9                   | Indenture dated as of April 19, 2005 among Chesapeake, as issuer, the subsidiaries signatory thereto, as Subsidiary Guarantors and The Bank of New York Trust Company, N.A., as Trustee, with respect to 6.625% senior notes due 2016. Incorporated herein by reference to Exhibit 4.12 to Chesapeake's quarterly report on Form 10-Q for the quarter ended March 31, 2005. First Supplemental Indenture dated as of July 15, 2005. Incorporated herein by reference to Exhibit 4.12.1 to Chesapeake's quarterly report on Form 10-Q for the quarter ended June 30, 2005.                                                                                                                                                                                                                                                                                                                                                             |
| 4.9.1*                | Second Supplemental Indenture dated as of November 14, 2005 to Indenture dated as of April 19, 2005 among Chesapeake, as issuer, the subsidiaries signatory thereto, as Subsidiary Guarantors, and The Bank of New York Trust Company, N.A., as Trustee, with respect to 6.625% senior notes due 2016.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                |
| 4.9.2*                | Third Supplemental Indenture dated as of February 24, 2006 to Indenture dated as of April 19, 2005 among Chesapeake, as issuer, the subsidiaries signatory thereto, as Subsidiary Guarantors, and The Bank of New York Trust Company, N.A., as Trustee, with respect to 6.625% senior notes due 2016.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                 |
| 4.10                  | Indenture dated as of June 20, 2005 among Chesapeake, as issuer, the subsidiaries signatory thereto, as Subsidiary Guarantors and The Bank of New York Trust Company, N.A., as Trustee, with respect to 6.25% senior notes due 2018. Incorporated herein by reference to Exhibit 4.1 to Chesapeake's quarterly report on Form 10-Q for the quarter ended June 30, 2005.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                               |
| 4.10.1*               | First Supplemental Indenture dated as of November 14, 2005 to Indenture dated as of June 20, 2005 among Chesapeake, as issuer, the subsidiaries signatory thereto, as Subsidiary Guarantors, and The Bank of New York Trust Company, N.A., as Trustee, with respect to 6.25% senior notes due 2018.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                   |
| 4.10.2*               | Second Supplemental Indenture dated as of February 24, 2006 to Indenture dated as of June 20, 2005 among Chesapeake, as issuer, the subsidiaries signatory thereto, as Subsidiary Guarantors, and The Bank of New York Trust Company, N.A., as Trustee, with respect to 6.25% senior notes due 2018.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                  |
| 4.11                  | Indenture dated as of August 16, 2005 among Chesapeake, as issuer, the subsidiaries signatory thereto, as Subsidiary Guarantors and The Bank of New York Trust Company, N.A., as Trustee, with respect to 6.50% senior notes due 2017. Incorporated herein by reference to Exhibit 4.1 to Chesapeake's current report on Form 8-K dated August 16, 2005.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                              |

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| <b>Exhibit Number</b> | <b>Description</b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                     |
|-----------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 4.11.1*               | First Supplemental Indenture dated as of November 14, 2005 to Indenture dated as of August 16, 2005 among Chesapeake, as issuer, the subsidiaries signatory thereto, as Subsidiary Guarantors, and The Bank of New York Trust Company, N.A., as Trustee, with respect to 6.50% senior notes due 2017.                                                                                                                                                                                                                                                                                                                                                                                                                                                  |
| 4.11.2*               | Second Supplemental Indenture dated as of February 1, 2006 to Indenture dated as of August 16, 2005 among Chesapeake, as issuer, the subsidiaries signatory thereto, as Subsidiary Guarantors, and The Bank of New York Trust Company, N.A., as Trustee, with respect to 6.50% senior notes due 2017.                                                                                                                                                                                                                                                                                                                                                                                                                                                  |
| 4.11.3*               | Third Supplemental Indenture dated as of February 24, 2006 to Indenture dated as of August 16, 2005 among Chesapeake, as issuer, the subsidiaries signatory thereto, as Subsidiary Guarantors, and The Bank of New York Trust Company, N.A., as Trustee, with respect to 6.50% senior notes due 2017.                                                                                                                                                                                                                                                                                                                                                                                                                                                  |
| 4.12                  | Indenture dated as of November 8, 2005 among Chesapeake, as issuer, the subsidiaries signatory thereto, as Subsidiary Guarantors and The Bank of New York Trust Company, N.A., as Trustee, with respect to 6.875% senior notes due 2020. Incorporated herein by reference to Exhibit 4.1.1 to Chesapeake's current report on Form 8-K dated November 8, 2005. First Supplemental Indenture dated as of November 14, 2005. Incorporated herein by reference to Exhibit 4.3 to Chesapeake's registration statement on Form S-4 (No. 333-132263). Second Supplemental Indenture dated as of February 24, 2006. Incorporated herein by reference to Exhibit 4.4 to Chesapeake's registration statement on Form S-4 (No. 333-132263).                       |
| 4.13                  | Indenture dated as of November 8, 2005 among Chesapeake, as issuer, the subsidiaries signatory thereto, as Subsidiary Guarantors and The Bank of New York Trust Company, N.A., as Trustee, with respect to 2.75% contingent convertible senior notes due 2035. Incorporated herein by reference to Exhibit 4.1.2 to Chesapeake's current report on Form 8-K dated November 8, 2005. First Supplemental Indenture dated as of November 14, 2005. Incorporated herein by reference to Exhibit 4.5 to Chesapeake's registration statement on Form S-3 (No. 333-132261). Second Supplemental Indenture dated as of February 24, 2006. Incorporated herein by reference to Exhibit 4.6 to Chesapeake's registration statement on Form S-3 (No. 333-132261). |
| 4.14                  | Registration Rights Agreement dated as of November 8, 2005 among Chesapeake and the Initial Purchasers named therein, with respect to 6.875% Senior Notes due 2020. Incorporated herein by reference to Exhibit 4.1.3 to Chesapeake's current report on Form 8-K dated November 15, 2005.                                                                                                                                                                                                                                                                                                                                                                                                                                                              |
| 4.15                  | Registration Rights Agreement dated as of February 3, 2006 among Chesapeake and the Initial Purchasers named therein, with respect to 6.5% Senior Notes due 2017. Incorporated herein by reference to Exhibit 4.1.2 to Chesapeake's current report on Form 8-K dated February 3, 2006.                                                                                                                                                                                                                                                                                                                                                                                                                                                                 |
| 10.1.1                | Chesapeake's 2003 Stock Incentive Plan. Incorporated herein by reference to Exhibit A to Chesapeake's definitive proxy statement for its 2003 annual meeting of shareholders filed April 17, 2003.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                     |
| 10.1.1.1              | Form of Restricted Stock Award Agreement for Chesapeake's 2003 Stock Incentive Plan. Incorporated herein by reference to Exhibit 10.1.14.1 to Chesapeake's quarterly report on Form 10-Q for the quarter ended September 30, 2004.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                     |
| 10.1.2                | Chesapeake's 1992 Nonstatutory Stock Option Plan, as amended. Incorporated herein by reference to Exhibit 10.1.2 to Chesapeake's quarterly report on Form 10-Q for the quarter ended December 31, 1996.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                |
| 10.1.3                | Chesapeake's 1994 Stock Option Plan, as amended. Incorporated herein by reference to Exhibit 10.1.3 to Chesapeake's quarterly report on Form 10-Q for the quarter ended December 31, 1996.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                             |
| 10.1.4                | Chesapeake's 1996 Stock Option Plan. Incorporated herein by reference to Exhibit B to Chesapeake's definitive proxy statement for its 1996 annual meeting of shareholders.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                             |

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| <b>Exhibit Number</b> | <b>Description</b>                                                                                                                                                                                                                                                         |
|-----------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 10.1.4.1              | Form of Incentive Stock Option Agreement for Chesapeake's 1996 Stock Option Plan. Incorporated herein by reference to Exhibit 10.1.4.1 to Chesapeake's quarterly report on Form 10-Q for the quarter ended September 30, 2004.                                             |
| 10.1.4.2              | Form of Nonqualified Stock Option Agreement for Chesapeake's 1996 Stock Option Plan. Incorporated herein by reference to Exhibit 10.1.4.2 to Chesapeake's quarterly report on Form 10-Q for the quarter ended September 30, 2004.                                          |
| 10.1.5                | Chesapeake's 1999 Stock Option Plan. Incorporated herein by reference to Exhibit 10.1.5 to Chesapeake's quarterly report on Form 10-Q for the quarter ended June 30, 1999.                                                                                                 |
| 10.1.5.1              | Form of Nonqualified Stock Option Agreement for Chesapeake's 1999 Stock Option Plan. Incorporated herein by reference to Exhibit 10.1.5.1 to Chesapeake's quarterly report on Form 10-Q for the quarter ended September 30, 2004.                                          |
| 10.1.6                | Chesapeake's 2000 Employee Stock Option Plan. Incorporated herein by reference to Exhibit 10.1.6 to Chesapeake's quarterly report on Form 10-Q for the quarter ended March 31, 2000.                                                                                       |
| 10.1.6.1              | Form of Nonqualified Stock Option Agreement for Chesapeake's 2000 Employee Stock Option Plan. Incorporated herein by reference to Exhibit 10.1.6 to Chesapeake's quarterly report on Form 10-Q for the quarter ended March 31, 2000.                                       |
| 10.1.7                | Chesapeake's 2000 Executive Officer Stock Option Plan. Incorporated herein by reference to Exhibit 10.1.7 to Chesapeake's quarterly report on Form 10-Q for the quarter ended March 31, 2000.                                                                              |
| 10.1.8                | Chesapeake's 2001 Stock Option Plan. Incorporated herein by reference to Exhibit B to Chesapeake's definitive proxy statement for its 2001 annual meeting of shareholders filed April 30, 2001.                                                                            |
| 10.1.8.1              | Form of Incentive Stock Option Agreement for Chesapeake's 2001 Stock Option Plan. Incorporated herein by reference to Exhibit 10.1.8.1 to Chesapeake's quarterly report on Form 10-Q for the quarter ended September 30, 2004.                                             |
| 10.1.8.2              | Form of Nonqualified Stock Option Agreement for Chesapeake's 2001 Stock Option Plan and 2001 Nonqualified Stock Option Plan. Incorporated herein by reference to Exhibit 10.1.8.2 to Chesapeake's quarterly report on Form 10-Q for the quarter ended September 30, 2004.  |
| 10.1.9                | Chesapeake's 2001 Executive Officer Stock Option Plan. Incorporated herein by reference to Exhibit 10.1.9 to Chesapeake's quarterly report on Form 10-Q for the quarter ended June 30, 2001.                                                                               |
| 10.1.10               | Chesapeake's 2001 Nonqualified Stock Option Plan. Incorporated herein by reference to Exhibit 10.1.10 to Chesapeake's quarterly report on Form 10-Q for the quarter ended June 30, 2001.                                                                                   |
| 10.1.11               | Chesapeake's 2002 Stock Option Plan. Incorporated herein by reference to Exhibit A to Chesapeake's definitive proxy statement for its 2002 annual meeting of shareholders filed April 29, 2002.                                                                            |
| 10.1.11.1             | Form of Incentive Stock Option Agreement for Chesapeake's 2002 Stock Option Plan. Incorporated herein by reference to Exhibit 10.1.11.1 to Chesapeake's quarterly report on Form 10-Q for the quarter ended September 30, 2004.                                            |
| 10.1.11.2             | Form of Nonqualified Stock Option Agreement for Chesapeake's 2002 Stock Option Plan and 2002 Nonqualified Stock Option Plan. Incorporated herein by reference to Exhibit 10.1.11.2 to Chesapeake's quarterly report on Form 10-Q for the quarter ended September 30, 2004. |
| 10.1.12               | Chesapeake's 2002 Non-Employee Director Stock Option Plan. Incorporated herein by reference to Exhibit B to Chesapeake's definitive proxy statement for its 2002 annual meeting of shareholders filed April 29, 2002.                                                      |



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| <b>Exhibit Number</b> | <b>Description</b>                                                                                                                                                                                                                                           |
|-----------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 10.1.12.1             | Form of Stock Option Agreement for Chesapeake's 2002 Non-Employee Director Stock Option Plan. Incorporated herein by reference to Exhibit 10.1.12.1 to Chesapeake's quarterly report on Form 10-Q for the quarter ended September 30, 2004.                  |
| 10.1.13               | Chesapeake's 2002 Nonqualified Stock Option Plan. Incorporated herein by reference to Exhibit 10.1.11 to Chesapeake's quarterly report on Form 10-Q for the quarter ended June 30, 2002.                                                                     |
| 10.1.14               | Chesapeake's 2003 Stock Award Plan for Non-Employee Directors. Incorporated herein by reference to Exhibit 10.1.14 to Chesapeake's annual report of Form 10-K/A for the year ended December 31, 2002.                                                        |
| 10.1.15               | Chesapeake Energy Corporation 401(k) Make-Up Plan. Incorporated herein by reference to Exhibit 10.1.15 to Chesapeake's annual report on Form 10-K/A for the year ended December 31, 2002.                                                                    |
| 10.1.15.1             | Chesapeake Energy Corporation 401(k) Make-Up Plan 2005. Incorporated herein by reference to Exhibit 10.1.15.1 to Chesapeake's annual report on Form 10-K for the year ended December 31, 2004.                                                               |
| 10.1.16               | Chesapeake Energy Corporation Deferred Compensation Plan. Incorporated herein by reference to Exhibit 10.1.16 to Chesapeake's annual report on Form 10-K/A for the year ended December 31, 2002.                                                             |
| 10.1.16.1             | Chesapeake Energy Corporation Deferred Compensation Plan 2005. Incorporated herein by reference to Exhibit 10.1.16.1 to Chesapeake's annual report on Form 10-K for the year ended December 31, 2004.                                                        |
| 10.1.17               | Form of Stock Option Grant Notice. Incorporated herein by reference to Exhibit 10.1.15 to Chesapeake's quarterly report on Form 10-Q for the quarter ended September 30, 2004.                                                                               |
| 10.1.18               | Chesapeake's Long Term Incentive Plan. Incorporated herein by reference to Exhibit A to Chesapeake's definitive proxy statement for its 2005 annual meeting of shareholders filed April 29, 2005.                                                            |
| 10.1.18.1             | Form of Non-Employee Director Stock Option Agreement for the Long Term Incentive Plan. Incorporated herein by reference to Exhibit 10.1.18.1 to Chesapeake's current report on Form 8-K dated June 16, 2005.                                                 |
| 10.1.18.2             | Form of Restricted Stock Award Agreement for the Long Term Incentive Plan. Incorporated herein by reference to Exhibit 10.1.18.2 to Chesapeake's current report on Form 8-K dated June 16, 2005.                                                             |
| 10.1.18.3             | Form of Non-Employee Director Restricted Stock Award Agreement for the Long Term Incentive Plan. Incorporated herein by reference to Exhibit 10.1.18.3 to Chesapeake's current report on Form 8-K dated June 16, 2005.                                       |
| 10.1.19               | Founder Well Participation Program. Incorporated herein by reference to Exhibit B to Chesapeake's definitive proxy statement for its 2005 annual meeting of shareholders filed April 29, 2005.                                                               |
| 10.2.1                | Fourth Amended and Restated Employment Agreement dated as of July 1, 2005, between Aubrey K. McClendon and Chesapeake Energy Corporation. Incorporated herein by reference to Exhibit 10.2.1 to Chesapeake's current report on Form 8-K dated June 16, 2005. |
| 10.2.2                | Fourth Amended and Restated Employment Agreement dated as of July 1, 2005, between Tom L. Ward and Chesapeake Energy Corporation. Incorporated herein by reference to Exhibit 10.2.2 to Chesapeake's current report on Form 8-K dated June 16, 2005.         |

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| <b>Exhibit<br/>Number</b> | <b>Description</b>                                                                                                                                                                                                                                                                                                                                                                                    |
|---------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 10.2.3                    | Amended and Restated Employment Agreement dated as of July 1, 2003 between Marcus C. Rowland and Chesapeake Energy Corporation. Incorporated herein by reference to Exhibit 10.2.3 to Chesapeake's quarterly report on Form 10-Q for the quarter ended September 30, 2003.                                                                                                                            |
| 10.2.4                    | Employment Agreement dated as of July 1, 2003 between Steven C. Dixon and Chesapeake Energy Corporation. Incorporated herein by reference to Exhibit 10.2.4 to Chesapeake's current report on Form 8-K dated February 15, 2006.                                                                                                                                                                       |
| 10.2.5                    | Resignation Agreement dated as of February 10, 2006 between Tom L. Ward and Chesapeake Energy Corporation. Incorporated herein by reference to Exhibit 10.2.8 to Chesapeake's current report on Form 8-K dated February 15, 2006.                                                                                                                                                                     |
| 10.2.8                    | Employment Agreement dated as of July 1, 2003 between Michael A. Johnson and Chesapeake Energy Corporation. Incorporated herein by reference to Exhibit 10.2.8 to Chesapeake's quarterly report on Form 10-Q for the quarter ended September 30, 2003.                                                                                                                                                |
| 10.2.9                    | Employment Agreement dated as of July 1, 2003 between Martha A. Burger and Chesapeake Energy Corporation. Incorporated herein by reference to Exhibit 10.2.9 to Chesapeake's quarterly report on Form 10-Q for the quarter ended September 30, 2003.                                                                                                                                                  |
| 10.3                      | Form of Indemnity Agreement for officers and directors of Chesapeake and its subsidiaries. Incorporated herein by reference to Exhibit 10.30 to Chesapeake's registration statement on Form S-1 (No. 33-55600).                                                                                                                                                                                       |
| 10.4                      | Non-Employee Director Compensation. Incorporated herein by reference to Exhibit 10.4 to Chesapeake's quarterly report on Form 10-Q for the quarter ended June 30, 2005.                                                                                                                                                                                                                               |
| 10.5 *                    | Named Executive Officer Compensation.                                                                                                                                                                                                                                                                                                                                                                 |
| 10.6                      | Rights Agreement dated July 15, 1998 between Chesapeake and UMB Bank, N.A., as Rights Agent. Incorporated herein by reference to Exhibit 1 to Chesapeake's registration statement on Form 8-A filed July 16, 1998. Amendment No. 1 dated September 11, 1998. Incorporated herein by reference to Exhibit 10.3 to Chesapeake's quarterly report on Form 10-Q for the quarter ended September 30, 1998. |
| 10.6.1*                   | Amendment No. 2 dated March 3, 2006 to Rights Agreement dated July 15, 1998 between Chesapeake and UMB Bank, N.A., as Rights Agent.                                                                                                                                                                                                                                                                   |
| 12*                       | Ratios of Earnings to Fixed Charges and Preferred Dividends.                                                                                                                                                                                                                                                                                                                                          |
| 21*                       | Subsidiaries of Chesapeake.                                                                                                                                                                                                                                                                                                                                                                           |
| 23.1*                     | Consent of Pricewaterhouse Coopers, LLP                                                                                                                                                                                                                                                                                                                                                               |
| 23.2*                     | Consent of Netherland, Sewell & Associates, Inc.                                                                                                                                                                                                                                                                                                                                                      |
| 23.3*                     | Consent of Data & Consulting Services, Division of Schlumberger Technology Corporation                                                                                                                                                                                                                                                                                                                |
| 23.4*                     | Consent of Lee Keeling and Associates, Inc.                                                                                                                                                                                                                                                                                                                                                           |
| 23.5*                     | Consent of Ryder Scott Company L.P.                                                                                                                                                                                                                                                                                                                                                                   |
| 23.6*                     | Consent of LaRoche Petroleum Consultants, Ltd.                                                                                                                                                                                                                                                                                                                                                        |
| 23.7*                     | Consent of H.J. Gruy and Associates, Inc.                                                                                                                                                                                                                                                                                                                                                             |
| 23.8*                     | Consent of Miller and Lents, Ltd.                                                                                                                                                                                                                                                                                                                                                                     |
| 31.1*                     | Aubrey K. McClendon, Chairman and Chief Executive Officer, Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.                                                                                                                                                                                                                                                                   |

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| <b>Exhibit<br/>Number</b> | <b>Description</b>                                                                                                                                |
|---------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------|
| 31.2*                     | Marcus C. Rowland, Executive Vice President and Chief Financial Officer, Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1*                     | Aubrey K. McClendon, Chairman and Chief Executive Officer, Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.               |
| 32.2*                     | Marcus C. Rowland, Executive Vice President and Chief Financial Officer, Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |

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\* Filed herewith.  
Management contract or compensatory plan or arrangement.

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**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

By /s/ AUBREY K. McCLENDON  
**Aubrey K. McClendon**

**Chairman of the Board and**

**Chief Executive Officer**

Date: March 13, 2006

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.

| Signature                                             | Capacity                                                                                                       | Date           |
|-------------------------------------------------------|----------------------------------------------------------------------------------------------------------------|----------------|
| /s/ AUBREY K. McCLENDON<br><b>Aubrey K. McClendon</b> | Chairman of the Board, Chief Executive Officer<br>and Director (Principal Executive Officer)                   | March 13, 2006 |
| /s/ MARCUS C. ROWLAND<br><b>Marcus C. Rowland</b>     | Executive Vice President and Chief Financial<br>Officer (Principal Financial Officer)                          | March 13, 2006 |
| /s/ MICHAEL A. JOHNSON<br><b>Michael A. Johnson</b>   | Senior Vice President Accounting, Controller and<br>Chief Accounting Officer (Principal Accounting<br>Officer) | March 13, 2006 |
| /s/ RICHARD K. DAVIDSON<br><b>Richard K. Davidson</b> | Director                                                                                                       | March 13, 2006 |
| /s/ FRANK KEATING<br><b>Frank Keating</b>             | Director                                                                                                       | March 13, 2006 |
| /s/ BREENE M. KERR<br><b>Breene M. Kerr</b>           | Director                                                                                                       | March 13, 2006 |
| /s/ CHARLES T. MAXWELL<br><b>Charles T. Maxwell</b>   | Director                                                                                                       | March 13, 2006 |
| /s/ DON NICKLES<br><b>Don Nickles</b>                 | Director                                                                                                       | March 13, 2006 |

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/s/ FREDERICK B. WHITEMORE

Director

March 13, 2006

**Frederick B. Whittemore**

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Annex B

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**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

x Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the quarterly period ended September 30, 2006

.. Transition Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the transition period from to

Commission File No. 1-13726

**Chesapeake Energy Corporation**

(Exact name of registrant as specified in its charter)

**Oklahoma**  
(State or other jurisdiction of

incorporation or organization)

**6100 North Western Avenue**

**Oklahoma City, Oklahoma**  
(Address of principal executive offices)

**73-1395733**  
(I.R.S. Employer

Identification No.)

**73118**  
(Zip Code)

**(405) 848-8000**

Registrant's telephone number, including area code

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

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Large accelerated filer ☒ Accelerated filer ☐ Non-accelerated filer ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ☐ No ☒

As of November 3, 2006, there were 436,865,417 shares of our \$0.01 par value common stock outstanding.

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**CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES**

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| Item 6.                             | <u>Exhibits</u> B-60                                                                                                                 |



**Table of Contents****PART I. FINANCIAL INFORMATION****CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS****(Unaudited)**

|                                                                                              | September<br>30,  | December 31,  |
|----------------------------------------------------------------------------------------------|-------------------|---------------|
|                                                                                              | 2006              | 2005          |
|                                                                                              | (\$ in thousands) |               |
| ASSETS                                                                                       |                   |               |
| CURRENT ASSETS:                                                                              |                   |               |
| Cash and cash equivalents                                                                    | \$ 716            | \$ 60,027     |
| Accounts receivable                                                                          | 735,005           | 791,194       |
| Deferred income taxes                                                                        |                   | 234,592       |
| Short-term derivative instruments                                                            | 1,097,578         | 10,503        |
| Inventory and other                                                                          | 78,996            | 87,081        |
| Total Current Assets                                                                         | 1,912,295         | 1,183,397     |
| PROPERTY AND EQUIPMENT:                                                                      |                   |               |
| Oil and natural gas properties, at cost based on full-cost accounting:                       |                   |               |
| Evaluated oil and natural gas properties                                                     | 20,191,783        | 15,880,919    |
| Unevaluated properties                                                                       | 3,440,181         | 1,739,095     |
| Less: accumulated depreciation, depletion and amortization of oil and natural gas properties | (4,913,749)       | (3,945,703)   |
| Total oil and natural gas properties, at cost based on full-cost accounting                  | 18,718,215        | 13,674,311    |
| Other property and equipment:                                                                |                   |               |
| Natural gas gathering systems                                                                | 457,321           | 333,365       |
| Drilling rigs                                                                                | 301,611           | 116,133       |
| Buildings and land                                                                           | 381,751           | 233,467       |
| Natural gas compressors                                                                      | 108,847           | 73,043        |
| Other                                                                                        | 205,781           | 110,208       |
| Less: accumulated depreciation and amortization of other property and equipment              | (172,563)         | (128,640)     |
| Total Property and Equipment                                                                 | 20,000,963        | 14,411,887    |
| OTHER ASSETS:                                                                                |                   |               |
| Investments                                                                                  | 686,343           | 297,443       |
| Long-term derivative instruments                                                             | 604,796           | 78,860        |
| Other assets                                                                                 | 190,524           | 146,875       |
| Total Other Assets                                                                           | 1,481,663         | 523,178       |
| TOTAL ASSETS                                                                                 | \$ 23,394,921     | \$ 16,118,462 |

**Table of Contents****CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS (Continued)****(Unaudited)**

|                                                                                                                                                                                                                                       | September 30,<br>2006<br>(\$ in thousands) | December 31,<br>2005 |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------|----------------------|
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                                                                                                                                                                                           |                                            |                      |
| <b>CURRENT LIABILITIES:</b>                                                                                                                                                                                                           |                                            |                      |
| Accounts payable                                                                                                                                                                                                                      | \$ 754,996                                 | \$ 516,792           |
| Short-term derivative instruments                                                                                                                                                                                                     | 81,438                                     | 577,681              |
| Other accrued liabilities                                                                                                                                                                                                             | 398,611                                    | 364,501              |
| Deferred income taxes                                                                                                                                                                                                                 | 369,410                                    |                      |
| Revenues and royalties due others                                                                                                                                                                                                     | 305,422                                    | 394,693              |
| Accrued interest                                                                                                                                                                                                                      | 94,395                                     | 110,421              |
| Total Current Liabilities                                                                                                                                                                                                             | 2,004,272                                  | 1,964,088            |
| <b>LONG-TERM LIABILITIES:</b>                                                                                                                                                                                                         |                                            |                      |
| Long-term debt, net                                                                                                                                                                                                                   | 7,861,108                                  | 5,489,742            |
| Deferred income tax liability                                                                                                                                                                                                         | 2,903,688                                  | 1,804,978            |
| Asset retirement obligation                                                                                                                                                                                                           | 179,149                                    | 156,593              |
| Long-term derivative instruments                                                                                                                                                                                                      | 181,941                                    | 479,996              |
| Revenues and royalties due others                                                                                                                                                                                                     | 22,962                                     | 22,585               |
| Other liabilities                                                                                                                                                                                                                     | 48,981                                     | 26,157               |
| Total Long-Term Liabilities                                                                                                                                                                                                           | 11,197,829                                 | 7,980,051            |
| <b>CONTINGENCIES AND COMMITMENTS (Note 3)</b>                                                                                                                                                                                         |                                            |                      |
| <b>STOCKHOLDERS' EQUITY:</b>                                                                                                                                                                                                          |                                            |                      |
| Preferred Stock, \$.01 par value, 20,000,000 shares authorized:                                                                                                                                                                       |                                            |                      |
| 6.00% cumulative convertible preferred stock, 0 and 99,310 shares issued and outstanding as of September 30, 2006 and December 31, 2005, respectively, entitled in liquidation to \$0 and \$4,965,500                                 |                                            | 4,966                |
| 5.00% cumulative convertible preferred stock (series 2003), 38,625 and 1,025,946 shares issued and outstanding as of September 30, 2006 and December 31, 2005, respectively, entitled in liquidation to \$3,862,500 and \$102,594,600 | 3,863                                      | 102,595              |
| 4.125% cumulative convertible preferred stock, 3,065 and 89,060 shares issued and outstanding as of September 30, 2006 and December 31, 2005, respectively, entitled in liquidation to \$3,065,000 and \$89,060,000                   | 3,065                                      | 89,060               |
| 5.00% cumulative convertible preferred stock (series 2005), 4,600,000 shares issued and outstanding as of September 30, 2006 and December 31, 2005, entitled in liquidation to \$460,000,000                                          | 460,000                                    | 460,000              |
| 4.50% cumulative convertible preferred stock, 3,450,000 shares issued and outstanding as of September 30, 2006 and December 31, 2005, entitled in liquidation to \$345,000,000                                                        | 345,000                                    | 345,000              |
| 5.00% cumulative convertible preferred stock (series 2005B), 5,750,000 shares issued and outstanding as of September 30, 2006 and December 31, 2005, entitled in liquidation to \$575,000,000                                         | 575,000                                    | 575,000              |
| 6.25% mandatory convertible preferred stock, 2,300,000 and 0 shares issued and outstanding as of September 30, 2006 and December 31, 2005, respectively, entitled in liquidation to \$575,000,000 and \$0                             | 575,000                                    |                      |
| Common Stock, \$.01 par value, 750,000,000 and 500,000,000 shares authorized, 437,859,397 and 375,510,521 shares issued at September 30, 2006 and December 31, 2005, respectively                                                     | 4,379                                      | 3,755                |
| Paid-in capital                                                                                                                                                                                                                       | 4,899,634                                  | 3,803,312            |
| Retained earnings                                                                                                                                                                                                                     | 2,495,215                                  | 1,100,841            |

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|                                                                                                                                   |                      |                      |
|-----------------------------------------------------------------------------------------------------------------------------------|----------------------|----------------------|
| Accumulated other comprehensive income (loss), net of tax of (\$518,564,000) and \$112,071,000, respectively                      | 862,241              | (194,972)            |
| Unearned compensation                                                                                                             |                      | (89,242)             |
| Less: treasury stock, at cost; 1,306,528 and 5,320,816 common shares as of September 30, 2006 and December 31, 2005, respectively | (30,577)             | (25,992)             |
| Total Stockholders' Equity                                                                                                        | 10,192,820           | 6,174,323            |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>                                                                                 | <b>\$ 23,394,921</b> | <b>\$ 16,118,462</b> |

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

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**Table of Contents****CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****(Unaudited)**

|                                                              | Three Months Ended<br>September 30,      |                   | Nine Months Ended<br>September 30, |                   |
|--------------------------------------------------------------|------------------------------------------|-------------------|------------------------------------|-------------------|
|                                                              | 2006                                     | 2005              | 2006                               | 2005              |
|                                                              | (\$ in thousands, except per share data) |                   |                                    |                   |
| <b>REVENUES:</b>                                             |                                          |                   |                                    |                   |
| Oil and natural gas sales                                    | \$ 1,493,226                             | \$ 720,928        | \$ 4,190,430                       | \$ 2,032,271      |
| Oil and natural gas marketing sales                          | 398,114                                  | 361,915           | 1,170,091                          | 882,040           |
| Service operations revenue                                   | 38,071                                   |                   | 97,473                             |                   |
| <b>Total Revenues</b>                                        | <b>1,929,411</b>                         | <b>1,082,843</b>  | <b>5,457,994</b>                   | <b>2,914,311</b>  |
| <b>OPERATING COSTS:</b>                                      |                                          |                   |                                    |                   |
| Production expenses                                          | 124,045                                  | 80,765            | 364,134                            | 222,660           |
| Production taxes                                             | 40,562                                   | 53,102            | 129,858                            | 136,313           |
| General and administrative expenses                          | 37,382                                   | 15,785            | 99,728                             | 39,640            |
| Oil and natural gas marketing expenses                       | 384,473                                  | 353,510           | 1,131,521                          | 860,789           |
| Service operations expense                                   | 18,821                                   |                   | 48,925                             |                   |
| Oil and natural gas depreciation, depletion and amortization | 343,723                                  | 231,145           | 976,839                            | 621,484           |
| Depreciation and amortization of other assets                | 27,016                                   | 12,902            | 74,051                             | 34,791            |
| Employee retirement expense                                  |                                          |                   | 54,753                             |                   |
| <b>Total Operating Costs</b>                                 | <b>976,022</b>                           | <b>747,209</b>    | <b>2,879,809</b>                   | <b>1,915,677</b>  |
| <b>INCOME FROM OPERATIONS</b>                                | <b>953,389</b>                           | <b>335,634</b>    | <b>2,578,185</b>                   | <b>998,634</b>    |
| <b>OTHER INCOME (EXPENSE):</b>                               |                                          |                   |                                    |                   |
| Interest and other income                                    | 5,132                                    | 2,428             | 19,742                             | 7,790             |
| Interest expense                                             | (74,112)                                 | (58,593)          | (220,226)                          | (155,623)         |
| Gain on sale of investment                                   |                                          |                   | 117,396                            |                   |
| Loss on repurchases or exchanges of Chesapeake senior notes  |                                          | (747)             |                                    | (70,047)          |
| <b>Total Other Income (Expense)</b>                          | <b>(68,980)</b>                          | <b>(56,912)</b>   | <b>(83,088)</b>                    | <b>(217,880)</b>  |
| <b>INCOME BEFORE INCOME TAXES</b>                            | <b>884,409</b>                           | <b>278,722</b>    | <b>2,495,097</b>                   | <b>780,754</b>    |
| <b>INCOME TAX EXPENSE:</b>                                   |                                          |                   |                                    |                   |
| Current                                                      |                                          |                   |                                    |                   |
| Deferred                                                     | 336,074                                  | 101,734           | 963,136                            | 284,977           |
| <b>Total Income Tax Expense</b>                              | <b>336,074</b>                           | <b>101,734</b>    | <b>963,136</b>                     | <b>284,977</b>    |
| <b>NET INCOME</b>                                            | <b>548,335</b>                           | <b>176,988</b>    | <b>1,531,961</b>                   | <b>495,777</b>    |
| <b>PREFERRED STOCK DIVIDENDS</b>                             | <b>(25,753)</b>                          | <b>(10,204)</b>   | <b>(62,793)</b>                    | <b>(25,526)</b>   |
| <b>LOSS ON CONVERSION/EXCHANGE OF PREFERRED STOCK</b>        |                                          | <b>(17,725)</b>   | <b>(10,556)</b>                    | <b>(22,468)</b>   |
| <b>NET INCOME AVAILABLE TO COMMON SHAREHOLDERS</b>           | <b>\$ 522,582</b>                        | <b>\$ 149,059</b> | <b>\$ 1,458,612</b>                | <b>\$ 447,783</b> |

**EARNINGS PER COMMON SHARE:**

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|                                                |    |       |    |       |    |       |    |       |
|------------------------------------------------|----|-------|----|-------|----|-------|----|-------|
| Basic                                          | \$ | 1.25  | \$ | 0.46  | \$ | 3.75  | \$ | 1.42  |
| Assuming dilution                              | \$ | 1.13  | \$ | 0.43  | \$ | 3.40  | \$ | 1.32  |
| <b>CASH DIVIDEND DECLARED PER COMMON SHARE</b> | \$ | 0.060 | \$ | 0.050 | \$ | 0.170 | \$ | 0.145 |

**WEIGHTED AVERAGE COMMON AND COMMON  
EQUIVALENT SHARES OUTSTANDING**

**(in thousands):**

|                   |         |         |         |         |
|-------------------|---------|---------|---------|---------|
| Basic             | 417,569 | 322,101 | 389,136 | 314,425 |
| Assuming dilution | 483,273 | 367,639 | 450,680 | 352,210 |

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

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**Table of Contents****CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(Unaudited)**

|                                                                                                     | <div> <div>Nine Months Ended</div> <div>September 30,</div> <div>2006</div> <div>2005</div> </div> |             |
|-----------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------|-------------|
|                                                                                                     | (\$ in thousands)                                                                                  |             |
| CASH FLOWS FROM OPERATING ACTIVITIES:                                                               |                                                                                                    |             |
| NET INCOME                                                                                          | \$ 1,531,961                                                                                       | \$ 495,777  |
| ADJUSTMENTS TO RECONCILE NET INCOME TO CASH PROVIDED BY OPERATING ACTIVITIES:                       |                                                                                                    |             |
| Depreciation, depletion and amortization                                                            | 1,041,246                                                                                          | 649,907     |
| Unrealized (gains) losses on derivatives                                                            | (453,347)                                                                                          | 135,175     |
| Deferred income taxes                                                                               | 963,136                                                                                            | 284,977     |
| Amortization of loan costs and bond discount                                                        | 14,952                                                                                             | 10,576      |
| Realized (gains) losses on financing derivatives                                                    | (96,377)                                                                                           |             |
| Stock-based compensation                                                                            | 78,200                                                                                             | 10,172      |
| Gain on sale of investment in Pioneer Drilling Company                                              | (117,396)                                                                                          |             |
| Income from equity investments                                                                      | (9,187)                                                                                            | (2,171)     |
| Loss on repurchases or exchanges of Chesapeake senior notes                                         |                                                                                                    | 70,047      |
| Premiums paid for repurchasing of senior notes                                                      |                                                                                                    | (61,023)    |
| Other                                                                                               | (3,556)                                                                                            | (503)       |
| Change in assets and liabilities                                                                    | 32,787                                                                                             | (15,589)    |
| Cash provided by operating activities                                                               | 2,982,419                                                                                          | 1,577,345   |
| CASH FLOWS FROM INVESTING ACTIVITIES:                                                               |                                                                                                    |             |
| Acquisitions of oil and natural gas companies, proved and unproved properties, net of cash acquired | (3,089,710)                                                                                        | (1,932,934) |
| Exploration and development of oil and natural gas properties                                       | (2,583,841)                                                                                        | (1,488,145) |
| Additions to buildings and other fixed assets                                                       | (406,752)                                                                                          | (156,978)   |
| Additions to drilling rig equipment                                                                 | (340,814)                                                                                          | (42,056)    |
| Proceeds from sale of investment in Pioneer Drilling Company                                        | 158,890                                                                                            |             |
| Proceeds from sale of drilling rigs and equipment                                                   | 187,500                                                                                            |             |
| Additions to investments                                                                            | (537,703)                                                                                          | (37,273)    |
| Acquisition of trucking company, net of cash acquired                                               | (45,166)                                                                                           |             |
| Deposits for acquisitions                                                                           | (12,070)                                                                                           |             |
| Other                                                                                               | 1,661                                                                                              | 2,342       |
| Cash used in investing activities                                                                   | (6,668,005)                                                                                        | (3,655,044) |
| CASH FLOWS FROM FINANCING ACTIVITIES:                                                               |                                                                                                    |             |
| Proceeds from long-term borrowings                                                                  | 7,058,000                                                                                          | 3,561,000   |
| Payments on long-term borrowings                                                                    | (5,666,000)                                                                                        | (3,620,000) |
| Proceeds from issuance of senior notes, net of offering costs                                       | 969,193                                                                                            | 1,765,383   |
| Proceeds from issuance of common stock, net of offering costs                                       | 803,720                                                                                            | 289,391     |
| Proceeds from issuance of preferred stock, net of offering costs                                    | 557,627                                                                                            | 782,368     |
| Purchases or exchanges of Chesapeake senior notes                                                   |                                                                                                    | (556,407)   |
| Common stock dividends                                                                              | (61,829)                                                                                           | (45,771)    |
| Preferred stock dividends                                                                           | (62,541)                                                                                           | (17,315)    |
| Financing costs of credit facility                                                                  | (5,079)                                                                                            | (4,672)     |
| Purchases of treasury shares                                                                        | (86,185)                                                                                           | (4,000)     |
| Derivative settlements                                                                              | (68,361)                                                                                           |             |

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|                                                                |           |            |
|----------------------------------------------------------------|-----------|------------|
| Net increase in outstanding payments in excess of cash balance | 43,250    | 33,751     |
| Cash received from exercise of stock options and warrants      | 71,254    | 19,940     |
| Excess tax benefit from stock-based compensation               | 85,649    |            |
| Other financing costs                                          | (12,423)  | (5,763)    |
| Cash provided by financing activities                          | 3,626,275 | 2,197,905  |
| Net increase (decrease) in cash and cash equivalents           | (59,311)  | 120,206    |
| Cash and cash equivalents, beginning of period                 | 60,027    | 6,896      |
| Cash and cash equivalents, end of period                       | \$ 716    | \$ 127,102 |

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

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**Table of Contents****CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)****(Unaudited)**

|                                                                        | Nine Months Ended<br>September 30,<br>20062005<br>(\$ in thousands) |            |
|------------------------------------------------------------------------|---------------------------------------------------------------------|------------|
| SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION OF CASH PAYMENTS FOR: |                                                                     |            |
| Interest, net of capitalized interest                                  | \$ 245,190                                                          | \$ 162,218 |
| Income taxes, net of refunds received                                  | \$                                                                  | \$         |

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

In September 2006, we acquired 32% of the outstanding common stock of Chaparral Energy, Inc. for \$240 million in cash and 1,375,989 newly issued shares of our common stock valued at \$40 million. Chaparral is a privately-held independent oil and natural gas company headquartered in Oklahoma City, Oklahoma, with estimated proved reserves of approximately 618 bcfe and daily production of approximately 83 mmcfe.

For the nine months ended September 30, 2006 and 2005, holders of our 6.0% cumulative convertible preferred stock converted 99,310 and 1,835 shares, respectively, into 482,694 and 8,918 shares, respectively, of common stock.

For the nine months ended September 30, 2006 and 2005, holders of our 4.125% cumulative convertible preferred stock exchanged 2,750 and 178,675 shares, respectively, for 172,594 and 11,441,008 shares, respectively, of common stock in privately negotiated exchanges.

For the nine months ended September 30, 2006 and 2005, holders of our 5.0% (Series 2003) cumulative convertible preferred stock exchanged 183,273 and 697,724 shares, respectively, for 1,140,223 and 4,354,439 shares, respectively, of common stock in privately negotiated exchanges.

During the nine months ended September 30, 2006, we completed tender offers for our 4.125% and 5.0% (Series 2003) cumulative convertible preferred stock, issuing 5.2 million shares of our common stock in exchange for 83,245 shares of the 4.125% preferred stock, which represented 96.4% or \$83.2 million of the aggregate liquidation value of the shares outstanding, and 5.0 million shares of our common stock in exchange for 804,048 shares of the 5.0% (Series 2003) preferred stock, which represented 95.4% or \$80.4 million of the aggregate liquidation value of the shares outstanding. No cash was received or paid in connection with these transactions.

As of September 30, 2006 and 2005, dividends payable on our common and preferred stock were \$51.1 million and \$28.7 million, respectively.

For the nine months ended September 30, 2006 and 2005, oil and natural gas properties were adjusted by \$177.7 million and \$253.2 million, respectively, for net income tax liabilities related to acquisitions.

For the nine months ended September 30, 2006 and 2005, \$72.6 million and \$22.4 million, respectively, of accrued exploration and development costs were recorded as additions to oil and natural gas properties.

We recorded non-cash asset additions to net oil and natural gas properties of \$13.7 million and \$8.0 million for the nine months ended September 30, 2006 and 2005, respectively, for asset retirement obligations.

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



**Table of Contents****CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY****(Unaudited)**

|                                                                                                      | Nine Months Ended<br>September 30,<br>20062005<br>(\$ in thousands) |            |
|------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------|------------|
| <b>PREFERRED STOCK:</b>                                                                              |                                                                     |            |
| Balance, beginning of period                                                                         | \$ 1,576,621                                                        | \$ 490,906 |
| Issuance of 6.25% mandatory convertible preferred stock                                              | 575,000                                                             |            |
| Issuance of 5.00% cumulative convertible preferred stock (Series 2005)                               |                                                                     | 460,000    |
| Issuance of 4.50% cumulative convertible preferred stock                                             |                                                                     | 345,000    |
| Exchange of common stock for 85,995 and 178,675 shares of 4.125% preferred stock                     | (85,995)                                                            | (178,675)  |
| Exchange of common stock for 987,321 and 697,724 shares of 5.00% preferred stock (Series 2003)       | (98,732)                                                            | (69,772)   |
| Exchange of common stock for 99,310 and 1,835 shares of 6.00% preferred stock                        | (4,966)                                                             | (92)       |
| Balance, end of period                                                                               | 1,961,928                                                           | 1,047,367  |
| <b>COMMON STOCK:</b>                                                                                 |                                                                     |            |
| Balance, beginning of period                                                                         | 3,755                                                               | 3,169      |
| Issuance of 28,750,000 and 9,200,000 shares of common stock                                          | 288                                                                 | 92         |
| Issuance of 1,375,989 shares of common stock for the purchase of Chaparral Energy, Inc. common stock | 14                                                                  |            |
| Exchange of 12,016,423 and 15,804,365 shares of common stock for preferred stock                     | 120                                                                 | 158        |
| Exercise of stock options and warrants                                                               | 67                                                                  | 38         |
| Restricted stock grants                                                                              | 135                                                                 | 37         |
| Balance, end of period                                                                               | 4,379                                                               | 3,494      |
| <b>PAID-IN CAPITAL:</b>                                                                              |                                                                     |            |
| Balance, beginning of period                                                                         | 3,803,312                                                           | 2,440,105  |
| Issuance of common stock                                                                             | 834,900                                                             | 300,932    |
| Issuance of common stock for the purchase of Chaparral Energy, Inc. common stock                     | 39,986                                                              |            |
| Exchange of 12,016,423 and 15,804,365 shares of common stock for preferred stock                     | 189,572                                                             | 248,381    |
| Equity-based compensation                                                                            | 88,989                                                              | 78,943     |
| Adoption of SFAS 123(R)                                                                              | (89,242)                                                            |            |
| Offering expenses                                                                                    | (48,829)                                                            | (34,302)   |
| Exercise of stock options and warrants                                                               | 71,187                                                              | 19,902     |
| Release of 6,500,000 shares from treasury stock upon exercise of stock options                       | (75,102)                                                            |            |
| Tax benefit from exercise of stock options and restricted stock                                      | 85,649                                                              | 17,397     |
| Preferred stock conversion/exchange expenses                                                         | (788)                                                               | (103)      |
| Balance, end of period                                                                               | 4,899,634                                                           | 3,071,255  |
| <b>RETAINED EARNINGS:</b>                                                                            |                                                                     |            |
| Balance, beginning of period                                                                         | 1,100,841                                                           | 262,987    |
| Net income                                                                                           | 1,531,961                                                           | 495,777    |
| Dividends on common stock                                                                            | (68,789)                                                            | (46,612)   |
| Dividends on preferred stock                                                                         | (68,798)                                                            | (25,726)   |
| Balance, end of period                                                                               | 2,495,215                                                           | 686,426    |
| <b>ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS):</b>                                                |                                                                     |            |
| Balance, beginning of period                                                                         | (194,972)                                                           | 20,425     |
| Hedging activity                                                                                     | 1,143,738                                                           | (546,305)  |
| Marketable securities activity                                                                       | (86,525)                                                            | 44,440     |

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|                                                            |                      |                     |
|------------------------------------------------------------|----------------------|---------------------|
| Balance, end of period                                     | 862,241              | (481,440)           |
| <b>UNEARNED COMPENSATION:</b>                              |                      |                     |
| Balance, beginning of period                               | (89,242)             | (32,618)            |
| Restricted stock granted                                   |                      | (78,148)            |
| Amortization of unearned compensation                      |                      | 16,075              |
| Adoption of SFAS 123(R)                                    | 89,242               |                     |
| Balance, end of period                                     |                      | (94,691)            |
| <b>TREASURY STOCK COMMON:</b>                              |                      |                     |
| Balance, beginning of period                               | (25,992)             | (22,091)            |
| Purchase of 2,707,471 and 257,220 shares of treasury stock | (86,185)             | (4,000)             |
| Release of 6,500,000 shares upon exercise of stock options | 75,102               |                     |
| Release of 221,759 shares for company benefit plans        | 6,498                |                     |
| Balance, end of period                                     | (30,577)             | (26,091)            |
| <b>TOTAL STOCKHOLDERS EQUITY</b>                           | <b>\$ 10,192,820</b> | <b>\$ 4,206,320</b> |

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

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**Table of Contents****CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME****(Unaudited)**

|                                                                                                                                                                     | <b>Three Months Ended<br/>September 30,</b> |              | <b>Nine Months Ended<br/>September 30,</b> |             |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------|--------------|--------------------------------------------|-------------|
|                                                                                                                                                                     | <b>2006</b>                                 | <b>2005</b>  | <b>2006</b>                                | <b>2005</b> |
|                                                                                                                                                                     | <b>(\$ in thousands)</b>                    |              |                                            |             |
| Net income                                                                                                                                                          | \$ 548,335                                  | \$ 176,988   | \$ 1,531,961                               | \$ 495,777  |
| Other comprehensive income, net of income tax:                                                                                                                      |                                             |              |                                            |             |
| Change in fair value of derivative instruments, net of income taxes of \$451,888,000, (\$345,346,000), \$1,084,370,000 and (\$389,909,000)                          | 750,588                                     | (600,807)    | 1,799,636                                  | (678,334)   |
| Reclassification of (gain) loss on settled contracts, net of income taxes of (\$105,162,000), \$40,815,000, (\$268,896,000) and \$39,798,000                        | (174,040)                                   | 71,007       | (444,770)                                  | 69,238      |
| Ineffective portion of derivatives qualifying for cash flow hedge accounting, net of income taxes of (\$64,099,000), \$36,307,000, (\$125,599,000) and \$36,092,000 | (107,730)                                   | 63,165       | (211,128)                                  | 62,791      |
| Unrealized gain (loss) on marketable securities, net of income taxes of (\$2,336,000), \$12,046,000, (\$7,995,000) and \$25,544,000                                 | (3,926)                                     | 20,957       | (13,439)                                   | 44,440      |
| Reclassification of gain on sales of investments, net of income taxes of \$0, \$0, (\$45,824,000) and \$0                                                           |                                             |              | (73,086)                                   |             |
| Comprehensive income                                                                                                                                                | \$ 1,013,227                                | \$ (268,690) | \$ 2,589,174                               | \$ (6,088)  |

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

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**CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**1. Basis of Presentation and Summary of Significant Accounting Policies**

*Principles of Consolidation*

The accompanying unaudited condensed consolidated financial statements of Chesapeake Energy Corporation and its subsidiaries have been prepared in accordance with the instructions to Form 10-Q as prescribed by the Securities and Exchange Commission. Chesapeake's 2005 Annual Report on Form 10-K includes certain definitions and a summary of significant accounting policies and should be read in conjunction with this Form 10-Q. All material adjustments (consisting solely of normal recurring adjustments) which, in the opinion of management, are necessary for a fair statement of the results for the interim periods have been reflected. The results for the three and nine months ended September 30, 2006 are not necessarily indicative of the results to be expected for the full year. This Form 10-Q relates to the three and nine months ended September 30, 2006 (the Current Quarter and the Current Period, respectively) and the three and nine months ended September 30, 2005 (the Prior Quarter and the Prior Period, respectively).

*Stock-Based Compensation*

On January 1, 2006, we adopted Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment* (SFAS 123(R)), to account for stock-based compensation. Among other items, SFAS 123(R) eliminates the use of APB Opinion No. 25 and the intrinsic value method of accounting for equity compensation and requires companies to recognize the cost of employee services received in exchange for awards of equity instruments based on the fair value at grant date of those awards in their financial statements. We elected to use the modified prospective method for adoption, which requires compensation expense to be recorded for all unvested stock options and other equity-based compensation beginning in the first quarter of adoption. For all unvested options outstanding as of January 1, 2006, the previously measured but unrecognized compensation expense, based on the fair value at the original grant date, will be recognized in our financial statements over the remaining vesting period. For equity-based compensation awards granted or modified subsequent to January 1, 2006, compensation expense based on the fair value on the date of grant or modification will be recognized in our financial statements over the vesting period. We utilize the Black-Scholes option pricing model to measure the fair value of stock options. To the extent compensation cost relates to employees directly involved in oil and natural gas exploration and development activities, such amounts are capitalized to oil and natural gas properties. Amounts not capitalized to oil and natural gas properties are recognized as general and administrative expenses or production expenses.

Prior to the adoption of SFAS 123(R), we followed the intrinsic value method in accordance with APB 25 to account for employee stock-based compensation. Prior period financial statements have not been restated. Upon adoption of SFAS 123(R), we eliminated \$89.2 million of unearned compensation cost and reduced additional paid-in capital by the same amount on our condensed consolidated balance sheet.

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**Table of Contents****CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

For the three and nine months ended September 30, 2006 and 2005, we recorded the following stock-based compensation (\$ in thousands):

|                                                 | Restricted Stock |          | Stock Options |          | Total     |           |
|-------------------------------------------------|------------------|----------|---------------|----------|-----------|-----------|
|                                                 | 2006             | 2005     | 2006          | 2005     | 2006      | 2005      |
| <b>For the Three Months Ended September 30:</b> |                  |          |               |          |           |           |
| Production expenses                             | \$ 2,742         | \$       | \$ 143        | \$       | \$ 2,885  | \$        |
| General and administrative expenses             | 7,949            | 4,315    | 530           | 934      | 8,479     | 5,249     |
| Oil and natural gas properties                  | 9,452            | 3,676    | 492           | 1,390    | 9,944     | 5,066     |
| Total                                           | \$ 20,143        | \$ 7,991 | \$ 1,165      | \$ 2,324 | \$ 21,308 | \$ 10,315 |

|                                                |           |           |           |          |           |           |
|------------------------------------------------|-----------|-----------|-----------|----------|-----------|-----------|
| <b>For the Nine Months Ended September 30:</b> |           |           |           |          |           |           |
| Production expenses                            | \$ 5,191  | \$        | \$ 523    | \$       | \$ 5,714  | \$        |
| General and administrative expenses            | 18,066    | 8,837     | 3,190     | 1,335    | 21,256    | 10,172    |
| Employee retirement expense                    | 35,720    |           | 15,510    |          | 51,230    |           |
| Oil and natural gas properties                 | 17,739    | 7,395     | 1,755     | 1,390    | 19,494    | 8,785     |
| Total                                          | \$ 76,716 | \$ 16,232 | \$ 20,978 | \$ 2,725 | \$ 97,694 | \$ 18,957 |

The impact to income before income taxes of adopting SFAS 123(R) for the Current Quarter and the Current Period was a reduction of \$0.6 million and \$2.5 million, respectively. SFAS 123(R) also requires cash inflows resulting from tax deductions in excess of compensation expense recognized for stock options and restricted stock ( excess tax benefits ) to be classified as financing cash inflows in our statements of cash flows. Accordingly, for the nine months ended September 30, 2006, we reported \$85.6 million of excess tax benefits from stock-based compensation as cash provided by financing activities on our statement of cash flows.

*Pro forma Disclosures*

Prior to January 1, 2006, we accounted for our employee and non-employee director stock options using the intrinsic value method prescribed by APB 25. As required by SFAS 123(R), we have disclosed below the effect on net income and earnings per share that would have been recorded using the fair value based method for the three and nine months ended September 30, 2005 (\$ in thousands, except per share amounts):

|                                                                                                                           | Three Months Ended<br>September 30,<br>2005 | Nine Months Ended<br>September 30,<br>2005 |
|---------------------------------------------------------------------------------------------------------------------------|---------------------------------------------|--------------------------------------------|
| Net Income:                                                                                                               |                                             |                                            |
| As reported                                                                                                               | \$ 176,988                                  | \$ 495,777                                 |
| Add: Stock-based compensation expense included in reported net income, net of income tax                                  | 3,333                                       | 6,459                                      |
| Deduct: Total stock-based compensation expense determined under fair value based method for all awards, net of income tax | (5,218)                                     | (13,176)                                   |
| Pro forma net income                                                                                                      | \$ 175,103                                  | \$ 489,060                                 |
| Basic earnings per common share:                                                                                          |                                             |                                            |
| As reported                                                                                                               | \$ 0.46                                     | \$ 1.42                                    |

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|                                    |    |      |    |      |
|------------------------------------|----|------|----|------|
| Pro forma                          | \$ | 0.46 | \$ | 1.40 |
| Diluted earnings per common share: |    |      |    |      |
| As reported                        | \$ | 0.43 | \$ | 1.32 |
| Pro forma                          | \$ | 0.42 | \$ | 1.30 |

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**Table of Contents****CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)***Restricted Stock*

Chesapeake began issuing shares of restricted common stock to employees in January 2004 and to non-employee directors in July 2005. The fair value of the awards issued is determined based on the fair market value of the shares on the date of grant. This value is amortized over the vesting period, which is four or five years from the date of grant for employees and three years for non-employee directors.

A summary of the status of the unvested shares of restricted stock as of September 30, 2006, and changes during the Current Period, is presented below:

|                                          | <b>Number of<br/>Unvested<br/>Restricted Shares</b> | <b>Weighted Average<br/>Grant-Date<br/>Fair Value</b> |
|------------------------------------------|-----------------------------------------------------|-------------------------------------------------------|
| Unvested shares as of January 1, 2006    | 5,805,210                                           | \$ 18.38                                              |
| Granted                                  | 14,183,418                                          | 32.12                                                 |
| Vested                                   | (2,794,835)                                         | 19.73                                                 |
| Forfeited                                | (315,948)                                           | 25.76                                                 |
| Unvested shares as of September 30, 2006 | 16,877,845                                          | \$ 29.57                                              |

The aggregate intrinsic value of restricted stock vested during the Current Period was approximately \$85.4 million.

Included in the 14.2 million shares of restricted stock granted during the Current Period are 9.9 million shares of restricted stock granted during the Current Quarter to our employees (except for our CEO and CFO, who did not participate in the stock awards) under a long-term stock incentive and retention program. These shares vest 50% in three years with the remaining 50% vesting in five years.

As of September 30, 2006, there was \$478.6 million of total unrecognized compensation cost related to unvested restricted stock. The cost is expected to be recognized over a weighted average period of 4.09 years.

During the Current Quarter, the Prior Quarter, the Current Period and the Prior Period, we recognized excess tax benefits related to restricted stock of \$1.3 million, \$1.5 million, \$4.3 million and \$1.6 million, respectively, which were recorded as adjustments to additional paid-in capital and deferred income taxes with respect to such benefits.

*Stock Options*

We granted stock options in previous years under several stock compensation plans. Outstanding options expire ten years from the date of grant and become exercisable over a four-year period.

**Table of Contents****CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

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

|                                   | Number of<br>Shares<br>Underlying<br>Options | Weighted<br>Average<br>Exercise<br>Price<br><br>Per Share | Weighted<br>Average<br>Contract<br>Life in Years | Aggregate<br>Intrinsic<br>Value <sup>(a)</sup><br><br>(\$ in thousands) |
|-----------------------------------|----------------------------------------------|-----------------------------------------------------------|--------------------------------------------------|-------------------------------------------------------------------------|
| Outstanding at January 1, 2006    | 20,256,013                                   | \$ 6.14                                                   |                                                  |                                                                         |
| Exercised                         | (13,198,705)                                 | 5.32                                                      |                                                  |                                                                         |
| Forfeited                         | (72,713)                                     | 9.18                                                      |                                                  |                                                                         |
| Outstanding at September 30, 2006 | 6,984,595                                    | \$ 7.65                                                   | 5.54                                             | \$ 149,081                                                              |
| Exercisable at September 30, 2006 | 5,688,614                                    | \$ 7.31                                                   | 5.30                                             | \$ 123,403                                                              |

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

The aggregate intrinsic value of stock options exercised during the Current Period was approximately \$345.0 million.

As of September 30, 2006, there was \$2.5 million of total unrecognized compensation cost related to unvested stock options. The cost is expected to be recognized over a weighted average period of 0.52 years.

During the Current Quarter, the Prior Quarter, the Current Period and the Prior Period, we recognized excess tax benefits related to stock options of \$2.8 million, \$7.4 million, \$81.3 million and \$15.8 million, respectively, which were recorded as adjustments to additional paid-in capital and deferred income taxes with respect to such benefits.

### *Critical Accounting Policies*

We consider accounting policies related to hedging, oil and natural gas properties, income taxes and business combinations to be critical policies. These policies are summarized in Management's Discussion and Analysis of Financial Condition and Results of Operations in our annual report on Form 10-K for the year ended December 31, 2005.

## **2. Financial Instruments and Hedging Activities**

### *Oil and Natural Gas Hedging Activities*

Our results of operations and operating cash flows are impacted by changes in market prices for oil and natural gas. To mitigate a portion of the exposure to adverse market changes, we have entered into various derivative instruments. As of September 30, 2006, our oil and natural gas derivative instruments were comprised of swaps, cap-swaps, basis protection swaps, call options and collars. These instruments allow us to predict with greater certainty the effective oil and natural gas prices to be received for our hedged production. Although derivatives often fail to achieve 100% effectiveness for accounting purposes, we believe our derivative instruments continue to be highly effective in achieving the risk management objectives for which they were intended.



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For swap instruments, Chesapeake receives a fixed price for the hedged commodity and pays a floating market price to the counterparty. The fixed-price payment and the floating-price payment are netted, resulting in a net amount due to or from the counterparty.

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**CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES**

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

For cap-swaps, Chesapeake receives a fixed price and pays a floating market price. The fixed price received by Chesapeake includes a premium in exchange for a cap limiting the counterparty's exposure. In other words, there is no limit to Chesapeake's exposure but there is a limit to the downside exposure of the counterparty.

Basis protection swaps are arrangements that guarantee a price differential for oil or natural gas from a specified delivery point. For Mid-Continent basis protection swaps, which have negative differentials to NYMEX, Chesapeake receives a payment from the counterparty if the price differential is greater than the stated terms of the contract and pays the counterparty if the price differential is less than the stated terms of the contract. For Appalachian Basin basis protection swaps, which have positive differentials to NYMEX, Chesapeake receives a payment from the counterparty if the price differential is less than the stated terms of the contract and pays the counterparty if the price differential is greater than the stated terms of the contract.

For call options, Chesapeake receives a cash premium from the counterparty in exchange for the sale of a call option. If the market price exceeds the fixed price of the call option, Chesapeake pays the counterparty such excess. If the market price settles below the fixed price of the call option, no payment is due from Chesapeake.

Collars contain a fixed floor price (put) and ceiling price (call). If the market price exceeds the call strike price or falls below the put strike price, Chesapeake receives the fixed price and pays the market price. If the market price is between the call and the put strike price, no payments are due from either party.

Chesapeake enters into counter-swaps from time to time for the purpose of locking-in the value of a swap. Under the counter-swap, Chesapeake receives a floating price for the hedged commodity and pays a fixed price to the counterparty. The counter-swap is 100% effective in locking-in the value of a swap since subsequent changes in the market value of the swap are entirely offset by subsequent changes in the market value of the counter-swap. We refer to this locked-in value as a locked swap. Generally, at the time Chesapeake enters into a counter-swap, Chesapeake removes the original swap's designation as a cash flow hedge and classifies the original swap as a non-qualifying hedge under SFAS 133. The reason for this new designation is that collectively the swap and the counter-swap no longer hedge the exposure to variability in expected future cash flows. Instead, the swap and counter-swap effectively lock-in a specific gain (or loss) that will be unaffected by subsequent variability in oil and natural gas prices. Any locked-in gain or loss is recorded in accumulated other comprehensive income and reclassified to oil and natural gas sales in the month of related production.

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

In accordance with FASB Interpretation No. 39, to the extent that a legal right of set-off exists, Chesapeake nets the value of its derivative arrangements with the same counterparty in the accompanying condensed consolidated balance sheets.

Chesapeake enters into basis protection swaps for the purpose of locking-in a price differential for oil or natural gas from a specified delivery point. We currently have basis protection swaps covering six different

**Table of Contents****CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

delivery points, four in the Mid-Continent and two in the Appalachian Basin, which correspond to the actual prices we receive for much of our natural gas production. By entering into these basis protection swaps, we have effectively reduced our exposure to market changes in future natural gas price differentials. As of September 30, 2006, the fair value of our basis protection swaps was \$178.8 million. As of September 30, 2006, our Mid-Continent basis protection swaps cover approximately 29% of our anticipated remaining Mid-Continent natural gas production in 2006, 25% in 2007, 18% in 2008 and 13% in 2009. As of September 30, 2006, our Appalachian Basin basis protection swaps cover approximately 74% of our anticipated Appalachian Basin natural gas production in 2007, 65% in 2008 and 30% in 2009.

Gains or losses from certain derivative transactions are reflected as adjustments to oil and natural gas sales on the condensed consolidated statements of operations. Realized gains (losses) included in oil and natural gas sales were \$301.4 million, (\$122.6) million, \$807.1 million and (\$126.6) million in the Current Quarter, Prior Quarter, Current Period and Prior Period, respectively. Pursuant to SFAS 133, certain derivatives do not qualify for designation as cash flow hedges. Changes in the fair value of these non-qualifying derivatives that occur prior to their maturity (i.e., temporary fluctuations in value) are reported currently in the condensed consolidated statements of operations as unrealized gains (losses) within oil and natural gas sales. Unrealized gains (losses) included in oil and natural gas sales were \$238.5 million, (\$104.0) million, \$452.6 million and (\$137.1) million, in the Current Quarter, Prior Quarter, Current Period and Prior Period, respectively.

Following provisions of SFAS 133, changes in the fair value of derivative instruments designated as cash flow hedges, to the extent they are effective in offsetting cash flows attributable to the hedged risk, are recorded in other comprehensive income until the hedged item is recognized in earnings. Any change in fair value resulting from ineffectiveness is recognized currently in oil and natural gas sales as unrealized gains (losses). We recorded an unrealized gain (loss) on ineffectiveness of \$171.8 million, (\$99.5) million, \$336.7 million and (\$98.9) million in the Current Quarter, Prior Quarter, Current Period and Prior Period, respectively.

The estimated fair values of our oil and natural gas derivative instruments as of September 30, 2006 and December 31, 2005 are provided below. The associated carrying values of these instruments are equal to the estimated fair values.

|                                       | September 30,<br>2006 | December 31,<br>2005 |
|---------------------------------------|-----------------------|----------------------|
|                                       | (\$ in thousands)     |                      |
| Derivative assets (liabilities):      |                       |                      |
| Fixed-price natural gas swaps         | \$ 1,234,681          | \$ (1,047,094)       |
| Natural gas basis protection swaps    | 178,832               | 307,308              |
| Fixed-price natural gas cap-swaps     | 69,136                | (161,056)            |
| Fixed-price natural gas counter-swaps | 6,646                 | 37,785               |
| Natural gas call options (a)          | (21,816)              | (21,461)             |
| Fixed-price natural gas collars       | (7,016)               | (9,374)              |
| Fixed-price natural gas locked swaps  | (16,333)              | (34,229)             |
| Floating-price natural gas swaps      |                       | 2,607                |
| Fixed-price oil swaps                 | 13,547                | (16,936)             |
| Fixed-price oil cap-swaps             | 18,317                | (3,364)              |
| Estimated fair value                  | \$ 1,475,994          | \$ (945,814)         |

- (a) After adjusting for \$49.6 million and \$23.0 million of unrealized premiums, the cumulative unrealized gain related to these call options as of September 30, 2006 and December 31, 2005 was \$27.8 million and \$1.6 million, respectively.

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**CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES**

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

Based upon the market prices at September 30, 2006, we expect to transfer approximately \$530.2 million (net of income taxes) of the gain included in the balance in accumulated other comprehensive income to earnings during the next 12 months in the related month of production. All transactions hedged as of September 30, 2006 are expected to mature by December 31, 2009.

We have two secured hedging facilities, each of which permits us to enter into cash-settled natural gas and oil commodity transactions, valued by the counterparty, for up to \$500 million. The scheduled maturity date for each of these facilities is May 2010. Outstanding transactions under each facility are collateralized by certain of our oil and natural gas properties that do not secure any of our other obligations. Both of the hedging facilities are subject to a 1.0% per annum exposure fee, which is assessed quarterly on the average of the daily negative fair market value amounts, if any, during the quarter. As of September 30, 2006, the fair market value of the natural gas and oil hedging transactions was an asset of \$252.1 million under one of the facilities and an asset of \$823.2 million under the other facility. As of November 3, 2006, the fair market value of the same transactions was an asset of approximately \$152.2 million and \$255.5 million, respectively. The hedging facilities contain the standard representations and default provisions that are typical of such agreements. The agreements also contain various restrictive provisions which govern the aggregate natural gas and oil production volumes that we are permitted to hedge under all of our agreements at any one time.

We assumed certain liabilities related to open derivative positions in connection with our acquisition of Columbia Natural Resources, LLC in November 2005. In accordance with SFAS 141, these derivative positions were recorded at fair value in the purchase price allocation as a liability of \$592 million. The recognition of the derivative liability and other assumed liabilities resulted in an increase in the total purchase price which was allocated to the assets acquired. Because of this accounting treatment, only cash settlements for changes in fair value subsequent to the acquisition date for the derivative positions assumed result in adjustments to our oil and natural gas revenues upon settlement. For example, if the fair value of the derivative positions assumed does not change, then upon the sale of the underlying production and corresponding settlement of the derivative positions, cash would be paid to the counterparties and there would be no adjustment to oil and natural gas revenues related to the derivative positions. If, however, the actual sales price is different from the price assumed in the original fair value calculation, the difference would be reflected as either a decrease or increase in oil and natural gas revenues, depending upon whether the sales price was higher or lower, respectively, than the prices assumed in the original fair value calculation. For accounting purposes, the net effect of these acquired hedges is that we hedged the production volumes at market prices on the date of our acquisition of CNR.

Pursuant to Statement of Financial Accounting Standards No. 149, *Amendment of SFAS 133 on Derivative Instruments and Hedging Activities*, the derivative instruments assumed in connection with the CNR acquisition are deemed to contain a significant financing element, and all cash flows associated with these positions are reported as financing activity in the statement of cash flows for the periods in which settlement occurs.

**Table of Contents****CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The following details the assumed CNR derivatives remaining as of September 30, 2006:

|                             |            |          |                 |          |          | Fair                |
|-----------------------------|------------|----------|-----------------|----------|----------|---------------------|
|                             |            | Weighted |                 | Weighted | Weighted | Value at            |
|                             |            | Average  |                 | Average  | Average  | September 30,       |
|                             |            |          | Fixed           | Put      | Call     | 2006                |
|                             | Volume     |          | Price to be     | Fixed    | Fixed    |                     |
|                             |            |          | Received (Paid) | Price    | Price    | (SFAS 133 Hedge)    |
|                             |            |          |                 |          |          | (\$ in thousands)   |
| <b>Natural Gas (mmbtu):</b> |            |          |                 |          |          |                     |
| Swaps:                      |            |          |                 |          |          |                     |
| 4Q 2006                     | 10,626,000 | \$       | 4.86            | \$       | \$       | Yes (9,313)         |
| 1Q 2007                     | 10,350,000 |          | 4.82            |          |          | Yes (30,297)        |
| 2Q 2007                     | 10,465,000 |          | 4.82            |          |          | Yes (24,548)        |
| 3Q 2007                     | 10,580,000 |          | 4.82            |          |          | Yes (26,672)        |
| 4Q 2007                     | 10,580,000 |          | 4.82            |          |          | Yes (33,722)        |
| 1Q 2008                     | 9,555,000  |          | 4.68            |          |          | Yes (39,074)        |
| 2Q 2008                     | 9,555,000  |          | 4.68            |          |          | Yes (23,387)        |
| 3Q 2008                     | 9,660,000  |          | 4.68            |          |          | Yes (24,581)        |
| 4Q 2008                     | 9,660,000  |          | 4.66            |          |          | Yes (29,997)        |
| 1Q 2009                     | 4,500,000  |          | 5.18            |          |          | Yes (14,498)        |
| 2Q 2009                     | 4,550,000  |          | 5.18            |          |          | Yes (7,627)         |
| 3Q 2009                     | 4,600,000  |          | 5.18            |          |          | Yes (8,162)         |
| 4Q 2009                     | 4,600,000  |          | 5.18            |          |          | Yes (10,574)        |
| Collars:                    |            |          |                 |          |          |                     |
| 1Q 2009                     | 900,000    |          |                 | 4.50     | 6.00     | Yes (2,538)         |
| 2Q 2009                     | 910,000    |          |                 | 4.50     | 6.00     | Yes (1,268)         |
| 3Q 2009                     | 920,000    |          |                 | 4.50     | 6.00     | Yes (1,375)         |
| 4Q 2009                     | 920,000    |          |                 | 4.50     | 6.00     | Yes (1,835)         |
| <b>Total Natural Gas</b>    |            |          |                 |          |          | <b>\$ (289,468)</b> |

Subsequent to September 30, 2006, Chesapeake lifted a portion of its fourth quarter 2006 and full-year 2007, 2008 and 2009 hedges and as a result received \$407 million in cash from its hedging counterparties. The gain will be recorded in accumulated other comprehensive income and in unrealized oil and natural gas sales based on the designation of the hedges. The gain will be recognized in realized oil and natural gas sales in the month of the hedged production.

*Interest Rate Derivatives*

We use interest rate derivatives to mitigate our exposure to the volatility in interest rates. For interest rate derivative instruments designated as fair value hedges (in accordance with SFAS 133), changes in fair value are recorded on the condensed consolidated balance sheets as assets (liabilities), and the debt's carrying value amount is adjusted by the change in the fair value of the debt subsequent to the initiation of the derivative. Changes in the fair value of derivative instruments not qualifying as fair value hedges are recorded currently as adjustments to interest expense.

Gains or losses from certain derivative transactions are reflected as adjustments to interest expense on the condensed consolidated statements of operations. Realized gains (losses) included in interest expense were (\$1.6) million, \$0.8 million, \$0.9 million and \$2.6 million in the Current

Quarter, Prior Quarter, Current Period and

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**Table of Contents****CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Prior Period, respectively. Pursuant to SFAS 133, certain derivatives do not qualify for designation as fair value hedges. Changes in the fair value of these non-qualifying derivatives that occur prior to their maturity (i.e., temporary fluctuations in value) are reported currently in the condensed consolidated statements of operations as unrealized gains (losses) within interest expense. Unrealized gains (losses) included in interest expense were \$2.5 million, (\$1.2) million, \$0.8 million and \$1.9 million, in the Current Quarter, Prior Quarter, Current Period and Prior Period, respectively.

As of September 30, 2006, the following interest rate swaps used to convert a portion of our long-term fixed-rate debt to floating-rate debt were outstanding:

| Term           |              | Notional<br>Amount | Fixed<br>Rate | Floating Rate                         | Fair Value<br>(\$ in thousands) |
|----------------|--------------|--------------------|---------------|---------------------------------------|---------------------------------|
| September 2004 | August 2012  | \$ 75,000,000      | 9.000%        | 6 month LIBOR plus 452 basis points   | \$ (2,919)                      |
| July 2005      | January 2015 | \$ 150,000,000     | 7.750%        | 6 month LIBOR plus 289 basis points   | (6,301)                         |
| July 2005      | June 2014    | \$ 150,000,000     | 7.500%        | 6 month LIBOR plus 282 basis points   | (6,456)                         |
| September 2005 | August 2014  | \$ 250,000,000     | 7.000%        | 6 month LIBOR plus 205.5 basis points | (7,305)                         |
| October 2005   | June 2015    | \$ 200,000,000     | 6.375%        | 6 month LIBOR plus 112 basis points   | (3,308)                         |
| October 2005   | January 2018 | \$ 250,000,000     | 6.250%        | 6 month LIBOR plus 99 basis points    | (7,124)                         |
| January 2006   | January 2016 | \$ 250,000,000     | 6.625%        | 6 month LIBOR plus 129 basis points   | (3,178)                         |
| March 2006     | January 2016 | \$ 250,000,000     | 6.875%        | 6 month LIBOR plus 120 basis points   | (172)                           |
|                |              |                    |               |                                       | \$ (36,763)                     |

In the Current Period, we closed three interest rate swaps for gains totaling \$3.0 million. These interest rate swaps were designated as fair value hedges, and the settlement amounts received will be amortized as a reduction to realized interest expense over the remaining terms of the related senior notes.

To mitigate our short-term exposure to rising interest rates on a portion of our long-term debt that has been converted to floating-rate, we have entered into zero-cost collar transactions. These collars contain a fixed floor rate (put) and fixed ceiling rate (call). If LIBOR exceeds the ceiling rate or falls below the floor rate, Chesapeake pays the fixed rate and receives LIBOR. If LIBOR is between the ceiling and floor rates, no payments are due from either party. As of September 30, 2006, we were a party to the following zero-cost interest rate collars:

| Payment Dates             | Notional Amount | LIBOR Floor | LIBOR Ceiling |
|---------------------------|-----------------|-------------|---------------|
| July 2007 January 2010    | \$150,000,000   | 4.53%       | 5.37%         |
| June 2007 December 2009   | \$150,000,000   | 4.53%       | 5.37%         |
| August 2007 February 2010 | \$250,000,000   | 4.53%       | 5.37%         |
| July 2007 January 2010    | \$250,000,000   | 4.53%       | 5.37%         |

*Fair Value of Financial Instruments*

The following disclosure of the estimated fair value of financial instruments is made in accordance with the requirements of Statement of Financial Accounting Standards No. 107, *Disclosures About Fair Value of Financial Instruments*. We have determined the estimated fair values by 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.

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**CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES**

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

The carrying values of financial instruments comprising current assets and current liabilities approximate fair values due to the short-term maturities of these instruments. We estimate the fair value of our long-term fixed-rate debt and our convertible preferred stock using primarily quoted market prices. Our carrying amounts for such debt, excluding discounts or premiums related to interest rate derivatives, at September 30, 2006 and December 31, 2005 were \$6.421 billion and \$5.429 billion, respectively, compared to approximate fair values of \$6.317 billion and \$5.582 billion, respectively. The carrying amounts for our convertible preferred stock as of September 30, 2006 and December 31, 2005 were \$1.962 billion and \$1.577 billion, respectively, compared to approximate fair values of \$1.950 billion and \$1.686 billion, respectively.

*Concentration of Credit Risk*

A significant portion of our liquidity is concentrated in derivative instruments that enable us to hedge a portion of our exposure to price volatility from producing oil and natural gas. These arrangements expose us to credit risk from our counterparties. Accounts receivable potentially subject us to concentrations of credit risk as well. Our accounts receivable are primarily from purchasers of oil and natural gas products and exploration and production companies which own interests in properties we operate. This industry concentration has the potential to impact our overall exposure to credit risk, either positively or negatively, in that our customers may be similarly affected by changes in economic, industry or other conditions. We generally require letters of credit for receivables from customers which are judged to have sub-standard credit, unless the credit risk can otherwise be mitigated.

**3. Contingencies and Commitments**

*Litigation*

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

*Employment Agreements with Officers*

Chesapeake has employment agreements with its chief executive officer, chief operating officer, chief financial officer and other executive officers, which provide for annual base salaries, various benefits and eligibility for bonus compensation. The agreement with the chief executive officer has a term of five years commencing July 1, 2006. The term of the agreement is automatically extended for one additional year on each January 31 unless the company provides 30 days notice of non-extension. In the event of termination of employment without cause, the chief executive officer's base compensation and benefits would continue during the remaining term of the agreement. The agreements with the chief operating officer, chief financial officer and other executive officers expire on September 30, 2009 and provide for the continuation of salary for one year in the event of termination of employment without cause. The company's employment agreements with the executive officers provide for payments in the event of a change of control. The chief executive officer is entitled to receive a payment in the amount of three times his base compensation and three times the value of the prior year's benefits, plus a tax gross-up payment, upon the happening of certain events following a change of control, and the company will also provide him office space and secretarial and accounting support for a period of 12 months thereafter. The chief operating officer, chief financial officer and other executive officers are each entitled to receive a payment in the amount of two times his or her base compensation plus bonuses paid during the prior year in the event of a change of control. Any stock-based awards held by an executive officer will immediately become 100% vested upon termination of employment without cause or upon a change of control event.

**Table of Contents****CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)***Environmental Risk*

Due to the nature of the oil and natural gas business, Chesapeake and its subsidiaries are exposed to possible environmental risks. Chesapeake has implemented various policies and procedures to avoid environmental contamination and risks from environmental contamination. Chesapeake conducts periodic reviews, on a company-wide basis, to identify changes in our environmental risk profile. These reviews evaluate whether there is a contingent liability, its amount, and the likelihood that the liability will be incurred. The amount of any potential liability is determined by considering, among other matters, incremental direct costs of any likely remediation and the proportionate cost of employees who are expected to devote a significant amount of time directly to any possible remediation effort. We manage our exposure to environmental liabilities on properties to be acquired by identifying existing problems and assessing the potential liability. Depending on the extent of an identified environmental problem, Chesapeake may exclude a property from the acquisition, require the seller to remediate the property to our satisfaction, or agree to assume liability for the remediation of the property. Chesapeake has historically not experienced any significant environmental liability, and is not aware of any potential material environmental issues or claims at September 30, 2006.

*Rig Leases*

In September 2006, our wholly owned subsidiary, Nomac Drilling Corporation, sold 18 of its drilling rigs and related equipment for \$187.5 million and entered into a master lease agreement under which it agreed to lease the rigs from the buyer for an initial term of eight years from October 1, 2006 for rental payments of \$26.0 million annually. Nomac's lease obligations are guaranteed by Chesapeake and its other material domestic subsidiaries. This transaction was recorded as a sale and operating leaseback, with an aggregate deferred gain of \$14.8 million on the sale which will be amortized to service operations expense over the lease term. Under the rig lease, we have the option to purchase the rigs on September 30, 2013 or on the expiration of the lease term for a purchase price equal to the then fair market value of the rigs. Additionally, we have the option to renew the rig lease for a negotiated renewal term at a periodic rental equal to the fair market rental value of the rigs as determined at the time of renewal.

Commitments related to these lease payments are not recorded in the accompanying consolidated balance sheets. As of September 30, 2006, minimum future rig lease payments were as follows (in thousands):

|              |                   |
|--------------|-------------------|
| 2006         | \$ 6,130          |
| 2007         | 25,993            |
| 2008         | 25,993            |
| 2009         | 25,993            |
| 2010         | 25,993            |
| Thereafter   | 97,478            |
| <b>Total</b> | <b>\$ 207,580</b> |

*Other Commitments*

As of September 30, 2006, Chesapeake's wholly owned subsidiary, Nomac Drilling Corporation, had contracted to acquire 22 rigs to be constructed during 2006 and 2007. The total remaining cost of the rigs will be approximately \$200 million.

Currently, Chesapeake has contracts with various drilling contractors to use approximately 50 rigs in 2006 with terms of one to three years. As of September 30, 2006, the minimum aggregate drilling rig commitment was approximately \$450 million.

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**CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES**

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

Chesapeake and a leading investment bank have an agreement to lend Mountain Drilling Company, of which Chesapeake is a 49% equity owner, up to \$25 million each through December 31, 2009. At September 30, 2006, there was a \$19.5 million loan outstanding under this agreement.

As of September 30, 2006, Chesapeake had agreed to acquire 16,600 net acres of Barnett Shale leasehold from the Dallas/Fort Worth International Airport Board and the cities of Dallas and Fort Worth for \$181 million in cash and a 25% royalty (subject to an assignment of a 20% interest to various minority and women businesses that will participate with Chesapeake in the development of the lease). This transaction closed on October 5, 2006.

As of September 30, 2006, Chesapeake had agreed to acquire oil and natural gas properties and mid-stream natural gas systems from Dale Resources, L.L.C. et al. for approximately \$220 million of which \$10.9 million was paid in the Current Quarter. This transaction closed on October 12, 2006.

**4. Net Income Per Share**

Statement of Financial Accounting Standards No. 128, *Earnings Per Share*, requires presentation of basic and diluted earnings per share, as defined, on the face of the statements of operations for all entities with complex capital structures. SFAS 128 requires a reconciliation of the numerator and denominator of the basic and diluted EPS computations.

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

For the Current Quarter, Prior Quarter and the Prior Period, outstanding options to purchase 0.1 million shares of common stock at a weighted average exercise price of \$30.63, \$30.59 and \$29.85, respectively, were antidilutive because the exercise price of the options was greater than the average market price of the common stock during the period.

For the Prior Quarter and Prior Period, diluted shares do not include the common stock equivalent of our 4.125% preferred stock outstanding prior to conversion (convertible into 3,913,918 and 8,403,579 shares, respectively), and the preferred stock adjustment to net income does not include \$14.7 million and \$22.9 million, respectively, of dividends and loss on conversion related to these preferred shares, as the effect on diluted earnings per share would have been antidilutive.

For the Prior Quarter and Prior Period, diluted shares do not include the common stock equivalent of our 5.0% (Series 2003) preferred stock outstanding prior to conversion (convertible into 3,603,567 and 4,034,450 shares, respectively), and the preferred stock adjustment to net income does not include \$4.0 million and \$5.8 million, respectively, of dividends and loss on conversion related to these preferred shares, as the effect on diluted earnings per share would have been antidilutive.

For the Prior Quarter and the Prior Period, diluted shares do not include the common stock equivalent of our 4.5% preferred stock outstanding prior to conversion (convertible into 1,443,236 and 486,365 shares, respectively), and the preferred stock adjustment to net income does not include \$0.7 million and \$0.7 million, respectively, of dividends related to these preferred shares, as the effect on diluted earnings per share would have been antidilutive.

**Table of Contents****CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Reconciliations for the three months ended September 30, 2006 and 2005 and the nine months ended September 30, 2006 and 2005 are as follows:

|                                                                                                         |                                          |               | Per     |
|---------------------------------------------------------------------------------------------------------|------------------------------------------|---------------|---------|
|                                                                                                         | Income                                   | Shares        | Share   |
| For the Three Months Ended September 30, 2006:                                                          | (Numerator)                              | (Denominator) | Amount  |
|                                                                                                         | (\$ in thousands, except per share data) |               |         |
| Basic EPS:                                                                                              |                                          |               |         |
| Income available to common shareholders                                                                 | \$ 522,582                               | 417,569       | \$ 1.25 |
| Effect of Dilutive Securities                                                                           |                                          |               |         |
| Assumed conversion as of the beginning of the period of preferred shares outstanding during the period: |                                          |               |         |
| Common shares assumed issued for 4.125% convertible preferred stock                                     |                                          | 184           |         |
| Common shares assumed issued for 4.50% convertible preferred stock                                      |                                          | 7,811         |         |
| Common shares assumed issued for 5.00% convertible preferred stock (Series 2003)                        |                                          | 235           |         |
| Common shares assumed issued for 5.00% convertible preferred stock (Series 2005)                        |                                          | 17,856        |         |
| Common shares assumed issued for 5.00% convertible preferred stock (Series 2005B)                       |                                          | 14,717        |         |
| Common shares assumed issued for 6.25% convertible preferred stock                                      |                                          | 19,100        |         |
| Employee stock options                                                                                  |                                          | 4,248         |         |
| Restricted stock                                                                                        |                                          | 1,553         |         |
| Preferred stock dividends                                                                               | 25,753                                   |               |         |
| Diluted EPS Income available to common shareholders and assumed conversions                             | \$ 548,335                               | 483,273       | \$ 1.13 |
| For the Three Months Ended September 30, 2005:                                                          |                                          |               |         |
| Basic EPS:                                                                                              |                                          |               |         |
| Income available to common shareholders                                                                 | \$ 149,059                               | 322,101       | \$ 0.46 |
| Effect of Dilutive Securities                                                                           |                                          |               |         |
| Assumed conversion as of the beginning of the period of preferred shares outstanding during the period: |                                          |               |         |
| Common shares assumed issued for 4.125% convertible preferred stock                                     |                                          | 8,082         |         |
| Common shares assumed issued for 5.00% convertible preferred stock (Series 2003)                        |                                          | 6,262         |         |
| Common shares assumed issued for 5.00% convertible preferred stock (Series 2005)                        |                                          | 17,853        |         |
| Common shares assumed issued for 6.00% convertible preferred stock                                      |                                          | 492           |         |
| Employee stock options                                                                                  |                                          | 11,006        |         |
| Restricted stock                                                                                        |                                          | 1,843         |         |
| Preferred stock dividends                                                                               | 8,498                                    |               |         |
| Diluted EPS Income available to common shareholders and assumed conversions                             | \$ 157,557                               | 367,639       | \$ 0.43 |

**Table of Contents****CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

|                                                                                                           | Income                                   | Shares         | Per<br>Share   |
|-----------------------------------------------------------------------------------------------------------|------------------------------------------|----------------|----------------|
|                                                                                                           | (Numerator)                              | (Denominator)  | Amount         |
| For the Nine Months Ended September 30, 2006:                                                             | (\$ in thousands, except per share data) |                |                |
| <b>Basic EPS:</b>                                                                                         |                                          |                |                |
| Income available to common shareholders                                                                   | \$ 1,458,612                             | 389,136        | \$ 3.75        |
| <b>Effect of Dilutive Securities</b>                                                                      |                                          |                |                |
| Assumed conversion as of the beginning of the period of preferred shares outstanding during the period:   |                                          |                |                |
| Common shares assumed issued for 4.125% convertible preferred stock                                       |                                          | 184            |                |
| Common shares assumed issued for 4.50% convertible preferred stock                                        |                                          | 7,811          |                |
| Common shares assumed issued for 5.00% convertible preferred stock (Series 2003)                          |                                          | 235            |                |
| Common shares assumed issued for 5.00% convertible preferred stock (Series 2005)                          |                                          | 17,856         |                |
| Common shares assumed issued for 5.00% convertible preferred stock (Series 2005B)                         |                                          | 14,717         |                |
| Common shares assumed issued for 6.25% convertible preferred stock                                        |                                          | 6,498          |                |
| Assumed conversion as of the beginning of the period of preferred shares outstanding prior to conversion: |                                          |                |                |
| Common stock equivalent of preferred stock outstanding prior to conversion,                               |                                          |                |                |
| 6.00% convertible preferred stock                                                                         |                                          | 137            |                |
| 4.125% convertible preferred stock                                                                        |                                          | 2,795          |                |
| 5.00% convertible preferred stock (Series 2003)                                                           |                                          | 2,807          |                |
| Employee stock options                                                                                    |                                          | 6,714          |                |
| Restricted stock                                                                                          |                                          | 1,790          |                |
| Loss on redemption of preferred stock                                                                     | 10,556                                   |                |                |
| Preferred stock dividends                                                                                 | 62,793                                   |                |                |
| <b>Diluted EPS Income available to common shareholders and assumed conversions</b>                        | <b>\$ 1,531,961</b>                      | <b>450,680</b> | <b>\$ 3.40</b> |

**For the Nine Months Ended September 30, 2005:**

|                                                                                                           |            |         |         |
|-----------------------------------------------------------------------------------------------------------|------------|---------|---------|
| <b>Basic EPS:</b>                                                                                         |            |         |         |
| Income available to common shareholders                                                                   | \$ 447,783 | 314,425 | \$ 1.42 |
| <b>Effect of Dilutive Securities</b>                                                                      |            |         |         |
| Assumed conversion as of the beginning of the period of preferred shares outstanding during the period:   |            |         |         |
| Common shares assumed issued for 4.125% convertible preferred stock                                       |            | 8,082   |         |
| Common shares assumed issued for 5.00% convertible preferred stock (Series 2003)                          |            | 6,262   |         |
| Common shares assumed issued for 5.00% convertible preferred stock (Series 2005)                          |            | 10,739  |         |
| Common shares assumed issued for 6.00% convertible preferred stock                                        |            | 492     |         |
| Assumed conversion as of the beginning of the period of preferred shares outstanding prior to conversion: |            |         |         |
| Common stock equivalent of preferred stock outstanding prior to conversion,                               |            |         |         |
| 6.00% convertible preferred stock                                                                         |            | 5       |         |
| Employee stock options                                                                                    |            | 10,810  |         |
| Restricted stock                                                                                          |            | 1,382   |         |
| Warrants assumed in Gothic acquisition                                                                    |            | 13      |         |
| Preferred stock dividends                                                                                 | 18,546     |         |         |

|                                                                                    |            |         |         |
|------------------------------------------------------------------------------------|------------|---------|---------|
| <b>Diluted EPS Income available to common shareholders and assumed conversions</b> | \$ 466,329 | 352,210 | \$ 1.32 |
|------------------------------------------------------------------------------------|------------|---------|---------|

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**Table of Contents****CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****5. Stockholders' Equity**

The following is a summary of the changes in our common shares outstanding for the nine months ended September 30, 2006 and 2005:

|                                                                             | 2006<br>(in thousands) | 2005    |
|-----------------------------------------------------------------------------|------------------------|---------|
| Shares outstanding at January 1                                             | 375,511                | 316,941 |
| Stock option and warrant exercises                                          | 6,676                  | 3,820   |
| Restricted stock issuances                                                  | 13,530                 | 3,619   |
| Preferred stock conversions/exchanges                                       | 12,016                 | 15,804  |
| Common stock issuances                                                      | 28,750                 | 9,200   |
| Common stock issued for the purchase of Chaparral Energy, Inc. common stock | 1,376                  |         |
| Shares outstanding at September 30                                          | 437,859                | 349,384 |

The following is a summary of the changes in our preferred shares outstanding for the nine months ended September 30, 2006 and 2005:

|                                                   | 6.00%          | 5.00%          | 4.125%         | 5.00%          | 4.50%          | 5.00%          | 6.25%          |
|---------------------------------------------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|
|                                                   | (2003)         | (2003)         | (2005)         | (2005B)        | (2005B)        | (2005B)        | (2005B)        |
|                                                   | (in thousands) | (in thousands) | (in thousands) | (in thousands) | (in thousands) | (in thousands) | (in thousands) |
| Shares outstanding at January 1, 2006             | 99             | 1,026          | 89             | 4,600          | 3,450          | 5,750          | 2,300          |
| Preferred stock issuances                         |                |                |                |                |                |                | 2,300          |
| Conversion/exchange of preferred for common stock | (99)           | (987)          | (86)           |                |                |                |                |
| Shares outstanding at September 30, 2006          |                | 39             | 3              | 4,600          | 3,450          | 5,750          | 2,300          |
| Shares outstanding at January 1, 2005             | 103            | 1,725          | 313            |                |                |                |                |
| Preferred stock issuances                         |                |                |                | 4,600          | 3,450          |                |                |
| Conversion/exchange of preferred for common stock | (2)            | (698)          | (178)          |                |                |                |                |
| Shares outstanding at September 30, 2005          | 101            | 1,027          | 135            | 4,600          | 3,450          |                |                |

In connection with the exchanges and conversions noted above, we recorded a loss of \$17.7 million, \$10.6 million and \$22.5 million in the Prior Quarter, Current Period and Prior Period, respectively. In general, the loss is equal to the excess of the fair value of all common stock exchanged over the fair value of the securities issuable pursuant to the original conversion terms of the preferred stock.

During the Current Period, holders of our 5.0% (Series 2003) cumulative convertible preferred stock exchanged 183,273 shares for 1,140,223 shares of our common stock.

During the Current Period, holders of our 4.125% cumulative convertible preferred stock exchanged 2,750 shares for 172,594 shares of our common stock.

During the Current Period, the remaining 99,310 shares of our 6.0% preferred stock were converted into or exchanged for 482,694 shares of common stock.

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During the Current Period, we completed tender offers for our 4.125% and 5.0% (Series 2003) cumulative convertible preferred stock, issuing 5.2 million shares of our common stock in exchange for 83,245 shares of the

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4.125% preferred stock, which represented 96.4% or \$83.2 million of the aggregate liquidation value of the shares outstanding, and 5.0 million shares of our common stock in exchange for 804,048 shares of the 5.0% (Series 2003) preferred stock, which represented 95.4% or \$80.4 million of the aggregate liquidation value of the shares outstanding. No cash was received or paid in connection with these transactions.

In June 2006, we issued 2,000,000 shares of 6.25% mandatory convertible preferred stock, par value \$0.01 per share and liquidation preference \$250 per share, in a public offering for net proceeds of \$484.8 million. We issued an additional 300,000 shares of such preferred stock in July 2006, upon the exercise of the underwriters' option to purchase the additional shares, for net proceeds of \$72.8 million.

In June 2006, we issued 25,000,000 shares of Chesapeake common stock at \$29.05 per share in a public offering for net proceeds of \$698.9 million. We issued an additional 3,750,000 shares in July 2006 at the same price pursuant to the underwriters' exercise of their overallotment option to purchase the additional shares for net proceeds of \$104.8 million.

In the Current Quarter, we issued 9.9 million shares of restricted stock to our employees (except for our CEO and CFO, who did not participate in the stock awards) under a long-term stock incentive and retention program. These shares vest 50% in three years with the remaining 50% vesting in five years.

In September 2006, we acquired 32% of the outstanding common stock of Chaparral Energy, Inc. for \$240 million in cash and 1,375,989 newly issued shares of our common stock valued at \$40 million. Chaparral is a privately-held independent oil and natural gas company headquartered in Oklahoma City, Oklahoma, with estimated proved reserves of approximately 618 bcfe and daily production of approximately 83 mmcf.

**6. Senior Notes and Revolving Bank Credit Facility**

Our long-term debt consisted of the following as of September 30, 2006 and December 31, 2005:

|                                                        | September 30,<br>2006 | December 31,<br>2005 |
|--------------------------------------------------------|-----------------------|----------------------|
|                                                        | (\$ in thousands)     |                      |
| 7.5% Senior Notes due 2013                             | \$ 363,823            | \$ 363,823           |
| 7.625% Senior Notes due 2013                           | 500,000               |                      |
| 7.0% Senior Notes due 2014                             | 300,000               | 300,000              |
| 7.5% Senior Notes due 2014                             | 300,000               | 300,000              |
| 7.75% Senior Notes due 2015                            | 300,408               | 300,408              |
| 6.375% Senior Notes due 2015                           | 600,000               | 600,000              |
| 6.625% Senior Notes due 2016                           | 600,000               | 600,000              |
| 6.875% Senior Notes due 2016                           | 670,437               | 670,437              |
| 6.5% Senior Notes due 2017                             | 1,100,000             | 600,000              |
| 6.25% Senior Notes due 2018                            | 600,000               | 600,000              |
| 6.875% Senior Notes due 2020                           | 500,000               | 500,000              |
| 2.75% Contingent Convertible Senior Notes due 2035 (a) | 690,000               | 690,000              |
| Revolving bank credit facility                         | 1,464,000             | 72,000               |
| Discount on senior notes                               | (103,939)             | (95,577)             |
| Discount for interest rate derivatives (b)             | (23,621)              | (11,349)             |
| Total senior notes and long-term debt                  | \$ 7,861,108          | \$ 5,489,742         |

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- (a) The holders of the 2.75% Contingent Convertible Senior Notes due 2035 may require us to repurchase all or a portion of these notes on November 15, 2015, 2020, 2025 and 2030, or upon a fundamental change, at

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100% of the principal amount of these notes. The notes are convertible, at the holder's option, prior to maturity under certain circumstances, into cash and, if applicable, shares of our common stock using a net share settlement process. In general, upon conversion of a convertible senior note, the holder will receive cash equal to the principal amount of the note and common stock for the note's conversion value in excess of such principal amount. In addition, we will pay contingent interest on the convertible senior notes, beginning with the nine-month period ending May 14, 2016, under certain conditions. We may redeem the convertible senior notes on or after November 15, 2015 at a redemption price of 100% of the principal amount of such notes.

(b) See Note 2 for a description of these instruments.

No scheduled principal payments are required under our senior notes until 2013 when \$863.8 million is due.

There were no repurchases or exchanges of Chesapeake debt in the Current Quarter or the Current Period. The following table sets forth the losses we incurred in connection with repurchases of senior notes in the Prior Quarter and Prior Period, respectively (\$ in millions):

|                                                       | Notes    | Loss on Repurchases/Exchanges |          |         |
|-------------------------------------------------------|----------|-------------------------------|----------|---------|
|                                                       | Retired  | Premium                       | Other(a) | Total   |
| <b>For the Three Months Ended September 30, 2005:</b> |          |                               |          |         |
| 8.125% Senior Notes due 2011                          | \$ 7.6   | \$ 0.5                        | \$ 0.1   | \$ 0.6  |
| 9.0% Senior Notes due 2012                            | 1.1      | 0.1                           | 0.0      | 0.1     |
|                                                       | \$ 8.7   | \$ 0.6                        | \$ 0.1   | \$ 0.7  |
| <b>For the Nine Months Ended September 30, 2005:</b>  |          |                               |          |         |
| 8.375% Senior Notes due 2008                          | \$ 11.0  | \$ 0.8                        | \$ 0.1   | \$ 0.9  |
| 8.125% Senior Notes due 2011                          | 245.4    | 17.3                          | 4.4      | 21.7    |
| 9.0% Senior Notes due 2012                            | 300.0    | 41.4                          | 6.0      | 47.4    |
|                                                       | \$ 556.4 | \$ 59.5                       | \$ 10.5  | \$ 70.0 |

(a) Includes the write-off of unamortized discounts, deferred charges, transaction costs and derivative charges.

Our outstanding senior notes are unsecured senior obligations of Chesapeake that rank equally in right of payment with all of our existing and future senior indebtedness and rank senior in right of payment to all of our future subordinated indebtedness. We may redeem the senior notes, other than the 2.75% Contingent Convertible Senior Notes due 2035, at any time at specified make-whole or redemption prices. Senior notes issued before July 2005 are governed by indentures containing covenants that limit our ability and our restricted subsidiaries' ability to incur additional indebtedness; pay dividends on our capital stock or redeem, repurchase or retire our capital stock or subordinated indebtedness; make investments and other restricted payments; incur liens; enter into sale-leaseback transactions; create restrictions on the payment of dividends or other amounts to us from our restricted subsidiaries; engage in transactions with affiliates; sell assets; and consolidate, merge or transfer assets. Senior notes issued after June 2005 are governed by indentures containing covenants that limit our ability and our restricted subsidiaries' ability to incur certain secured indebtedness; enter into sale-leaseback transactions; and consolidate, merge or transfer assets.

Chesapeake is a holding company and owns no operating assets and has no significant operations independent of its subsidiaries. Our obligations under our outstanding senior notes have been fully and unconditionally guaranteed, jointly and severally, by all of our wholly owned subsidiaries, other than minor subsidiaries, on a senior unsecured basis.

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### **CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES**

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

We have a \$2.5 billion syndicated revolving bank credit facility which matures in February 2011. The credit facility was increased from \$1.25 billion to \$2.0 billion in February 2006 and to \$2.5 billion in September 2006. As of September 30, 2006, we had \$1.464 billion in outstanding borrowings under our facility and utilized \$6.2 million of the facility for various letters of credit. Borrowings under our facility are collateralized by certain producing oil and natural gas properties and bear interest at either (i) the greater of the reference rate of Union Bank of California, N.A. or the federal funds effective rate plus 0.50% or (ii) the London Interbank Offered Rate (LIBOR), at our option, plus a margin that varies from 0.875% to 1.50% according to our senior unsecured long-term debt ratings. The collateral value and borrowing base are determined periodically. The unused portion of the facility is subject to a commitment fee that also varies according to our senior unsecured long-term debt ratings, from 0.125% to 0.30% per annum. Currently, the commitment fee rate is 0.25% per annum. Interest is payable quarterly or, if LIBOR applies, it may be payable at more frequent intervals.

The credit facility agreement contains various covenants and restrictive provisions which govern our ability to incur additional indebtedness, make investments or loans and create liens. The credit facility agreement requires us to maintain an indebtedness to total capitalization ratio (as defined) not to exceed 0.65 to 1 and an indebtedness to EBITDA ratio (as defined) not to exceed 3.5 to 1. As defined by the credit facility agreement, our indebtedness to total capitalization ratio was 0.44 to 1 and our indebtedness to EBITDA ratio was 1.87 to 1 at September 30, 2006. If we should fail to perform our obligations under these and other covenants, the revolving credit commitment could be terminated and any outstanding borrowings under the facility could be declared immediately due and payable. Such acceleration, if involving a principal amount of \$10 million (\$50 million in the case of our senior notes issued after 2004), would constitute an event of default under our senior note indentures, which could in turn result in the acceleration of a significant portion of our senior note indebtedness. The credit facility agreement also has cross default provisions that apply to other indebtedness we may have with an outstanding principal amount in excess of \$75 million.

Two of our subsidiaries, Chesapeake Exploration Limited Partnership and Chesapeake Appalachia, L.L.C., are the borrowers under our revolving bank credit facility. The facility is fully and unconditionally guaranteed, on a joint and several basis, by Chesapeake and all of our other wholly owned subsidiaries except minor subsidiaries.

#### **7. Segment Information**

In accordance with Statement of Financial Accounting Standards No. 131, *Disclosures about Segments of an Enterprise and Related Information*, we have two reportable operating segments. Our exploration and production segment and oil and natural gas marketing segment are managed separately because of the nature of their products and services. The exploration and production segment is responsible for finding and producing natural gas and crude oil. The marketing segment is responsible for gathering, processing, compressing, transporting and selling natural gas and crude oil primarily from Chesapeake-operated wells. We also have drilling rig and trucking operations, which were considered a part of the exploration and production segment prior to 2006. These service operations are responsible for providing drilling rigs primarily used on Chesapeake-operated wells and trucking services utilized in the transportation of drilling rigs on both Chesapeake-operated wells and wells operated by third parties.

Management evaluates the performance of our segments based upon income before income taxes. Revenues from the marketing segment's sale of oil and natural gas related to Chesapeake's ownership interests are reflected as exploration and production revenues. Such amounts totaled \$631.0 million, \$617.4 million, \$1.919 billion and

**Table of Contents****CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

\$1.486 billion for the Current Quarter, Prior Quarter, Current Period and Prior Period, respectively. The following table presents selected financial information for Chesapeake's operating segments. Our drilling rig and trucking service operations are presented in Other Operations for all periods presented.

| <b>For the Three Months Ended September 30, 2006:</b> | <b>Exploration<br/>and Production</b> | <b>Marketing</b>    | <b>Other<br/>Operations<br/>(\$ in thousands)</b> | <b>Intercompany<br/>Eliminations</b> | <b>Consolidated<br/>Total</b> |
|-------------------------------------------------------|---------------------------------------|---------------------|---------------------------------------------------|--------------------------------------|-------------------------------|
| Revenues                                              | \$ 1,493,226                          | \$ 1,029,126        | \$ 98,401                                         | \$ (691,342)                         | \$ 1,929,411                  |
| Intersegment revenues                                 |                                       | (631,012)           | (60,330)                                          | 691,342                              |                               |
| <b>Total revenues</b>                                 | <b>\$ 1,493,226</b>                   | <b>\$ 398,114</b>   | <b>\$ 38,071</b>                                  | <b>\$</b>                            | <b>\$ 1,929,411</b>           |
| Income before income taxes                            | \$ 866,789                            | \$ 9,661            | \$ 33,900                                         | \$ (25,941)                          | \$ 884,409                    |
| <b>For the Three Months Ended September 30, 2005:</b> |                                       |                     |                                                   |                                      |                               |
| Revenues                                              | \$ 720,928                            | \$ 979,281          | \$ 16,405                                         | \$ (633,771)                         | \$ 1,082,843                  |
| Intersegment revenues                                 |                                       | (617,366)           | (16,405)                                          | 633,771                              |                               |
| <b>Total revenues</b>                                 | <b>\$ 720,928</b>                     | <b>\$ 361,915</b>   | <b>\$</b>                                         | <b>\$</b>                            | <b>\$ 1,082,843</b>           |
| Income before income taxes                            | \$ 271,835                            | \$ 6,887            | \$ 1,823                                          | \$ (1,823)                           | \$ 278,722                    |
| <b>For the Nine Months Ended September 30, 2006:</b>  |                                       |                     |                                                   |                                      |                               |
| Revenues                                              | \$ 4,190,430                          | \$ 3,089,348        | \$ 218,909                                        | \$ (2,040,693)                       | \$ 5,457,994                  |
| Intersegment revenues                                 |                                       | (1,919,257)         | (121,436)                                         | 2,040,693                            |                               |
| <b>Total revenues</b>                                 | <b>\$ 4,190,430</b>                   | <b>\$ 1,170,091</b> | <b>\$ 97,473</b>                                  | <b>\$</b>                            | <b>\$ 5,457,994</b>           |
| Income before income taxes                            | \$ 2,448,286                          | \$ 29,099           | \$ 67,653                                         | \$ (49,941)                          | \$ 2,495,097                  |
| <b>For the Nine Months Ended September 30, 2005:</b>  |                                       |                     |                                                   |                                      |                               |
| Revenues                                              | \$ 2,032,271                          | \$ 2,368,502        | \$ 39,587                                         | \$ (1,526,049)                       | \$ 2,914,311                  |
| Intersegment revenues                                 |                                       | (1,486,462)         | (39,587)                                          | 1,526,049                            |                               |
| <b>Total revenues</b>                                 | <b>\$ 2,032,271</b>                   | <b>\$ 882,040</b>   | <b>\$</b>                                         | <b>\$</b>                            | <b>\$ 2,914,311</b>           |
| Income before income taxes                            | \$ 764,200                            | \$ 16,554           | \$ 4,638                                          | \$ (4,638)                           | \$ 780,754                    |
| <b>As of September 30, 2006:</b>                      |                                       |                     |                                                   |                                      |                               |
| Total assets                                          | \$ 22,669,668                         | \$ 667,399          | \$ 532,414                                        | \$ (474,560)                         | \$ 23,394,921                 |
| <b>As of December 31, 2005:</b>                       |                                       |                     |                                                   |                                      |                               |
| Total assets                                          | \$ 15,722,795                         | \$ 688,747          | \$ 305,875                                        | \$ (598,955)                         | \$ 16,118,462                 |

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**Table of Contents****CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****8. Acquisitions***Oil and Natural Gas Properties*

The following table describes oil and natural gas property acquisitions of proved and unproved properties that we completed in the Current Period (\$ in millions):

| Quarter | Acquired From                                          | Location of Properties             | Amount   |
|---------|--------------------------------------------------------|------------------------------------|----------|
| First   | Midland-based oil and gas company                      | Ark-La-Tex and Barnett Shale       | \$ 272   |
|         | Tulsa-based oil and gas company                        | Texas Gulf Coast and Mid-Continent | 146      |
|         | Houston-based oil and gas company                      | Texas Gulf Coast                   | 125      |
|         | Tulsa-based oil and gas company                        | Ark-La-Tex                         | 70       |
|         | Houston-based oil and gas company                      | Various                            | 53       |
|         | Dallas-based oil and gas company                       | Mid-Continent                      | 30       |
|         | Other                                                  | Various                            | 297      |
| Second  | Dallas-based oil and gas company                       | Permian                            | 375      |
|         | Oklahoma City-based oil and gas company                | Permian                            | 175      |
|         | Other                                                  | Various                            | 196      |
| Third   | Four Sevens Oil Co., Ltd. and Sinclair Oil Corporation | Barnett Shale                      | 845(a)   |
|         | Dallas-based oil and gas company                       | Ark-La-Tex and Texas Gulf Coast    | 200      |
|         | Houston-based oil and gas company                      | Texas Gulf Coast                   | 111      |
|         | Other                                                  | Various                            | 285      |
|         | Total oil and natural gas acquisitions                 |                                    | \$ 3,180 |

(a) Includes \$55 million related to mid-stream natural gas systems which was allocated to other property and equipment. We also recorded approximately \$177.7 million of deferred income taxes to reflect the tax effect of the cost paid in excess of the tax basis acquired on certain corporate acquisitions.

*Drilling Rigs and Oilfield Trucks*

In January 2006, we acquired a privately-owned Oklahoma-based oilfield trucking service company for \$47.5 million. In addition to the cash purchase price, we recorded approximately \$17.0 million of deferred income taxes to reflect the tax effect of the cost paid in excess of the tax basis acquired in connection with this acquisition. Of the total \$64.5 million purchase price, \$27.1 million was allocated to tangible equipment, \$11.0 million to intangibles and \$26.4 million to goodwill. The amounts allocated to intangibles and goodwill are included in long-term assets in the accompanying condensed consolidated balance sheet. Goodwill is not amortized but is subject to an annual assessment of impairment. In February 2006, we acquired 13 drilling rigs and related assets through our wholly-owned subsidiary, Nomac Drilling Corporation, from Martex Drilling Company, L.L.P., a privately-owned drilling contractor with operations in East Texas and North Louisiana, for \$150 million. In July 2006, we acquired a drilling contractor and an affiliated trucking company in the Appalachian Basin for approximately \$70 million in cash.

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### **CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES**

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

##### *Other*

In August 2006, we invested \$254 million to acquire a 19.9% interest in a privately-held provider of well stimulation and high pressure pumping services, with operations currently focused in Texas (principally in the Fort Worth Barnett Shale) and the Rocky Mountains. In September 2006, we acquired 32% of the outstanding common stock of Chaparral Energy, Inc. for \$240 million in cash and 1,375,989 newly issued shares of our common stock valued at \$40 million. Chaparral is a privately-held independent oil and natural gas company headquartered in Oklahoma City, Oklahoma, with estimated proved reserves of approximately 618 bcfe and daily production of 83 mmcfe.

#### **9. Full-Cost Ceiling Test**

We review the carrying value of our oil and natural gas properties under the full-cost accounting rules of the Securities and Exchange Commission (SEC) on a quarterly and annual basis. This review is referred to as a ceiling test. Under the ceiling test, capitalized costs, less accumulated amortization and related deferred income taxes, may not exceed an amount equal to the sum of the present value of estimated future net revenues (including the impact of cash flow hedges) less estimated future expenditures to be incurred in developing and producing the proved reserves, less any related income tax effects. The two primary factors impacting this test are reserve levels and current prices, and their associated impact on the present value of estimated future net revenues. Revisions to the estimates of natural gas and oil reserves and/or an increase or decrease in prices can have a material impact on the present value of estimated future net revenues. Any excess of the net book value, less deferred income taxes, is generally written off as an expense. Under SEC regulations, the excess above the ceiling is not expensed (or is reduced) if, subsequent to the end of the period, but prior to the release of the financial statements, oil and natural gas prices increase sufficiently such that an excess above the ceiling would have been eliminated (or reduced) if the increased prices were used in the calculations.

In calculating future net revenues, current prices and costs used are those as of the end of the appropriate quarterly period. Such prices are utilized except where different prices are fixed and determinable from applicable contracts for the remaining term of those contracts, including the effects of derivatives qualifying as cash flow hedges. Such derivative contracts, which consist of swaps and collars, and the related production volumes are discussed in Note 2 and in Item 3. *Quantitative and Qualitative Disclosures About Market Risk*. Based on spot prices for oil and natural gas as of September 30, 2006, these cash flow hedges increased the full cost ceiling by \$4.4 billion, thereby reducing any potential ceiling test write-down by the same amount.

At December 31, 2005, Chesapeake's net book value of oil and natural gas properties less deferred income taxes was below the calculated ceiling by approximately \$6.5 billion. From December 31, 2005 to September 30, 2006, spot natural gas prices decreased by approximately 59% from \$10.08 to \$4.18 per mcf. As a result, as of September 30, 2006, our ceiling test calculation indicated an impairment of our oil and natural gas properties of approximately \$415 million, net of income tax. However, natural gas prices subsequent to September 30, 2006, have improved sufficiently to eliminate this calculated impairment. As a result, we were not required to record a write-down of our oil and natural gas properties under the full-cost method of accounting in the third quarter of 2006.

#### **10. Recently Issued Accounting Standards**

The Financial Accounting Standards Board (FASB) recently issued the following standards which were reviewed by Chesapeake to determine the potential impact on our financial statements upon adoption.



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**CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES**

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

In December 2004, the FASB issued SFAS 123(R), *Share-Based Payment*, a revision of SFAS 123, *Accounting for Stock-Based Compensation*. This statement establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services by requiring a public entity to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. We adopted this statement effective January 1, 2006. The effect of SFAS 123(R) is more fully described in Note 1.

In September 2005, the Emerging Issues Task Force (EITF) reached a consensus on Issue No. 04-13, *Accounting for Purchases and Sales of Inventory with the Same Counterparty*. EITF Issue No. 04-13 requires that purchases and sales of inventory with the same counterparty in the same line of business should be accounted for as a single non-monetary exchange, if entered into in contemplation of one another. The consensus is effective for inventory arrangements entered into, modified or renewed in interim or annual reporting periods beginning after March 15, 2006. We adopted this issue effective April 1, 2006. The adoption of EITF Issue No. 04-13 did not have a material impact on our financial statements.

In June 2006, the FASB issued FASB Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes* an interpretation of FASB Statement No. 109. FIN 48 provides guidance for recognizing and measuring uncertain tax positions, as defined in SFAS 109, *Accounting for Income Taxes*. FIN 48 prescribes a threshold condition that a tax position must meet for any of the benefit of the uncertain tax position to be recognized in the financial statements. Guidance is also provided regarding de-recognition, classification and disclosure of these uncertain tax positions. FIN 48 is effective for fiscal years beginning after December 15, 2006. We do not expect that FIN 48 will have a material impact on our financial position, results of operations or cash flows.

In February 2006, the FASB issued SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments* an amendment of FASB Statements No. 133 and 140. SFAS 155 permits an entity to measure at fair value any financial instrument that contains an embedded derivative that otherwise would require bifurcation. This statement is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. We are currently evaluating the provisions of SFAS 155 and believe that adoption will not have a material effect on our financial position, results of operations or cash flows.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. This statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007. We are currently assessing the impact, if any, SFAS 157 will have on our financial position, results of operations or cash flows.

In September 2006, the FASB issued SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*. This statement requires an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. This statement is effective as of the end of the fiscal year ending after December 15, 2006. We do not expect that SFAS 158 will have a material impact on our financial position, results of operations or cash flows.

**Table of Contents****ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations****Overview**

The following table sets forth certain information regarding the production volumes, oil and natural gas sales, average sales prices received, other operating income and expenses for the three and nine months ended September 30, 2006 (the Current Quarter and the Current Period) and the three and nine months ended September 30, 2005 (the Prior Quarter and the Prior Period):

|                                                                                  | Three Months Ended<br>September 30, |            | Nine Months Ended<br>September 30, |              |
|----------------------------------------------------------------------------------|-------------------------------------|------------|------------------------------------|--------------|
|                                                                                  | 2006                                | 2005       | 2006                               | 2005         |
| <b>Net Production:</b>                                                           |                                     |            |                                    |              |
| Oil (mbbls)                                                                      | 2,178                               | 1,926      | 6,437                              | 5,684        |
| Natural gas (mmcf)                                                               | 133,822                             | 108,801    | 387,696                            | 304,060      |
| Natural gas equivalent (mmcfe)                                                   | 146,890                             | 120,357    | 426,318                            | 338,164      |
| <b>Oil and Natural Gas Sales (\$ in thousands):</b>                              |                                     |            |                                    |              |
| Oil sales                                                                        | \$ 141,687                          | \$ 113,590 | \$ 404,595                         | \$ 290,332   |
| Oil derivatives realized gains (losses)                                          | (9,660)                             | (10,937)   | (25,695)                           | (28,654)     |
| Oil derivatives unrealized gains (losses)                                        | 28,724                              | (4,009)    | 24,825                             | (5,951)      |
| Total oil sales                                                                  | 160,751                             | 98,644     | 403,725                            | 255,727      |
| Natural gas sales                                                                | 811,591                             | 833,992    | 2,526,168                          | 2,005,670    |
| Natural gas derivatives realized gains (losses)                                  | 311,090                             | (111,668)  | 832,769                            | (97,955)     |
| Natural gas derivatives unrealized gains (losses)                                | 209,794                             | (100,040)  | 427,768                            | (131,171)    |
| Total natural gas sales                                                          | 1,332,475                           | 622,284    | 3,786,705                          | 1,776,544    |
| Total oil and natural gas sales                                                  | \$ 1,493,226                        | \$ 720,928 | \$ 4,190,430                       | \$ 2,032,271 |
| <b>Average Sales Price (excluding all gains (losses) on derivatives):</b>        |                                     |            |                                    |              |
| Oil (\$ per bbl)                                                                 | \$ 65.05                            | \$ 58.98   | \$ 62.85                           | \$ 51.08     |
| Natural gas (\$ per mcf)                                                         | \$ 6.06                             | \$ 7.67    | \$ 6.52                            | \$ 6.60      |
| Natural gas equivalent (\$ per mcfe)                                             | \$ 6.49                             | \$ 7.87    | \$ 6.87                            | \$ 6.79      |
| <b>Average Sales Price (excluding unrealized gains (losses) on derivatives):</b> |                                     |            |                                    |              |
| Oil (\$ per bbl)                                                                 | \$ 60.62                            | \$ 53.30   | \$ 58.86                           | \$ 46.04     |
| Natural gas (\$ per mcf)                                                         | \$ 8.39                             | \$ 6.64    | \$ 8.66                            | \$ 6.27      |
| Natural gas equivalent (\$ per mcfe)                                             | \$ 8.54                             | \$ 6.85    | \$ 8.77                            | \$ 6.42      |
| <b>Other Operating Income (a) (\$ in thousands):</b>                             |                                     |            |                                    |              |
| Oil and natural gas marketing                                                    | \$ 13,641                           | \$ 8,405   | \$ 38,570                          | \$ 21,251    |
| Service operations                                                               | \$ 19,250                           | \$         | \$ 48,548                          | \$           |
| <b>Other Operating Income (\$ per mcfe):</b>                                     |                                     |            |                                    |              |
| Oil and natural gas marketing                                                    | \$ 0.09                             | \$ 0.07    | \$ 0.09                            | \$ 0.06      |
| Service operations                                                               | \$ 0.13                             | \$         | \$ 0.11                            | \$           |
| <b>Expenses (\$ per mcfe):</b>                                                   |                                     |            |                                    |              |
| Production expenses                                                              | \$ 0.84                             | \$ 0.67    | \$ 0.85                            | \$ 0.66      |
| Production taxes                                                                 | \$ 0.28                             | \$ 0.44    | \$ 0.30                            | \$ 0.40      |
| General and administrative expenses                                              | \$ 0.25                             | \$ 0.13    | \$ 0.23                            | \$ 0.12      |
| Oil and natural gas depreciation, depletion and amortization                     | \$ 2.34                             | \$ 1.92    | \$ 2.29                            | \$ 1.84      |
| Depreciation and amortization of other assets                                    | \$ 0.18                             | \$ 0.11    | \$ 0.17                            | \$ 0.10      |
| Interest expense (b)                                                             | \$ 0.52                             | \$ 0.48    | \$ 0.52                            | \$ 0.47      |
| <b>Interest Expense (\$ in thousands):</b>                                       |                                     |            |                                    |              |
| Interest expense                                                                 | \$ 75,100                           | \$ 58,206  | \$ 221,832                         | \$ 160,209   |
| Interest rate derivatives realized (gains) losses                                | 1,555                               | (843)      | (852)                              | (2,639)      |
| Interest rate derivatives unrealized (gains) losses                              | (2,543)                             | 1,230      | (754)                              | (1,947)      |

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|                        |           |           |            |            |
|------------------------|-----------|-----------|------------|------------|
| Total interest expense | \$ 74,112 | \$ 58,593 | \$ 220,226 | \$ 155,623 |
|------------------------|-----------|-----------|------------|------------|

|                                                        |        |       |        |       |
|--------------------------------------------------------|--------|-------|--------|-------|
| <b>Net Wells Drilled</b>                               | 401    | 218   | 985    | 583   |
| <b>Net Producing Wells as of the End of the Period</b> | 18,511 | 9,313 | 18,511 | 9,313 |

- (a) Includes revenue and operating costs.
- (b) Includes the effects of realized gains (losses) from interest rate derivatives, but does not include the effects of unrealized gains (losses) and is net of amounts capitalized.

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Chesapeake is the third largest independent producer of natural gas in the United States. We own interests in approximately 33,700 producing oil and natural gas wells that are currently producing approximately 1.66 bcfe per day, which includes approximately 0.1 bcfe per day of previously curtailed production that is now back on line. Our strategy is focused on discovering, developing and acquiring onshore natural gas reserves in the U.S. east of the Rocky Mountains. Our most important operating area has historically been in various conventional plays in the Mid-Continent region, which includes Oklahoma, Arkansas, Kansas and the Texas Panhandle. At September 30, 2006, 47% of our estimated proved oil and natural gas reserves were located in the Mid-Continent. During the past four years, we have also built significant positions in various conventional and unconventional plays in the South Texas and Texas Gulf Coast regions, the Permian Basin of West Texas and eastern New Mexico, the Barnett Shale area of North Texas, the Ark-La-Tex area of East Texas and northern Louisiana, the Appalachian Basin in West Virginia, eastern Kentucky, eastern Ohio and southern New York, the Caney and Woodford Shales in southeastern Oklahoma, the Fayetteville Shale in Arkansas, the Barnett and Woodford Shales in West Texas and the Conasauga, Floyd and Chattanooga Shales of Alabama.

Oil and natural gas production for the Current Quarter was 146.9 bcfe, an increase of 26.5 bcfe, or 22% over the 120.4 bcfe produced in the Prior Quarter. We have increased our production for 21 consecutive quarters. During these 21 quarters, Chesapeake's U.S. production has increased 308% for an average compound quarterly growth rate of 6.9% and an average compound annual growth rate of 30.5%.

In addition to increased oil and natural gas production, the prices we received were higher in the Current Quarter than in the Prior Quarter. On a natural gas equivalent basis, weighted average prices (excluding the effect of unrealized gains or losses on derivatives) were \$8.54 per mcfe in the Current Quarter compared to \$6.85 per mcfe in the Prior Quarter. The increase in prices resulted in an increase in revenue of \$247.9 million, and increased production resulted in an increase in revenue of \$181.8 million, for a total increase in revenue of \$429.7 million (excluding the effect of unrealized gains or losses on derivatives). In each of the operating areas where Chesapeake sells its oil and natural gas, established marketing and transportation infrastructures exist, thereby contributing to relatively high wellhead price realizations for our production.

During the Current Quarter, Chesapeake continued to lead the nation in drilling activity with an average utilization of 103 operated rigs and 71 non-operated rigs. Through this drilling activity, we drilled 411 (348 net) operated wells and participated in another 353 (53 net) wells operated by other companies. The company's drilling success rate was 99% for company-operated wells and 96% for non-operated wells. During the Current Quarter, Chesapeake invested \$674 million in operated wells, \$119 million in non-operated wells and \$162 million in acquiring 3-D seismic data and leasehold (excluding leasehold acquired through acquisitions). Our acquisition expenditures totaled \$1.391 billion during the Current Quarter, including amounts paid for unproved leasehold and excluding \$96.3 million of deferred income taxes in connection with certain corporate acquisitions. We expect to continue replacing reserves through the drillbit and acquisitions, although the timing and magnitude of future additions are uncertain.

Chesapeake began 2006 with estimated proved reserves of 7.521 tcf and based on internal estimates ended the Current Quarter with 8.433 tcf, an increase of 912 bcfe, or 12%. During the Current Period, we replaced 426 bcfe of production with an estimated 1.339 tcf of new proved reserves, for a reserve replacement rate of 314%. Reserve replacement through the drillbit was 825 bcfe, or 194% of production (including 541 bcfe of positive performance revisions and 387 bcfe of downward revisions resulting from natural gas price declines between December 31, 2005 and September 30, 2006) and 62% of the total increase. Reserve replacement through the acquisition of proved reserves was 514 bcfe, or 120% of production and 38% of the total increase. Based on our current drilling schedule and budget, we expect that virtually all of the proved undeveloped reserves added in 2006 will begin producing within the next three to five years. Generally, proved developed reserves are producing at the time they are added or will begin producing within one year.

Chesapeake attributes its strong drilling results and organic growth rates during the first nine months of 2006 (and in this decade) to management's early recognition that oil and natural gas prices were undergoing

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structural change and its subsequent decision to invest aggressively in the building blocks of value creation in the E&P industry people, land and seismic. During the past five years, Chesapeake has significantly strengthened its technical capabilities by increasing its land, geoscience and engineering staff to approximately 800 employees. Today, the company has more than 4,600 employees, of which approximately 65% work in the company's E&P operations and 35% work in the company's oilfield service operations.

Since 2000, Chesapeake has invested \$5.7 billion in new leasehold and 3-D seismic acquisitions and now owns what it believes to be one of the largest inventories of onshore leasehold (10.5 million net acres) and 3-D seismic (14.7 million acres) in the U.S. On this leasehold, the company has an estimated 25,000 net drilling locations representing an approximate 10-year inventory of drilling projects.

To further hedge its exposure to oilfield service costs and achieve greater operational efficiency, Chesapeake has recently invested \$254 million to acquire a 19.9% interest in a privately-held provider of well stimulation and high pressure pumping services with operations currently focused in Texas (principally in the Fort Worth Barnett Shale) and the Rocky Mountains. It also has expansion efforts underway in many other key regions in which Chesapeake operates.

This investment complements Chesapeake's direct and indirect drilling rig investments that have served as an effective hedge to higher service costs and have also provided competitive advantages in making acquisitions and in developing the company's own leasehold on a more timely and efficient basis. To date, Chesapeake has invested approximately \$254 million to build or acquire 42 drilling rigs and is building 22 additional rigs. Additionally, the company entered into a sale/leaseback transaction to monetize its investment in 18 of its rigs in exchange for cash proceeds of \$187.5 million. These rigs are under lease to Chesapeake through 2014 at which time the company has the option to reacquire them. In total, the company's drilling rig fleet should reach 82 rigs by mid-year 2007, which would rank Chesapeake as the sixth largest drilling rig contractor in the U.S. Additionally, the company has a \$69 million investment in two private drilling rig contractors, DHS Drilling Company and Mountain Drilling Company, in which Chesapeake's equity ownership is approximately 45% and 49%, respectively. DHS owns 16 rigs and Mountain is operating two rigs and has another eight rigs under construction or on order for delivery in 2006 and 2007.

As of September 30, 2006, the company's debt as a percentage of total capitalization (total capitalization is the sum of debt and stockholders equity) was 44% compared to 47% as of December 31, 2005. During the Current Period, we received net proceeds of \$2.3 billion through issuances of \$575 million of preferred equity, \$835 million of common equity and \$1.0 billion principal amount of senior notes. We used the net proceeds from these offerings primarily to fund the purchase price for acquisitions and to repay outstanding indebtedness under our revolving bank credit facility. As a result of our debt transactions in 2005 and the Current Period, we have extended the average maturity of our long-term debt to over nine years and have lowered our average interest rate to approximately 6.4%.

We intend to continue to focus on improving the strength of our balance sheet. We believe our business strategy and operational performance will lead to an investment grade credit rating for our unsecured debt at some point in the future.

## **Liquidity and Capital Resources**

### *Sources and Uses of Funds*

Our primary source of liquidity to meet operating expenses and fund capital expenditures (other than for certain acquisitions) is cash flow from operations. Based on our current production, price and expense assumptions, we expect cash flow from operations will exceed our drilling capital expenditures for the remainder of 2006 and 2007. Our budget for drilling, land and seismic activities for the remainder of 2006 is currently between \$1.1 billion and \$1.3 billion. We believe this level of exploration and development will be sufficient to increase our proved oil and natural gas reserves in 2006 and achieve our goal of an organic growth rate of more

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than 10% over 2005 production and at least a 23% increase in total production (inclusive of acquisitions completed or scheduled to close in 2006 through the filing date of this report but without regard to any additional acquisitions that may be completed in 2006). However, higher drilling and field operating costs, drilling results that alter planned development schedules, acquisitions, prolonged shut-ins or other factors could cause us to revise our drilling program, which is largely discretionary. Any cash flow from operations not needed to fund our drilling program will be available for acquisitions, debt repayment or other general corporate purposes.

Cash provided by operating activities was \$2.982 billion in the Current Period compared to \$1.577 billion in the Prior Period. The \$1.405 billion increase was primarily due to higher realized prices and higher oil and natural gas production. While a further decline in natural gas prices for the remainder of 2006 and 2007 would affect the amount of cash flow that would be generated from operations, we have 88% and 73% of our expected oil production for the fourth quarter of 2006 and 2007, respectively, hedged at an average NYMEX price of \$65.64 and \$71.42 per barrel of oil, respectively, and 57% of our expected natural gas production for both the fourth quarter of 2006 and 2007, respectively, hedged at an average NYMEX price of \$9.10 and \$9.61 per mmbtu, respectively. These levels of hedging provide greater certainty of the cash flow we will receive for a substantial portion of our remaining 2006 and 2007 production. Depending on changes in oil and natural gas futures markets and management's view of underlying oil and natural gas supply and demand trends, however, we may increase or decrease our current hedging positions.

Based on fluctuations in natural gas and oil prices, our hedging counterparties may require us to deliver cash collateral or other assurances of performance from time to time. All but two of our commodity price risk management counterparties require us to provide assurances of performance in the event that the counterparties' mark-to-market exposure to us exceeds certain levels. Most of these arrangements allow us to minimize the potential liquidity impact of significant mark-to-market fluctuations by making collateral allocations from our bank credit facility or directly pledging oil and natural gas properties, rather than posting cash or letters of credit with the counterparties. As of September 30, 2006, we had outstanding collateral allocations and pledges of oil and gas properties, with respect to commodity price risk management transactions but were not required to post any collateral with our counterparties through letters of credit issued under our bank credit facility. As of November 3, 2006, we had outstanding transactions with thirteen counterparties, seven of which hold collateral allocations from our bank facility or liens against certain oil and natural gas properties under our secured hedging facilities, and two of which do not require us to provide security for our risk management transactions. As of November 3, 2006, we were not required to post cash or letters of credit with the remaining four counterparties. Future collateral requirements are uncertain and will depend on the arrangements with our counterparties and highly volatile natural gas and oil prices.

A significant source of liquidity is our \$2.5 billion syndicated revolving bank credit facility which matures in February 2011. At November 3, 2006, there was \$749.8 million of borrowing capacity available under the revolving bank credit facility. We use the facility to fund daily operating activities and acquisitions as needed. We borrowed \$7.058 billion and repaid \$5.666 billion in the Current Period, and we borrowed \$3.561 billion and repaid \$3.620 billion in the Prior Period under the credit facility. We incurred \$5.1 million and \$4.7 million of financing costs related to amendments to the credit facility agreement in the Current Period and the Prior Period, respectively.

We believe that our available cash, cash provided by operating activities and funds available under our revolving bank credit facility will be sufficient to fund our operating, debt service and general and administrative expenses, our capital expenditure budget, our short-term contractual obligations and dividend payments at current levels for the foreseeable future.

The public and institutional markets have been our principal source of long-term financing for acquisitions. We have sold debt and equity in both public and private offerings in the past, and we expect that these sources of capital will continue to be available to us in the future to finance acquisitions. Nevertheless, we caution that ready access to capital on reasonable terms and the availability of desirable acquisition targets at attractive prices are subject to many uncertainties, as explained under "Risk Factors" in Item 1A of our Form 10-K for the year ended December 31, 2005.

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The following table reflects the proceeds from sales of securities we issued in the Current Period and the Prior Period (\$ in millions):

|                                                   | For the Nine Months Ended September 30,<br>2006 |              | 2005           |              |
|---------------------------------------------------|-------------------------------------------------|--------------|----------------|--------------|
|                                                   | Total Proceeds                                  | Net Proceeds | Total Proceeds | Net Proceeds |
| Convertible preferred stock                       | \$ 575.0                                        | \$ 557.6     | \$ 805.0       | \$ 782.4     |
| Common stock                                      | 835.2                                           | 803.7        | 301.0          | 289.4        |
| Unsecured senior notes guaranteed by subsidiaries | 1,000.0                                         | 969.2        | 1,800.0        | 1,765.4      |
| Total                                             | \$ 2,410.2                                      | \$ 2,330.5   | \$ 2,906.0     | \$ 2,837.2   |

We qualify as a well-known seasoned issuer (WKSI), as defined in Rule 405 of the Securities Act of 1933, and therefore we may utilize automatic shelf registration to register future debt and equity issuances with the Securities and Exchange Commission. A prospectus supplement will be prepared at the time of an offering and will contain a description of the security issued, the plan of distribution and other information.

We paid dividends on our common stock of \$61.8 million and \$45.8 million in the Current Period and the Prior Period, respectively. The board of directors increased the quarterly dividend on common stock from \$0.05 to \$0.06 per share beginning with the dividend paid in July 2006. We paid dividends on our preferred stock of \$62.5 million and \$17.3 million in the Current Period and the Prior Period, respectively. We received \$71.3 million and \$19.9 million from the exercise of employee and director stock options and warrants in the Current Period and the Prior Period, respectively. The Current Period amount included \$38.3 million paid by Tom L. Ward, our former President and Chief Operating Officer, to exercise all of his stock options following his resignation in February 2006.

In the Current Period, we paid \$68.4 million to settle a portion of the derivative liabilities assumed in our November 2005 acquisition of Columbia Natural Resources, LLC.

On January 1, 2006, we adopted SFAS 123(R), which requires tax benefits resulting from stock-based compensation deductions in excess of amounts reported for financial reporting purposes to be reported as cash flows from financing activities. In the Current Period, we reported a tax benefit from stock-based compensation of \$85.6 million.

Outstanding payments from certain disbursement accounts in excess of funded cash balances where no legal right of set-off exists increased by \$43.3 million and \$33.8 million in the Current Period and the Prior Period, respectively. All disbursements are funded on the day they are presented to our bank using available cash on hand or draws on our revolving bank credit facility.

Historically, we have used significant funds to redeem or purchase and retire outstanding senior notes issued by Chesapeake. The following table shows our purchases and exchanges of senior notes in the Prior Period (\$ in millions):

| For the Nine Months Ended September 30, 2005: | Retired  | Senior Notes Activity |          | Cash Paid |
|-----------------------------------------------|----------|-----------------------|----------|-----------|
|                                               |          | Premium               | Other(a) |           |
| 8.375% Senior Notes due 2008                  | \$ 11.0  | \$ 0.8                | \$       | \$ 11.8   |
| 8.125% Senior Notes due 2011                  | 245.4    | 17.3                  | 0.7      | 263.4     |
| 9.0% Senior Notes due 2012                    | 300.0    | 41.4                  | 0.8      | 342.2     |
|                                               | \$ 556.4 | \$ 59.5               | \$ 1.5   | \$ 617.4  |

- (a) Includes adjustments to accrued interest and discount associated with notes retired and new notes issued, cash in lieu of fractional notes, transaction costs and fair value hedging adjustments.

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Cash used in investing activities increased to \$6.668 billion during the Current Period, compared to \$3.655 billion during the Prior Period. The following table shows our cash used in (provided by) investing activities during these periods (\$ in millions):

|                                                                                           | Nine Months Ended<br>September 30, |            |
|-------------------------------------------------------------------------------------------|------------------------------------|------------|
|                                                                                           | 2006                               | 2005       |
| <b>Oil and Natural Gas Investing Activities:</b>                                          |                                    |            |
| Acquisitions of oil and natural gas companies and proved properties, net of cash acquired | \$ 960.8                           | \$ 1,175.3 |
| Acquisition of unproved properties                                                        | 2,128.9                            | 757.6      |
| Exploration and development of oil and natural gas properties                             | 2,041.8                            | 1,294.6    |
| Leasehold acquisitions                                                                    | 456.2                              | 164.6      |
| Geological and geophysical costs                                                          | 101.8                              | 44.3       |
| Other oil and natural gas activities                                                      | (16.0)                             | (15.4)     |
| Total oil and natural gas investing activities                                            | 5,673.5                            | 3,421.0    |
| <b>Other Investing Activities:</b>                                                        |                                    |            |
| Additions to buildings and other fixed assets                                             | 406.8                              | 157.0      |
| Additions to drilling rig equipment (including Martex Drilling Company, L.L.P)            | 340.8                              | 42.1       |
| Additions to investments                                                                  | 537.7                              | 37.3       |
| Proceeds from sale of investment in Pioneer Drilling Company                              | (158.9)                            |            |
| Proceeds from sale of drilling rigs and equipment                                         | (187.5)                            |            |
| Acquisition of trucking company, net of cash acquired                                     | 45.2                               |            |
| Deposits for acquisitions                                                                 | 12.1                               |            |
| Other                                                                                     | (1.7)                              | (2.4)      |
| Total other investing activities                                                          | 994.5                              | 234.0      |
| Total cash used in (provided by) investing activities                                     | \$ 6,668.0                         | \$ 3,655.0 |

Our accounts receivable are primarily from purchasers of oil and natural gas (\$499.0 million at September 30, 2006) and exploration and production companies which own interests in properties we operate (\$115.0 million at September 30, 2006). This industry concentration has the potential to impact our overall exposure to credit risk, either positively or negatively, in that our customers may be similarly affected by changes in economic, industry or other conditions. We generally require letters of credit for receivables from customers which are judged to have sub-standard credit, unless the credit risk can otherwise be mitigated.



**Table of Contents***Acquisitions and Financing Transactions*

The following table describes investing transactions related to the acquisition of proved and unproved properties that we completed in the Current Period (\$ in millions):

| Quarter | Acquired From                                                | Location of Properties             | Amount   |
|---------|--------------------------------------------------------------|------------------------------------|----------|
| First   | Midland-based oil and gas company                            | Ark-La-Tex and Barnett Shale       | \$ 272   |
|         | Tulsa-based oil and gas company                              | Texas Gulf Coast and Mid-Continent | 146      |
|         | Houston-based oil and gas company                            | Texas Gulf Coast                   | 125      |
|         | Tulsa-based oil and gas company                              | Ark-La-Tex                         | 70       |
|         | Houston-based oil and gas company                            | Various                            | 53       |
|         | Dallas-based oil and gas company                             | Mid-Continent                      | 30       |
|         | Other                                                        | Various                            | 297      |
| Second  | Dallas-based oil and gas company                             | Permian                            | 375      |
|         | Oklahoma City-based oil and gas company                      | Permian                            | 175      |
|         | Other                                                        | Various                            | 196      |
| Third   | Four Sevens Oil Co., Ltd. and Sinclair Oil Corporation       | Barnett Shale                      | 845(a)   |
|         | Dallas-based oil and gas company                             | Ark-La-Tex and Texas Gulf Coast    | 200      |
|         | Houston-based oil and gas company                            | Texas Gulf Coast                   | 111      |
|         | Other                                                        | Various                            | 285      |
|         | Total oil and natural gas acquisitions                       |                                    | 3,180    |
|         | Less cash deposits paid in 2005                              |                                    | (35)     |
|         | Total oil and natural gas acquisitions in the Current Period |                                    | \$ 3,145 |

(a) Includes \$55 million related to mid-stream natural gas systems which was allocated to other property and equipment. We also recorded approximately \$177.7 million of deferred income taxes to reflect the tax effect of the cost paid in excess of the tax basis acquired on certain corporate acquisitions.

In January 2006, we acquired a privately-owned Oklahoma-based oilfield trucking service company for \$47.5 million. We recorded approximately \$17.0 million of deferred income taxes to reflect the tax effect of the cost paid in excess of the tax basis acquired in connection with this acquisition. In February 2006, we acquired 13 drilling rigs and related assets through our wholly-owned subsidiary, Nomac Drilling Corporation, from Martex Drilling Company, L.L.P., a privately-owned drilling contractor with operations in East Texas and North Louisiana, for \$150 million. In July 2006, we acquired a drilling contractor and an affiliated trucking company in the Appalachian Basin for approximately \$70 million in cash.

In August 2006, we invested \$254 million to acquire a 19.9% interest in a privately-held provider of well stimulation and high pressure pumping services, with operations currently focused in Texas (principally in the Fort Worth Barnett Shale) and the Rocky Mountains. In September 2006, we acquired 32% of the outstanding common stock of Chaparral Energy, Inc. for \$240 million in cash and 1,375,989 newly issued shares of our common stock valued at \$40 million. Chaparral is a privately-held independent oil and natural gas company headquartered in Oklahoma City, Oklahoma, with estimated proved reserves of approximately 618 bcfe and daily production of approximately 83 mmcfe.

During 2005 and continuing in 2006, we have taken several steps to improve our capital structure. These transactions enabled us to extend our average maturity of long-term debt to over nine years with an average interest rate of approximately 6.4%. Maintaining a debt-to-total-capitalization ratio of below 50% and reducing debt per mcfe of proved reserves remain key goals of our business strategy.



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We completed the following significant financing transactions in the Current Period:

### **First Quarter 2006**

Amended and restated our revolving bank credit facility, increasing the commitments to \$2.0 billion and extending the maturity date to February 2011.

Issued an additional \$500 million of our 6.5% Senior Notes due 2017 in a private placement and used the proceeds of approximately \$487 million to repay outstanding borrowings under our revolving bank credit facility incurred primarily to fund our recent acquisitions.

### **Second Quarter 2006**

Completed a public exchange of 83,245 shares of our 4.125% cumulative convertible preferred stock, representing 96.4% or \$83.2 million of the aggregate liquidation value of the shares outstanding, for 5.2 million shares of our common stock pursuant to a tender offer. No cash was received or paid in connection with this transaction.

Completed a public exchange of 804,048 shares of our 5.0% (Series 2003) cumulative convertible preferred stock, representing 95.4% or \$80.4 million of the aggregate liquidation value of the shares outstanding, for 5.0 million shares of our common stock pursuant to a tender offer. No cash was received or paid in connection with this transaction.

Completed public offerings of \$500 million of 7.625% Senior Notes due 2013, 2.0 million shares of 6.25% mandatory convertible preferred stock having a liquidation preference of \$250 per share, and 25 million shares of common stock at \$29.05 per share. Net proceeds of approximately \$1.666 billion were used to fund acquisitions, to repay borrowings under our revolving bank credit facility and for general corporate purposes.

### **Third Quarter 2006**

Increased the commitments under our revolving bank credit facility to \$2.5 billion.

Issued 3.75 million shares of common stock at \$29.05 per share and 300,000 shares of our 6.25% mandatory convertible preferred stock having a liquidation preference of \$250 per share upon the exercise of the underwriters' options to purchase the additional shares pursuant to the June 2006 public offerings of our common stock and 6.25% preferred stock. Net proceeds of approximately \$177.6 million were used to repay borrowings under our revolving bank credit facility.

### ***Contractual Obligations***

We currently have a \$2.5 billion syndicated revolving bank credit facility which matures in February 2011. The credit facility was increased from \$1.25 billion to \$2.0 billion in February 2006 and to \$2.5 billion in September 2006. As of September 30, 2006, we had \$1.464 billion in outstanding borrowings under this facility and had utilized \$6.2 million of the facility for various letters of credit. Borrowings under the facility are collateralized by certain producing oil and natural gas properties and bear interest at either (i) the greater of the reference rate of Union Bank of California, N.A., or the federal funds effective rate plus 0.50% or (ii) London Interbank Offered Rate (LIBOR), at our option, plus a margin that varies from 0.875% to 1.50% per annum according to our senior unsecured long-term debt ratings. The collateral value and borrowing base are redetermined periodically. The unused portion of the facility is subject to a commitment fee that also varies according to our senior unsecured long-term debt ratings, from 0.125% to 0.30% per annum. Currently the commitment fee is 0.25% per annum. Interest is payable quarterly or, if LIBOR applies, it may be payable at more frequent intervals.

The credit facility agreement contains various covenants and restrictive provisions which limit our ability to incur additional indebtedness, make investments or loans and create liens. The credit facility agreement requires

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us to maintain an indebtedness to total capitalization ratio (as defined) not to exceed 0.65 to 1 and an indebtedness to EBITDA ratio (as defined) not to exceed 3.5 to 1. As defined by the credit facility, our indebtedness to total capitalization ratio was 0.44 to 1 and our indebtedness to EBITDA ratio was 1.87 to 1 at September 30, 2006. If we should fail to perform our obligations under these and other covenants, the revolving credit commitment could be terminated and any outstanding borrowings under the facility could be declared immediately due and payable. Such acceleration, if involving a principal amount of \$10 million (\$50 million in the case of our senior notes issued after 2004), would constitute an event of default under our senior note indentures which could in turn result in the acceleration of a significant portion of our senior note indebtedness. The credit facility agreement also has cross default provisions that apply to other indebtedness we may have with an outstanding principal amount in excess of \$75 million.

We also have two secured hedging facilities, each of which permits us to enter into cash-settled natural gas and oil commodity transactions, valued by the counterparty, for up to \$500 million. The scheduled maturity date for these facilities is May 2010. Outstanding transactions under each facility are collateralized by certain of our oil and natural gas properties that do not secure any of our other obligations. The hedging facilities are subject to a 1.0% per annum exposure fee, which is assessed quarterly on the average of the daily negative fair market value amounts, if any, during the quarter. As of September 30, 2006, the fair market value of the natural gas and oil hedging transactions was an asset of \$252.1 million under one of the facilities and an asset of \$823.2 million under the other facility. As of November 3, 2006, the fair market value of the same transactions was an asset of approximately \$152.2 million and \$255.5 million, respectively. The hedging facilities contain the standard representations and default provisions that are typical of such agreements. The agreements also contain various restrictive provisions which govern the aggregate oil and natural gas production volumes that we are permitted to hedge under all of our agreements at any one time.

Two of our subsidiaries, Chesapeake Exploration Limited Partnership and Chesapeake Appalachia, L.L.C., are the borrowers under our revolving bank credit facility and Chesapeake Exploration Limited Partnership is the named party to our hedging facilities. The facilities are guaranteed by Chesapeake and all its other wholly-owned subsidiaries except minor subsidiaries. Our revolving bank credit facility and secured hedging facilities do not contain material adverse change or adequate assurance covenants. Although the applicable interest rates and commitment fees in our bank credit facility fluctuate slightly based on our long-term senior unsecured credit ratings, the bank facility and the secured hedging facilities do not contain provisions which would trigger an acceleration of amounts due under the facilities or a requirement to post additional collateral in the event of a downgrade of our credit ratings.

As of September 30, 2006, our senior notes consisted of the following (\$ in thousands):

|                                                    |                     |
|----------------------------------------------------|---------------------|
| 7.5% Senior Notes due 2013                         | \$ 363,823          |
| 7.625% Senior Notes due 2013                       | 500,000             |
| 7.0% Senior Notes due 2014                         | 300,000             |
| 7.5% Senior Notes due 2014                         | 300,000             |
| 7.75% Senior Notes due 2015                        | 300,408             |
| 6.375% Senior Notes due 2015                       | 600,000             |
| 6.625% Senior Notes due 2016                       | 600,000             |
| 6.875% Senior Notes due 2016                       | 670,437             |
| 6.5% Senior Notes due 2017                         | 1,100,000           |
| 6.25% Senior Notes due 2018                        | 600,000             |
| 6.875% Senior Notes due 2020                       | 500,000             |
| 2.75% Contingent Convertible Senior Notes due 2035 | 690,000             |
| Discount on senior notes                           | (103,939)           |
| Discount for interest rate derivatives             | (23,621)            |
|                                                    | <b>\$ 6,397,108</b> |

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No scheduled principal payments are required under our senior notes until 2013, when \$863.8 million is due. The holders of the 2.75% Contingent Convertible Senior Notes due 2035 may require us to repurchase all or a portion of these notes on November 15, 2015, 2020, 2025 and 2030 at 100% of the principal amount of these notes.

As of September 30, 2006 and currently, debt ratings for the senior notes are Ba2 by Moody's Investor Service (stable outlook), BB by Standard & Poor's Ratings Services (stable outlook) and BB by Fitch Ratings.

Our senior notes are unsecured senior obligations of Chesapeake and rank equally in right of payment with all of our other existing and future senior indebtedness and rank senior in right of payment with all of our future subordinated indebtedness. All of our wholly-owned subsidiaries, except minor subsidiaries, fully and unconditionally guarantee the notes jointly and severally on an unsecured basis. Senior notes issued before July 2005 are governed by indentures containing covenants that limit our ability and our restricted subsidiaries' ability to incur additional indebtedness; pay dividends on our capital stock or redeem, repurchase or retire our capital stock or subordinated indebtedness; make investments and other restricted payments; incur liens; enter into sale-leaseback transactions; create restrictions on the payment of dividends or other amounts to us from our restricted subsidiaries; engage in transactions with affiliates; sell assets; and consolidate, merge or transfer assets. Senior notes issued after June 2005 are governed by indentures containing covenants that limit our ability and our restricted subsidiaries' ability to incur certain secured indebtedness; enter into sale-leaseback transactions; and consolidate, merge or transfer assets. The debt incurrence covenants do not presently restrict our ability to borrow under or expand our secured credit facility. As of September 30, 2006, we estimate that secured commercial bank indebtedness of approximately \$5.4 billion could have been incurred under the most restrictive indenture covenant.

In September 2006, our wholly owned subsidiary, Nomac Drilling Corporation, sold 18 of its drilling rigs and related equipment for \$187.5 million and entered into a master lease agreement under which it agreed to lease the rigs from the buyer for an initial term of eight years from October 1, 2006 at rental payments of \$26.0 million annually. Nomac's lease obligations are guaranteed by Chesapeake and its other material domestic subsidiaries. This transaction was recorded as a sale and operating leaseback, with an aggregate deferred gain of \$14.8 million on the sale which will be amortized to service operations expense over the lease term. Under the rig lease, we have the option to purchase the rigs on September 30, 2013 or on the expiration of the lease term for a purchase price equal to the then fair market value of the rigs. Additionally, we have the option to renew the rig lease for a negotiated renewal term at a periodic rental equal to the fair market rental value of the rigs as determined at the time of renewal.

Commitments related to these lease payments are not recorded in the accompanying condensed consolidated balance sheets. As of September 30, 2006, minimum future rig lease payments were as follows (in thousands):

|              |                   |
|--------------|-------------------|
| 2006         | \$ 6,130          |
| 2007         | 25,993            |
| 2008         | 25,993            |
| 2009         | 25,993            |
| 2010         | 25,993            |
| Thereafter   | 97,478            |
| <b>Total</b> | <b>\$ 207,580</b> |

**Results of Operations Three Months Ended September 30, 2006 vs. September 30, 2005**

*General.* For the Current Quarter, Chesapeake had net income of \$548.3 million, or \$1.13 per diluted common share, on total revenues of \$1.929 billion. This compares to net income of \$177.0 million, or \$0.43 per diluted common share, on total revenues of \$1.083 billion during the Prior Quarter.

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**Oil and Natural Gas Sales.** During the Current Quarter, oil and natural gas sales were \$1.493 billion compared to \$720.9 million in the Prior Quarter. In the Current Quarter, Chesapeake produced 146.9 bcfe at a weighted average price of \$8.54 per mcfe, compared to 120.4 bcfe produced in the Prior Quarter at a weighted average price of \$6.85 per mcfe (weighted average prices exclude the effect of unrealized gains or losses) on oil and natural gas derivatives of \$238.5 million and (\$104.0) million in the Current Quarter and Prior Quarter, respectively). In the Current Quarter, the increase in prices resulted in an increase in revenue of \$247.9 million and increased production resulted in a \$181.8 million increase, for a total increase in revenues of \$429.7 million (excluding unrealized gains or losses on oil and natural gas derivatives). The increase in production from the Prior Quarter to the Current Quarter is due to the combination of drilling and acquisitions completed in 2005 and 2006.

For the Current Quarter, we realized an average price per barrel of oil of \$60.62, compared to \$53.30 in the Prior Quarter (weighted average prices for both quarters discussed exclude the effect of unrealized gains or losses on derivatives). Natural gas prices realized per mcf (excluding unrealized gains or losses on derivatives) were \$8.39 and \$6.64 in the Current Quarter and Prior Quarter, respectively. Realized gains or losses from our oil and natural gas derivatives resulted in a net increase in oil and natural gas revenues of \$301.4 million, or \$2.05 per mcfe, in the Current Quarter and a net decrease of \$122.6 million, or \$1.02 per mcfe, in the Prior Quarter.

The change in oil and natural gas prices has a significant impact on our oil and natural gas revenues and cash flows. Assuming the Current Quarter production levels, a change of \$0.10 per mcf of natural gas sold would have resulted in an increase or decrease in revenues and cash flow of approximately \$13.4 million and \$12.8 million, respectively, and a change of \$1.00 per barrel of oil sold would have resulted in an increase or decrease in revenues and cash flow of approximately \$2.2 million and \$2.1 million, respectively, without considering the effect of derivative activities.

The following table shows our production by region for the Current Quarter and the Prior Quarter:

|                                  | For the Three Months Ended September 30,<br>2006 |         | 2005    |         |
|----------------------------------|--------------------------------------------------|---------|---------|---------|
|                                  | Mmcfe                                            | Percent | Mmcfe   | Percent |
| Mid-Continent                    | 80,946                                           | 55%     | 74,910  | 62%     |
| South Texas and Texas Gulf Coast | 19,421                                           | 13      | 17,018  | 14      |
| Appalachian Basin                | 11,750                                           | 8       |         |         |
| Barnett Shale                    | 11,557                                           | 8       | 4,898   | 4       |
| Ark-La-Tex                       | 11,529                                           | 8       | 10,945  | 9       |
| Permian Basin                    | 11,072                                           | 8       | 11,843  | 10      |
| Other                            | 615                                              |         | 743     | 1       |
| Total Production                 | 146,890                                          | 100%    | 120,357 | 100%    |

Natural gas production represented approximately 91% of our total production volume on a natural gas equivalent basis in the Current Quarter, compared to 90% in the Prior Quarter.

**Oil and Natural Gas Marketing Sales and Operating Expenses.** Oil and natural gas marketing activities are substantially for third parties that are owners in Chesapeake-operated wells. Chesapeake recognized \$398.1 million in oil and natural gas marketing sales to third parties in the Current Quarter, with corresponding oil and natural gas marketing expenses of \$384.5 million, for a net margin of \$13.6 million. This compares to sales of \$361.9 million, expenses of \$353.5 million and a net margin of \$8.4 million in the Prior Quarter. In the Current Quarter, Chesapeake realized an increase in oil and natural gas marketing sales volumes.

**Service Operations Revenue and Operating Expenses.** Service operations consist of third-party revenue and operating expenses related to our drilling and oilfield trucking operations. These operations have grown as a result of businesses we acquired in the Current Period. Chesapeake recognized \$38.1 million in service operations revenue in the Current Quarter with corresponding service operations expense of \$18.8 million, for a net margin of \$19.3 million. During the Prior Quarter, service operations for third parties were insignificant.

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*Production Expenses.* Production expenses, which include lifting costs and ad valorem taxes, were \$124.0 million in the Current Quarter compared to \$80.8 million in the Prior Quarter. On a unit-of-production basis, production expenses were \$0.84 per mcf in the Current Quarter compared to \$0.67 per mcf in the Prior Quarter. The increase in the Current Quarter was primarily due to higher third-party field service costs, energy costs, ad valorem tax increases and personnel costs. We expect that production expenses for the remainder of 2006 will range from \$0.85 to \$0.95 per mcf produced.

*Production Taxes.* Production taxes were \$40.6 million and \$53.1 million in the Current Quarter and the Prior Quarter, respectively. On a unit-of-production basis, production taxes were \$0.28 per mcf in the Current Quarter compared to \$0.44 per mcf in the Prior Quarter. This decrease is the result of an increase in production tax exemptions realized in addition to a decrease in natural gas prices. In general, production taxes are calculated using value-based formulas that produce higher per unit costs when oil and natural gas prices are higher. We expect production taxes for the remainder of 2006 to range from \$0.36 to \$0.40 per mcf produced based on NYMEX prices of \$56.25 per barrel of oil and natural gas prices ranging from \$6.40 to \$7.20 per mcf.

*General and Administrative Expenses.* General and administrative expenses, which are net of internal payroll and non-payroll costs capitalized in our oil and natural gas properties, were \$37.4 million in the Current Quarter and \$15.8 million in the Prior Quarter. General and administrative expenses were \$0.25 and \$0.13 per mcf for the Current Quarter and Prior Quarter, respectively. The increase in the Current Quarter was the result of the company's overall growth as well as cost and wage inflation. Included in general and administrative expenses is stock-based compensation of \$8.5 million and \$5.2 million for the Current Quarter and Prior Quarter, respectively. We anticipate that general and administrative expenses for the remainder of 2006 will be between \$0.27 and \$0.33 per mcf produced (including stock-based compensation ranging from \$0.10 to \$0.11 per mcf).

Our stock-based compensation for employees and non-employee directors is principally in the form of restricted stock. We have awarded shares of restricted stock to employees since January 2004 and to non-employee directors since July 2005. Stock-based compensation awards before 2004 (and before 2005 for non-employee directors) were in the form of stock options. Employee stock-based compensation awards vest over a period of four or five years. Our non-employee director awards vest over a period of three years.

Until December 31, 2005, as permitted under Statement of Financial Accounting Standards (SFAS) No. 123, *Accounting for Stock-Based Compensation*, as amended, we accounted for our stock options under the recognition and measurement provisions of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations. Generally, we recognized no compensation cost on grants of employee and non-employee director stock options because the exercise price was equal to the market price of our common stock on the date of grant. Effective January 1, 2006, we implemented the fair value recognition provisions of SFAS 123(R), *Share-Based Payment*, using the modified-prospective transition method. Under this transition method, compensation cost in 2006 includes the portion vesting in the period for (1) all share-based payments granted prior to, but not vested as of January 1, 2006, based on the grant-date fair value estimated in accordance with the original provisions of SFAS 123 and (2) all share-based payments granted subsequent to January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123(R). Results for prior periods have not been restated.

Stock-based compensation expense increased from \$5.2 million in the Prior Quarter to \$8.5 million in the Current Quarter. This increase is primarily due to additional restricted stock grants to employees during the past year.

The discussion of stock-based compensation in note 1 to the financial statements included in Part I of this report provides additional detail on the accounting for and reporting of our stock options and restricted stock, as well as the effects of our adoption of SFAS 123(R).

Chesapeake follows the full-cost method of accounting under which all costs associated with property acquisition, exploration and development activities are capitalized. We capitalize internal costs that can be



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directly identified with our exploration and development activities and do not include any costs related to production, general corporate overhead or similar activities. We capitalized \$49.0 million and \$29.5 million of internal costs in the Current Quarter and the Prior Quarter, respectively, directly related to our oil and natural gas property acquisition, exploration and development efforts.

*Oil and Natural Gas Depreciation, Depletion and Amortization.* Depreciation, depletion and amortization of oil and natural gas properties was \$343.7 million and \$231.1 million during the Current Quarter and the Prior Quarter, respectively. 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, was \$2.34 and \$1.92 in the Current Quarter and in the Prior Quarter, respectively. The \$0.42 increase in the average DD&A rate is primarily the result of higher drilling costs and higher costs associated with acquisitions, including the recognition of the tax effect of acquisition costs in excess of the tax basis acquired in certain corporate acquisitions. We expect the DD&A rate for the remainder of 2006 to be between \$2.35 and \$2.40 per mcfe produced.

*Depreciation and Amortization of Other Assets.* Depreciation and amortization of other assets was \$27.0 million in the Current Quarter, compared to \$12.9 million in the Prior Quarter. The increase in the Current Quarter was primarily the result of depreciation of assets acquired in 2005 and 2006. These assets include various gathering facilities and compression equipment, new buildings constructed at our corporate headquarters complex and at various field office locations, additional drilling rigs and oilfield trucks and new information technology equipment and software. Property and equipment costs are depreciated on a straight-line basis. Buildings are depreciated over 15 to 39 years, gathering facilities are depreciated over seven to 20 years, drilling rigs are depreciated over 15 years and all other property and equipment are depreciated over the estimated useful lives of the assets, which range from two to seven years. To the extent drilling rigs are used to drill Chesapeake wells, a substantial portion of the depreciation is capitalized in oil and natural gas properties as exploration or development costs. We expect depreciation and amortization of other assets for the remainder of 2006 to be between \$0.19 and \$0.23 per mcfe produced.

*Interest and Other Income.* Interest and other income was \$5.1 million in the Current Quarter compared to \$2.4 million in the Prior Quarter. The Current Quarter income consisted of \$1.8 million of interest income, \$2.3 million related to earnings of equity investees, a \$0.1 million gain on sale of assets and \$0.9 million of miscellaneous income. The Prior Quarter income consisted of \$0.4 million of interest income, (\$0.1) million related to earnings of equity investees and \$2.1 million of miscellaneous income.

*Interest Expense.* Interest expense increased to \$74.1 million in the Current Quarter compared to \$58.6 million in the Prior Quarter as follows:

|                                                                     | <b>Three Months Ended<br/>September 30,</b> |             |
|---------------------------------------------------------------------|---------------------------------------------|-------------|
|                                                                     | <b>2006</b>                                 | <b>2005</b> |
|                                                                     | <b>(\$ in millions)</b>                     |             |
| Interest expense on senior notes and revolving bank credit facility | \$ 122.3                                    | \$ 77.6     |
| Capitalized interest                                                | (49.3)                                      | (20.8)      |
| Amortization of loan discount                                       | 2.0                                         | 1.4         |
| Unrealized (gain) loss on interest rate derivatives                 | (2.5)                                       | 1.2         |
| Realized (gain) loss on interest rate derivatives                   | 1.6                                         | (0.8)       |
| Total interest expense                                              | \$ 74.1                                     | \$ 58.6     |
| Average long-term borrowings                                        | \$ 6,525                                    | \$ 4,047    |

We use interest rate derivatives to mitigate our exposure to the volatility in interest rates. For interest rate derivative instruments designated as fair value hedges (in accordance with SFAS 133), changes in fair value are recorded on the consolidated balance sheets as assets (liabilities) and the debt's carrying value amount is adjusted

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by the change in the fair value of the debt subsequent to the initiation of the derivative. Any resulting differences are recorded currently as ineffectiveness in the consolidated statements of operations as an adjustment to interest expense. Changes in the fair value of derivative instruments not qualifying as fair value hedges are recorded currently as adjustments to interest expense. A detailed explanation of our interest rate derivative activity appears later in Item 3 Quantitative and Qualitative Disclosures About Market Risk.

Interest expense, excluding unrealized gains or losses on derivatives and net of amounts capitalized, was \$0.52 per mcfe in the Current Quarter compared to \$0.48 per mcfe in the Prior Quarter. We expect interest expense for the remainder of 2006 to be between \$0.58 and \$0.62 per mcfe produced (before considering the effect of interest rate derivatives).

*Loss on Repurchases or Exchanges of Chesapeake Debt.* We repurchased or exchanged Chesapeake debt in the Prior Quarter and incurred losses in connection with the transactions. The following table shows the losses related to these transactions (\$ in millions):

|                                                       | Notes   | Loss on Repurchases/Exchanges |          |        |
|-------------------------------------------------------|---------|-------------------------------|----------|--------|
|                                                       | Retired | Premium                       | Other(a) | Total  |
| <b>For the Three Months Ended September 30, 2005:</b> |         |                               |          |        |
| 8.125% Senior Notes due 2011                          | \$ 7.6  | \$ 0.5                        | \$ 0.1   | \$ 0.6 |
| 9.0% Senior Notes due 2012                            | 1.1     | 0.1                           | 0.0      | 0.1    |
|                                                       | \$ 8.7  | \$ 0.6                        | \$ 0.1   | \$ 0.7 |

(a) Includes write-offs of discounts, deferred charges and interest rate derivatives associated with retired notes and transaction costs. There were no repurchases or exchanges of Chesapeake debt in the Current Quarter.

*Income Tax Expense.* Chesapeake recorded income tax expense of \$336.1 million in the Current Quarter, compared to income tax expense of \$101.7 million in the Prior Quarter. Our effective income tax rate increased to 38% in the Current Quarter compared to 36.5% in the Prior Quarter. This increase included the impact that both state income taxes and permanent differences had on our overall effective rate along with the effect of a Texas tax law change. In May 2006, Texas House Bill 3 was signed into law which eliminated the existing franchise tax and replaced it with a new income-based margin tax. The new tax is effective for tax returns due on or after January 1, 2008 for our 2007 business activity. Although the new margin tax is not effective until 2007, the provisions of SFAS 109, *Accounting for Income Taxes*, require us to record the impact that this change has on our liability for additional deferred income taxes in the period of enactment. All 2005 income tax expense was deferred, and we expect most, if not all, of our 2006 income tax expense to be deferred.

## Results of Operations Nine Months Ended September 30, 2006 vs. September 30, 2005

*General.* For the Current Period, Chesapeake had net income of \$1.532 billion, or \$3.40 per diluted common share, on total revenues of \$5.458 billion. This compares to net income of \$495.8 million, or \$1.32 per diluted common share, on total revenues of \$2.914 billion during the Prior Period.

*Oil and Natural Gas Sales.* During the Current Period, oil and natural gas sales were \$4.190 billion compared to \$2.032 billion in the Prior Period. In the Current Period, Chesapeake produced 426.3 bcfe at a weighted average price of \$8.77 per mcfe, compared to 338.2 bcfe produced in the Prior Period at a weighted average price of \$6.42 per mcfe (weighted average prices exclude the effect of unrealized gains or (losses) on oil and natural gas derivatives of \$452.6 million and (\$137.1) million in the Current Period and Prior Period, respectively). In the Current Period, the increase in prices resulted in an increase in revenue of \$1.003 billion and increased production resulted in a \$565.5 million increase, for a total increase in revenues of \$1.568 billion (excluding unrealized gains or losses on oil and natural gas derivatives). The increase in production from the Prior Period to the Current Period is due to the combination of drilling as well as acquisitions completed in 2005 and the Current Period.

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For the Current Period, we realized an average price per barrel of oil of \$58.86 compared to \$46.04 in the Prior Period (weighted average prices for both periods discussed exclude the effect of unrealized gains or losses on derivatives). Natural gas prices realized per mcf (excluding unrealized gains or losses on derivatives) were \$8.66 and \$6.27 in the Current Period and Prior Period, respectively. Realized gains or losses from our oil and natural gas derivatives resulted in a net increase in oil and natural gas revenues of \$807.1 million, or \$1.89 per mcfe, in the Current Period and a net decrease of \$126.6 million, or \$0.37 per mcfe, in the Prior Period.

The change in oil and natural gas prices has a significant impact on our oil and natural gas revenues and cash flows. Assuming the Current Period production levels, a change of \$0.10 per mcf of natural gas sold would have resulted in an increase or decrease in revenues and cash flow of approximately \$38.8 million and \$36.9 million, respectively, and a change of \$1.00 per barrel of oil sold would have resulted in an increase or decrease in revenues and cash flow of approximately \$6.4 million and \$6.1 million, respectively, without considering the effect of derivative activities.

The following table shows our production by region for the Current Period and the Prior Period:

|                                  | For the Nine Months Ended September 30, |         |         |         |
|----------------------------------|-----------------------------------------|---------|---------|---------|
|                                  | 2006                                    |         | 2005    |         |
|                                  | Mmcfe                                   | Percent | Mmcfe   | Percent |
| Mid-Continent                    | 233,078                                 | 55%     | 222,290 | 65%     |
| South Texas and Texas Gulf Coast | 59,040                                  | 14      | 45,082  | 13      |
| Permian Basin                    | 34,582                                  | 8       | 28,955  | 9       |
| Ark-La-Tex                       | 34,410                                  | 8       | 28,845  | 9       |
| Appalachian Basin                | 33,268                                  | 8       |         |         |
| Barnett Shale                    | 30,035                                  | 7       | 10,927  | 3       |
| Other                            | 1,905                                   |         | 2,065   | 1       |
| Total Production                 | 426,318                                 | 100%    | 338,164 | 100%    |

Natural gas production represented approximately 91% of our total production volume on a natural gas equivalent basis in the Current Period, compared to 90% in the Prior Period.

*Oil and Natural Gas Marketing Sales and Operating Expenses.* Oil and natural gas marketing activities are substantially for third parties that are owners in Chesapeake-operated wells. Chesapeake recognized \$1.170 billion in oil and natural gas marketing sales to third parties in the Current Period, with corresponding oil and natural gas marketing expenses of \$1.132 billion, for a net margin of \$38.6 million. This compares to sales of \$882.0 million, expenses of \$860.8 million and a net margin of \$21.2 million in the Prior Period. In the Current Period, Chesapeake realized an increase in oil and natural gas marketing sales volumes and an increase in oil and natural gas prices.

*Service Operations Revenue and Operating Expenses.* Service operations consist of third-party revenue and operating expenses related to our drilling and oilfield trucking operations. These operations have grown as a result of businesses we acquired in the Current Period. Chesapeake recognized \$97.5 million in service operations revenue in the Current Period with corresponding service operations expenses of \$48.9 million, for a net margin of \$48.6 million principally associated with businesses acquired in the Current Period. During the Prior Period, service operations for third parties were insignificant.

*Production Expenses.* Production expenses, which include lifting costs and ad valorem taxes, were \$364.1 million in the Current Period compared to \$222.7 million in the Prior Period. On a unit-of-production basis, production expenses were \$0.85 per mcfe in the Current Period compared to \$0.66 per mcfe in the Prior Period. The increase in the Current Period was primarily due to higher third-party field service costs, energy costs, ad valorem tax increases and personnel costs. We expect that production expenses for the remainder of 2006 will range from \$0.85 to \$0.95 per mcfe produced.

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*Production Taxes.* Production taxes were \$129.9 million and \$136.3 million in the Current Period and the Prior Period, respectively. On a unit-of-production basis, production taxes were \$0.30 per mcf in the Current

Period compared to \$0.40 per mcf in the Prior Period. The Current Period included a \$2.1 million accrual for certain severance tax claims and then a subsequent reversal of the cumulative \$11.6 million accrual for such severance tax claims as a result of their dismissal. The Prior Period included an accrual of \$5.0 million associated with such severance tax claims. Excluding these items, production taxes were \$0.33 per mcf in the Current Period and \$0.39 per mcf in the Prior Period. This decrease is the result of an increase in production tax exemptions realized. In general, production taxes are calculated using value-based formulas that produce higher per unit costs when oil and natural gas prices are higher. We expect production taxes for the remainder of 2006 to range from \$0.36 to \$0.40 per mcf produced based on NYMEX prices of \$56.25 per barrel of oil and natural gas prices ranging from \$6.40 to \$7.20 per mcf.

*General and Administrative Expenses.* General and administrative expenses, which are net of internal payroll and non-payroll costs capitalized in our oil and natural gas properties, were \$99.7 million in the Current Period and \$39.6 million in the Prior Period. General and administrative expenses were \$0.23 and \$0.12 per mcf for the Current Period and Prior Period, respectively. The increase in the Current Period was the result of the company's overall growth as well as cost and wage inflation. Included in general and administrative expenses is stock-based compensation of \$21.3 million and \$10.2 million for the Current Period and Prior Period, respectively. We anticipate that general and administrative expenses for the remainder of 2006 will be between \$0.27 and \$0.33 per mcf produced (including stock-based compensation ranging from \$0.10 to \$0.11 per mcf).

Our stock-based compensation for employees and non-employee directors is principally in the form of restricted stock. We have awarded shares of restricted stock to employees since January 2004 and to non-employee directors annually since July 2005. Employee compensation awards before 2004 (and before 2005 for non-employee directors) were in the form of stock options. These stock-based compensation awards vest over a period of four or five years. Our non-employee director awards vest over a period of three years.

Until December 31, 2005, as permitted under Statement of Financial Accounting Standards (SFAS) No. 123, *Accounting for Stock-Based Compensation*, as amended, we accounted for our stock options under the recognition and measurement provisions of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations. Generally, we recognized no compensation cost on grants of employee and non-employee director stock options because the exercise price was equal to the market price of our common stock on the date of grant. Effective January 1, 2006, we implemented the fair value recognition provisions of SFAS 123(R), *Share-Based Payment*, using the modified-prospective transition method. Under this transition method, compensation cost in 2006 includes the portion vesting in the period for (1) all share-based payments granted prior to, but not vested as of January 1, 2006, based on the grant-date fair value estimated in accordance with the original provisions of SFAS 123 and (2) all share-based payments granted subsequent to January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123(R). Results for prior periods have not been restated.

Stock-based compensation expense increased from \$10.2 million in the Prior Period to \$21.3 million in the Current Period. Of this increase, \$1.9 million was due to stock option expense, \$9.1 million was due to a higher number of unvested restricted shares outstanding during the Current Period compared to the Prior Period and \$0.1 million was due to stock granted to a new director.

The discussion of stock-based compensation in note 1 to the financial statements included in Part I of this report provides additional detail on the accounting for and reporting of our stock options and restricted stock, as well as the effects of our adoption of SFAS 123(R).

Chesapeake follows the full-cost method of accounting under which all costs associated with property acquisition, exploration and development activities are capitalized. We capitalize internal costs that can be directly identified with our exploration and development activities and do not include any costs related to

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production, general corporate overhead or similar activities. We capitalized \$119.3 million and \$75.3 million of internal costs in the Current Period and the Prior Period, respectively, directly related to our oil and natural gas property acquisition, exploration and development efforts.

*Oil and Natural Gas Depreciation, Depletion and Amortization.* Depreciation, depletion and amortization of oil and natural gas properties was \$976.8 million and \$621.5 million during the Current Period and the Prior Period, respectively. The average DD&A rate per mcf, which is a function of capitalized costs, future development costs and the related underlying reserves in the periods presented, was \$2.29 and \$1.84 in the Current Period and in the Prior Period, respectively. The \$0.45 increase in the average DD&A rate is primarily the result of higher drilling costs and higher costs associated with acquisitions, including the recognition of the tax effect of acquisition costs in excess of tax basis acquired in certain corporate acquisitions. We expect the DD&A rate for the remainder of 2006 to be between \$2.35 and \$2.40 per mcf produced.

*Depreciation and Amortization of Other Assets.* Depreciation and amortization of other assets was \$74.1 million in the Current Period, compared to \$34.8 million in the Prior Period. The increase in the Current Period was primarily the result of the depreciation of recently acquired assets resulting from our acquisition of various gathering facilities and compression equipment, the construction of new buildings at our corporate headquarters complex and at various field office locations, the purchase of additional drilling rigs and oilfield trucks and the purchase of additional information technology equipment and software. Property and equipment costs are depreciated on a straight-line basis. Buildings are depreciated over 15 to 39 years, gathering facilities are depreciated over seven to 20 years, drilling rigs are depreciated over 15 years and all other property and equipment are depreciated over the estimated useful lives of the assets, which range from two to seven years. To the extent drilling rigs are used to drill our wells, a substantial portion of the depreciation is capitalized in oil and natural gas properties as exploration or development costs. We expect depreciation and amortization of other assets for the remainder of 2006 to be between \$0.19 and \$0.23 per mcf produced.

*Employee Retirement Expense.* Our President and Chief Operating Officer, Tom L. Ward, resigned as a director, officer and employee of the company effective February 10, 2006. Mr. Ward's Resignation Agreement provided for the immediate vesting of all of his unvested stock options and restricted stock on February 10, 2006. As a result of such vesting, options to purchase 724,615 shares of Chesapeake's common stock at an average exercise price of \$8.01 per share and 1,291,875 shares of restricted common stock became immediately vested. As a result, we incurred an expense of \$54.8 million in the Current Period.

*Interest and Other Income.* Interest and other income was \$19.7 million in the Current Period compared to \$7.8 million in the Prior Period. The Current Period income consisted of \$3.1 million of interest income, \$9.5 million related to earnings of equity investees, a \$3.5 million gain on sale of assets and \$3.6 million of miscellaneous income. The Prior Period income consisted of \$3.5 million of interest income, \$1.1 million related to earnings of equity investees and \$3.2 million of miscellaneous income.

*Interest Expense.* Interest expense increased to \$220.2 million in the Current Period compared to \$155.6 million in the Prior Period as follows:

|                                                                     | Nine Months Ended<br>September 30, |          |
|---------------------------------------------------------------------|------------------------------------|----------|
|                                                                     | 2006                               | 2005     |
|                                                                     | (\$ in millions)                   |          |
| Interest expense on senior notes and revolving bank credit facility | \$ 335.8                           | \$ 210.7 |
| Capitalized interest                                                | (119.2)                            | (54.8)   |
| Amortization of loan discount                                       | 5.3                                | 4.2      |
| Unrealized (gain) loss on interest rate derivatives                 | (0.8)                              | (1.9)    |
| Realized (gain) loss on interest rate derivatives                   | (0.9)                              | (2.6)    |
| Total interest expense                                              | \$ 220.2                           | \$ 155.6 |
| Average long-term borrowings                                        | \$ 6,125                           | \$ 3,593 |

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We use interest rate derivatives to mitigate our exposure to the volatility in interest rates. For interest rate derivative instruments designated as fair value hedges (in accordance with SFAS 133), changes in fair value are recorded on the consolidated balance sheets as assets (liabilities), and the debt's carrying value amount is adjusted by the change in the fair value of the debt subsequent to the initiation of the derivative. Any resulting differences are recorded currently as ineffectiveness in the consolidated statements of operations as an adjustment to interest expense. Changes in the fair value of derivative instruments not qualifying as fair value hedges are recorded currently as adjustments to interest expense. A detailed explanation of our interest rate derivative activity appears later in Item 3 Quantitative and Qualitative Disclosures About Market Risk.

Interest expense, excluding unrealized gains or losses on derivatives and net of amounts capitalized, was \$0.52 per mcf in the Current Period compared to \$0.47 per mcf in the Prior Period. We expect interest expense for the remainder of 2006 to be between \$0.58 and \$0.62 per mcf produced (before considering the effect of interest rate derivatives).

*Gain on Sale of Investment.* In the Current Period, Chesapeake sold its investment in publicly-traded Pioneer Drilling Company ( Pioneer ) common stock, realizing proceeds of \$158.9 million and a gain of \$117.4 million. We owned 17% of the common stock of Pioneer, which we began acquiring in 2003.

*Loss on Repurchases or Exchanges of Chesapeake Senior Notes.* We repurchased or exchanged Chesapeake debt in the Prior Period and incurred losses in connection with the transactions. The following table shows the losses related to these transactions (\$ in millions):

|                                                      | Notes    | Loss on Repurchases/Exchanges |          |         |
|------------------------------------------------------|----------|-------------------------------|----------|---------|
|                                                      | Retired  | Premium                       | Other(a) | Total   |
| <b>For the Nine Months Ended September 30, 2005:</b> |          |                               |          |         |
| 8.375% Senior Notes due 2008                         | \$ 11.0  | \$ 0.8                        | \$ 0.1   | \$ 0.9  |
| 8.125% Senior Notes due 2011                         | 245.4    | 17.3                          | 4.4      | 21.7    |
| 9.0% Senior Notes due 2012                           | 300.0    | 41.4                          | 6.0      | 47.4    |
|                                                      | \$ 556.4 | \$ 59.5                       | \$ 10.5  | \$ 70.0 |

(a) Includes write-offs of discounts, deferred charges and interest rate derivatives associated with retired notes and transaction costs. There were no repurchases or exchanges of Chesapeake debt in the Current Period.

*Income Tax Expense.* Chesapeake recorded income tax expense of \$963.1 million in the Current Period, compared to income tax expense of \$285.0 million in the Prior Period. Our effective income tax rate increased to 38.6% in the Current Period compared to 36.5% in the Prior Period. This increase included the impact that both state income taxes and permanent differences had on our overall effective rate along with the effect of a Texas tax law change. In May 2006, Texas House Bill 3 was signed into law which eliminated the existing franchise tax and replaced it with a new income-based margin tax. The new tax is effective for tax returns due on or after January 1, 2008 for our 2007 business activity. Although the new margin tax is not effective until 2007, the provisions of SFAS 109, *Accounting for Income Taxes*, require us to record the impact that this change has on our liability for deferred income taxes in the period of enactment. As a result, we recorded \$15 million in additional deferred state income tax expense, net of the federal income tax benefit, in the Current Period. Excluding the effect of this adjustment, our effective income tax rate was 38% for the Current Period. All 2005 income tax expense was deferred, and we expect most, if not all, of our 2006 income tax expense to be deferred.

**Critical Accounting Policies**

We consider accounting policies related to hedging, oil and natural gas properties, income taxes and business combinations to be critical policies. These policies are summarized in Management's Discussion and Analysis of Financial Condition and Results of Operations in our annual report on Form 10-K for the year ended December 31, 2005.

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### **Recently Issued Accounting Standards**

The Financial Accounting Standards Board (FASB) recently issued the following standards which were reviewed by Chesapeake to determine the potential impact on our financial statements upon adoption.

In December 2004, the FASB issued SFAS 123(R), *Share-Based Payment*, a revision of SFAS 123, accounting for stock-based compensation. This statement establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services by requiring a public entity to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. We adopted this statement effective January 1, 2006. The effect of SFAS 123(R) is more fully described in Note 1.

In September 2005, the Emerging Issues Task Force (EITF) reached a consensus on Issue No. 04-13, *Accounting for Purchases and Sales of Inventory with the Same Counterparty*. EITF Issue No. 04-13 requires that purchases and sales of inventory with the same counterparty in the same line of business should be accounted for as a single non-monetary exchange, if entered into in contemplation of one another. The consensus is effective for inventory arrangements entered into, modified or renewed in interim or annual reporting periods beginning after March 15, 2006. We adopted this issue effective April 1, 2006. The adoption of EITF Issue No. 04-13 did not have a material impact on our financial statements.

In June 2006, the FASB issued FASB Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109*. FIN 48 provides guidance for recognizing and measuring uncertain tax positions, as defined in SFAS 109, *Accounting for Income Taxes*. FIN 48 prescribes a threshold condition that a tax position must meet for any of the benefit of the uncertain tax position to be recognized in the financial statements. Guidance is also provided regarding de-recognition, classification and disclosure of these uncertain tax positions. FIN 48 is effective for fiscal years beginning after December 15, 2006. We do not expect that FIN 48 will have a material impact on our financial position, results of operations or cash flows.

In February 2006, the FASB issued SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments – an amendment of FASB Statements No. 133 and 140*. SFAS 155 permits an entity to measure at fair value any financial instrument that contains an embedded derivative that otherwise would require bifurcation. This statement is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. We are currently evaluating the provisions of SFAS 155 and believe that adoption will not have a material effect on our financial position, results of operations or cash flows.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. This statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007. We are currently assessing the impact SFAS 157 will have on our financial position, results of operations or cash flows.

In September 2006, the FASB issued SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*. This statement requires an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. This statement is effective as of the end of the fiscal year ending after December 15, 2006. We do not expect that SFAS 158 will have a material impact on our financial position, results of operations or cash flows.

### **Forward-Looking Statements**

This report includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements give our current expectations or forecasts of future events. They include statements regarding oil and natural gas reserve

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estimates, planned capital expenditures, the drilling of oil and natural gas wells and future acquisitions, expected oil and natural gas production, cash flow and anticipated liquidity, business strategy and other plans and objectives for future operations and expected future expenses. Statements concerning the fair values of derivative contracts and their estimated contribution to our future results of operations are based upon market information as of a specific date. These market prices are subject to significant volatility.

Although we believe the expectations and forecasts reflected in these and other forward-looking statements are reasonable, we can give no assurance they will prove to have been correct. They can be affected by inaccurate assumptions or by known or unknown risks and uncertainties. Factors that could cause actual results to differ materially from expected results are described under **Risk Factors** in Item 1A of our annual report on Form 10-K for the year ended December 31, 2005 and include:

the volatility of oil and natural gas prices,

our level of indebtedness,

the strength and financial resources of our competitors,

the availability of capital on an economic basis to fund reserve replacement costs,

our ability to replace reserves and sustain production,

uncertainties inherent in estimating quantities of oil and natural gas reserves and projecting future rates of production and the timing of development expenditures,

uncertainties in evaluating oil and natural gas reserves of acquired properties and associated potential liabilities,

inability to effectively integrate and operate acquired companies and properties,

unsuccessful exploration and development drilling,

declines in the value of our oil and natural gas properties resulting in ceiling test write-downs,

lower prices realized on oil and natural gas sales and collateral required to secure hedging liabilities resulting from our commodity price risk management activities,

lower oil and natural gas prices negatively affecting our ability to borrow, and

drilling and operating risks.



We caution you not to place undue reliance on these forward-looking statements, which speak only as of the date of this report, and we undertake no obligation to update this information. We urge you to carefully review and consider the disclosures made in this report and our other filings with the Securities and Exchange Commission that attempt to advise interested parties of the risks and factors that may affect our business.

**ITEM 3. *Quantitative and Qualitative Disclosures About Market Risk***

*Oil and Natural Gas Hedging Activities*

Our results of operations and operating cash flows are impacted by changes in market prices for oil and natural gas. To mitigate a portion of the exposure to adverse market changes, we have entered into various derivative instruments. As of September 30, 2006, our oil and natural gas derivative instruments were comprised of swaps, cap-swaps, basis protection swaps, call options and collars. These instruments allow us to predict with greater certainty the effective oil and natural gas prices to be received for our hedged production. Although derivatives often fail to achieve 100% effectiveness for accounting purposes, we believe our derivative instruments continue to be highly effective in achieving the risk management objectives for which they were intended.

For swap instruments, Chesapeake receives a fixed price for the hedged commodity and pays a floating market price to the counterparty. The fixed-price payment and the floating-price payment are netted, resulting in a net amount due to or from the counterparty.

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For cap-swaps, Chesapeake receives a fixed price and pays a floating market price. The fixed price received by Chesapeake includes a premium in exchange for a cap limiting the counterparty's exposure. In other words, there is no limit to Chesapeake's exposure but there is a limit to the downside exposure of the counterparty.

Basis protection swaps are arrangements that guarantee a price differential for oil or natural gas from a specified delivery point. For Mid-Continent basis protection swaps, which have negative differentials to NYMEX, Chesapeake receives a payment from the counterparty if the price differential is greater than the stated terms of the contract and pays the counterparty if the price differential is less than the stated terms of the contract. For Appalachian Basin basis protection swaps, which have positive differentials to NYMEX, Chesapeake receives a payment from the counterparty if the price differential is less than the stated terms of the contract and pays the counterparty if the price differential is greater than the stated terms of the contract.

For call options, Chesapeake receives a cash premium from the counterparty in exchange for the sale of a call option. If the market price exceeds the fixed price of the call option, Chesapeake pays the counterparty such excess. If the market price settles below the fixed price of the call option, no payment is due from Chesapeake.

Collars contain a fixed floor price (put) and ceiling price (call). If the market price exceeds the call strike price or falls below the put strike price, Chesapeake receives the fixed price and pays the market price. If the market price is between the call and the put strike price, no payments are due from either party.

Chesapeake enters into counter-swaps from time to time for the purpose of locking-in the value of a swap. Under the counter-swap, Chesapeake receives a floating price for the hedged commodity and pays a fixed price to the counterparty. The counter-swap is 100% effective in locking-in the value of a swap since subsequent changes in the market value of the swap are entirely offset by subsequent changes in the market value of the counter-swap. We refer to this locked-in value as a locked swap. Generally, at the time Chesapeake enters into a counter-swap, Chesapeake removes the original swap's designation as a cash flow hedge and classifies the original swap as a non-qualifying hedge under SFAS 133. The reason for this new designation is that collectively the swap and the counter-swap no longer hedge the exposure to variability in expected future cash flows. Instead, the swap and counter-swap effectively lock-in a specific gain (or loss) that will be unaffected by subsequent variability in oil and natural gas prices. Any locked-in gain or loss is recorded in accumulated other comprehensive income and reclassified to oil and natural gas sales in the month of related production.

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

In accordance with FASB Interpretation No. 39, to the extent that a legal right of setoff exists, Chesapeake nets the value of its derivative arrangements with the same counterparty in the accompanying condensed consolidated balance sheets.

Chesapeake enters into basis protection swaps for the purpose of locking-in a price differential for oil or natural gas from a specified delivery point. We currently have basis protection swaps covering six different delivery points, four in the Mid-Continent and two in the Appalachian Basin, which correspond to the actual prices we receive for much of our natural gas production. By entering into these basis protection swaps, we have

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effectively reduced our exposure to market changes in future natural gas price differentials. As of September 30, 2006, the fair value of our basis protection swaps was \$178.8 million. As of September 30, 2006, our Mid-Continent basis protection swaps covered approximately 29% of our anticipated Mid-Continent natural gas production remaining in 2006, 25% in 2007, 18% in 2008 and 13% in 2009. As of September 30, 2006, our Appalachian Basin basis protection swaps cover approximately 74% of our anticipated Appalachian Basin natural gas production in 2007, 65% in 2008 and 30% in 2009.

Gains or losses from derivative transactions are reflected as adjustments to oil and natural gas sales on the condensed consolidated statements of operations. Realized gains (losses) included in oil and natural gas sales were \$301.4 million, (\$122.6) million, \$807.1 million and (\$126.6) million in the Current Quarter, Prior Quarter, Current Period and Prior Period, respectively. Pursuant to SFAS 133, certain derivatives do not qualify for designation as cash flow hedges. Changes in the fair value of these non-qualifying derivatives that occur prior to their maturity (i.e., temporary fluctuations in value) are reported currently in the condensed consolidated statements of operations as unrealized gains (losses) within oil and natural gas sales. Unrealized gains (losses) included in oil and natural gas sales were \$238.5 million, (\$104.0) million, \$452.6 million and (\$137.1) million in the Current Quarter, Prior Quarter, Current Period and Prior Period, respectively.

Following provisions of SFAS 133, changes in the fair value of derivative instruments designated as cash flow hedges, to the extent they are effective in offsetting cash flows attributable to the hedged risk, are recorded in other comprehensive income until the hedged item is recognized in earnings. Any change in fair value resulting from ineffectiveness is recognized currently in oil and natural gas sales as unrealized gains (losses). We recorded an unrealized gain (loss) on ineffectiveness of \$171.8 million, (\$99.5) million, \$336.7 million and (\$98.9) million in the Current Quarter, Prior Quarter, Current Period and Prior Period, respectively.

As of September 30, 2006, we had the following open oil and natural gas derivative instruments (excluding CNR derivatives assumed) designed to hedge a portion of our oil and natural gas production for periods after September 2006:

|                                            |             |                                                             |                                              |                                               |                                     |                   |                                                  | Fair<br>Value at<br>September 30,<br>2006<br>(\$ in<br>thousands) |
|--------------------------------------------|-------------|-------------------------------------------------------------|----------------------------------------------|-----------------------------------------------|-------------------------------------|-------------------|--------------------------------------------------|-------------------------------------------------------------------|
|                                            | Volume      | Weighted<br>Average Fixed<br>Price to be<br>Received (Paid) | Weighted<br>Average<br>Put<br>Fixed<br>Price | Weighted<br>Average<br>Call<br>Fixed<br>Price | Weighted<br>Average<br>Differential | SFAS 133<br>Hedge | Net Premiums<br>Received<br>(\$ in<br>thousands) |                                                                   |
| <b>Natural Gas (mmbtu):</b>                |             |                                                             |                                              |                                               |                                     |                   |                                                  |                                                                   |
| Swaps:                                     |             |                                                             |                                              |                                               |                                     |                   |                                                  |                                                                   |
| 4Q 2006                                    | 106,585,000 | \$ 9.68                                                     | \$                                           | \$                                            | \$                                  | Yes               | \$                                               | \$ 422,505                                                        |
| 1Q 2007                                    | 102,150,000 | 11.09                                                       |                                              |                                               |                                     | Yes               |                                                  | 336,329                                                           |
| 2Q 2007                                    | 78,715,000  | 9.18                                                        |                                              |                                               |                                     | Yes               |                                                  | 152,602                                                           |
| 3Q 2007                                    | 79,580,000  | 9.24                                                        |                                              |                                               |                                     | Yes               |                                                  | 142,030                                                           |
| 4Q 2007                                    | 79,580,000  | 9.90                                                        |                                              |                                               |                                     | Yes               |                                                  | 135,751                                                           |
| 1Q 2008                                    | 64,610,000  | 10.84                                                       |                                              |                                               |                                     | Yes               |                                                  | 114,992                                                           |
| 2Q 2008                                    | 64,610,000  | 8.45                                                        |                                              |                                               |                                     | Yes               |                                                  | 71,924                                                            |
| 3Q 2008                                    | 65,320,000  | 8.51                                                        |                                              |                                               |                                     | Yes               |                                                  | 67,639                                                            |
| 4Q 2008                                    | 65,320,000  | 9.15                                                        |                                              |                                               |                                     | Yes               |                                                  | 68,693                                                            |
| 1Q 2009                                    | 900,000     | 10.53                                                       |                                              |                                               |                                     | Yes               |                                                  | 1,551                                                             |
| 2Q 2009                                    | 910,000     | 8.29                                                        |                                              |                                               |                                     | Yes               |                                                  | 1,093                                                             |
| 3Q 2009                                    | 920,000     | 8.34                                                        |                                              |                                               |                                     | Yes               |                                                  | 1,026                                                             |
| 4Q 2009                                    | 920,000     | 8.95                                                        |                                              |                                               |                                     | Yes               |                                                  | 998                                                               |
| Basis Protection Swaps<br>(Mid-Continent): |             |                                                             |                                              |                                               |                                     |                   |                                                  |                                                                   |
| 4Q 2006                                    | 33,720,000  |                                                             |                                              |                                               | (0.32)                              | No                |                                                  | 13,446                                                            |
| 1Q 2007                                    | 32,850,000  |                                                             |                                              |                                               | (0.29)                              | No                |                                                  | 18,781                                                            |
| 2Q 2007                                    | 34,125,000  |                                                             |                                              |                                               | (0.35)                              | No                |                                                  | 13,449                                                            |
| 3Q 2007                                    | 34,500,000  |                                                             |                                              |                                               | (0.35)                              | No                |                                                  | 11,385                                                            |
| 4Q 2007                                    | 35,720,000  |                                                             |                                              |                                               | (0.32)                              | No                |                                                  | 25,796                                                            |
| 1Q 2008                                    | 33,215,000  |                                                             |                                              |                                               | (0.30)                              | No                |                                                  | 28,210                                                            |
| 2Q 2008                                    | 26,845,000  |                                                             |                                              |                                               | (0.25)                              | No                |                                                  | 15,241                                                            |
| 3Q 2008                                    | 27,140,000  |                                                             |                                              |                                               | (0.25)                              | No                |                                                  | 13,469                                                            |
| 4Q 2008                                    | 31,410,000  |                                                             |                                              |                                               | (0.28)                              | No                |                                                  | 18,293                                                            |
| 1Q 2009                                    | 26,100,000  |                                                             |                                              |                                               | (0.32)                              | No                |                                                  | 13,746                                                            |

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|         |            |        |    |       |
|---------|------------|--------|----|-------|
| 2Q 2009 | 20,020,000 | (0.28) | No | 1,906 |
| 3Q 2009 | 20,240,000 | (0.28) | No | 1,348 |
| 4Q 2009 | 20,240,000 | (0.28) | No | 4,726 |

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|                          |              |                                                             |                                              |                                               |                                     |                   |                                                  | Fair          |
|--------------------------|--------------|-------------------------------------------------------------|----------------------------------------------|-----------------------------------------------|-------------------------------------|-------------------|--------------------------------------------------|---------------|
|                          |              |                                                             |                                              |                                               |                                     |                   |                                                  | Value at      |
|                          |              |                                                             |                                              |                                               |                                     |                   |                                                  | September 30, |
|                          |              |                                                             |                                              |                                               |                                     |                   |                                                  | 2006          |
|                          |              |                                                             |                                              |                                               |                                     |                   |                                                  | (\$ in        |
|                          |              |                                                             |                                              |                                               |                                     |                   |                                                  | thousands)    |
|                          | Volume       | Weighted<br>Average Fixed<br>Price to be<br>Received (Paid) | Weighted<br>Average<br>Put<br>Fixed<br>Price | Weighted<br>Average<br>Call<br>Fixed<br>Price | Weighted<br>Average<br>Differential | SFAS 133<br>Hedge | Net Premiums<br>Received (\$<br>in<br>thousands) |               |
| Basis Protection Swaps   |              |                                                             |                                              |                                               |                                     |                   |                                                  |               |
| (Appalachian Basin):     |              |                                                             |                                              |                                               |                                     |                   |                                                  |               |
| 1Q 2007                  | 9,000,000    | \$                                                          | \$                                           | \$                                            | \$ 0.35                             | No                | \$                                               | \$ 273        |
| 2Q 2007                  | 9,100,000    |                                                             |                                              |                                               | 0.35                                | No                |                                                  | (462)         |
| 3Q 2007                  | 9,200,000    |                                                             |                                              |                                               | 0.35                                | No                |                                                  | (491)         |
| 4Q 2007                  | 9,200,000    |                                                             |                                              |                                               | 0.35                                | No                |                                                  | (55)          |
| 1Q 2008                  | 9,100,000    |                                                             |                                              |                                               | 0.35                                | No                |                                                  | 652           |
| 2Q 2008                  | 9,100,000    |                                                             |                                              |                                               | 0.35                                | No                |                                                  | (338)         |
| 3Q 2008                  | 9,200,000    |                                                             |                                              |                                               | 0.35                                | No                |                                                  | (365)         |
| 4Q 2008                  | 9,200,000    |                                                             |                                              |                                               | 0.35                                | No                |                                                  | (152)         |
| 1Q 2009                  | 4,500,000    |                                                             |                                              |                                               | 0.31                                | No                |                                                  | 205           |
| 2Q 2009                  | 4,550,000    |                                                             |                                              |                                               | 0.31                                | No                |                                                  | (108)         |
| 3Q 2009                  | 4,600,000    |                                                             |                                              |                                               | 0.31                                | No                |                                                  | (121)         |
| 4Q 2009                  | 4,600,000    |                                                             |                                              |                                               | 0.31                                | No                |                                                  | (2)           |
| Cap-Swaps:               |              |                                                             |                                              |                                               |                                     |                   |                                                  |               |
| 4Q 2006                  | 11,960,000   | 6.89                                                        | 5.13                                         |                                               |                                     | No                |                                                  | (1,869)       |
| 1Q 2007                  | 14,400,000   | 11.44                                                       | 5.73                                         |                                               |                                     | No                |                                                  | 28,620        |
| 2Q 2007                  | 19,110,000   | 9.57                                                        | 5.91                                         |                                               |                                     | No                |                                                  | 8,120         |
| 3Q 2007                  | 19,320,000   | 9.76                                                        | 5.91                                         |                                               |                                     | No                |                                                  | 2,402         |
| 4Q 2007                  | 19,320,000   | 10.56                                                       | 5.91                                         |                                               |                                     | No                |                                                  | 6,113         |
| 1Q 2008                  | 19,110,000   | 11.58                                                       | 6.18                                         |                                               |                                     | No                |                                                  | 11,135        |
| 2Q 2008                  | 19,110,000   | 10.00                                                       | 6.18                                         |                                               |                                     | No                |                                                  | 6,369         |
| 3Q 2008                  | 19,320,000   | 10.09                                                       | 6.18                                         |                                               |                                     | No                |                                                  | 3,863         |
| 4Q 2008                  | 19,320,000   | 10.65                                                       | 6.18                                         |                                               |                                     | No                |                                                  | 4,383         |
| Counter Swaps:           |              |                                                             |                                              |                                               |                                     |                   |                                                  |               |
| 4Q 2006                  | (36,605,000) | 5.27                                                        |                                              |                                               |                                     | No                |                                                  | 600           |
| 1Q 2007                  | (900,000)    | 7.53                                                        |                                              |                                               |                                     | No                |                                                  | 243           |
| 2Q 2007                  | (4,550,000)  | 7.09                                                        |                                              |                                               |                                     | No                |                                                  | 675           |
| 3Q 2007                  | (4,600,000)  | 7.31                                                        |                                              |                                               |                                     | No                |                                                  | 659           |
| 4Q 2007                  | (4,600,000)  | 8.03                                                        |                                              |                                               |                                     | No                |                                                  | 755           |
| 1Q 2008                  | (4,550,000)  | 8.84                                                        |                                              |                                               |                                     | No                |                                                  | 1,000         |
| 2Q 2008                  | (4,550,000)  | 7.14                                                        |                                              |                                               |                                     | No                |                                                  | 880           |
| 3Q 2008                  | (4,600,000)  | 7.28                                                        |                                              |                                               |                                     | No                |                                                  | 903           |
| 4Q 2008                  | (4,600,000)  | 7.90                                                        |                                              |                                               |                                     | No                |                                                  | 931           |
| Call Options:            |              |                                                             |                                              |                                               |                                     |                   |                                                  |               |
| 4Q 2006                  | 1,840,000    |                                                             |                                              | 12.50                                         |                                     | No                | 1,932                                            | (51)          |
| 1Q 2007                  | 6,300,000    |                                                             |                                              | 11.58                                         |                                     | No                | 1,890                                            | (2,575)       |
| 2Q 2007                  | 6,370,000    |                                                             |                                              | 9.96                                          |                                     | No                | 1,911                                            | (3,077)       |
| 3Q 2007                  | 6,440,000    |                                                             |                                              | 10.04                                         |                                     | No                | 1,932                                            | (4,835)       |
| 4Q 2007                  | 6,440,000    |                                                             |                                              | 10.56                                         |                                     | No                | 1,932                                            | (6,590)       |
| 1Q 2008                  | 1,820,000    |                                                             |                                              | 12.50                                         |                                     | No                | 1,911                                            | (1,997)       |
| 2Q 2008                  | 1,820,000    |                                                             |                                              | 12.50                                         |                                     | No                | 1,911                                            | (545)         |
| 3Q 2008                  | 1,840,000    |                                                             |                                              | 12.50                                         |                                     | No                | 1,932                                            | (773)         |
| 4Q 2008                  | 1,840,000    |                                                             |                                              | 12.50                                         |                                     | No                | 1,932                                            | (1,373)       |
| Locked Swaps:            |              |                                                             |                                              |                                               |                                     |                   |                                                  |               |
| 4Q 2006                  | 6,440,000    |                                                             |                                              |                                               |                                     | No                |                                                  | (4,706)       |
| 1Q 2007                  | 6,300,000    |                                                             |                                              |                                               |                                     | No                |                                                  | (4,789)       |
| 2Q 2007                  | 6,370,000    |                                                             |                                              |                                               |                                     | No                |                                                  | (2,517)       |
| 3Q 2007                  | 6,440,000    |                                                             |                                              |                                               |                                     | No                |                                                  | (2,049)       |
| 4Q 2007                  | 6,440,000    |                                                             |                                              |                                               |                                     | No                |                                                  | (2,272)       |
| <b>Total Natural Gas</b> |              |                                                             |                                              |                                               |                                     |                   | 17,283                                           | 1,733,598     |



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|                                  |           |                                                             |                                              |                                               |                                     |                   |                                                  | Fair<br>Value at<br>September 30,<br>2006<br>(\$ in<br>thousands) |
|----------------------------------|-----------|-------------------------------------------------------------|----------------------------------------------|-----------------------------------------------|-------------------------------------|-------------------|--------------------------------------------------|-------------------------------------------------------------------|
|                                  | Volume    | Weighted<br>Average Fixed<br>Price to be<br>Received (Paid) | Weighted<br>Average<br>Put<br>Fixed<br>Price | Weighted<br>Average<br>Call<br>Fixed<br>Price | Weighted<br>Average<br>Differential | SFAS 133<br>Hedge | Net Premiums<br>Received (\$<br>in<br>thousands) |                                                                   |
| <b>Oil (bbls):</b>               |           |                                                             |                                              |                                               |                                     |                   |                                                  |                                                                   |
| <b>Swaps:</b>                    |           |                                                             |                                              |                                               |                                     |                   |                                                  |                                                                   |
| 4Q 2006                          | 1,656,000 | \$ 65.38                                                    | \$                                           | \$                                            | \$                                  | Yes               | \$                                               | \$ 2,275                                                          |
| 1Q 2007                          | 1,350,000 | 67.98                                                       |                                              |                                               |                                     | Yes               |                                                  | 2,356                                                             |
| 2Q 2007                          | 1,092,000 | 70.04                                                       |                                              |                                               |                                     | Yes               |                                                  | 2,747                                                             |
| 3Q 2007                          | 1,104,000 | 69.71                                                       |                                              |                                               |                                     | Yes               |                                                  | 1,556                                                             |
| 4Q 2007                          | 1,104,000 | 69.31                                                       |                                              |                                               |                                     | Yes               |                                                  | 697                                                               |
| 1Q 2008                          | 1,001,000 | 70.44                                                       |                                              |                                               |                                     | Yes               |                                                  | 1,491                                                             |
| 2Q 2008                          | 1,001,000 | 70.02                                                       |                                              |                                               |                                     | Yes               |                                                  | 1,161                                                             |
| 3Q 2008                          | 1,012,000 | 69.60                                                       |                                              |                                               |                                     | Yes               |                                                  | 968                                                               |
| 4Q 2008                          | 920,000   | 68.79                                                       |                                              |                                               |                                     | Yes               |                                                  | 476                                                               |
| 1Q 2009                          | 45,000    | 66.64                                                       |                                              |                                               |                                     | Yes               |                                                  | (50)                                                              |
| 2Q 2009                          | 45,500    | 66.27                                                       |                                              |                                               |                                     | Yes               |                                                  | (47)                                                              |
| 3Q 2009                          | 46,000    | 65.92                                                       |                                              |                                               |                                     | Yes               |                                                  | (43)                                                              |
| 4Q 2009                          | 46,000    | 65.56                                                       |                                              |                                               |                                     | Yes               |                                                  | (40)                                                              |
| <b>Cap-Swaps:</b>                |           |                                                             |                                              |                                               |                                     |                   |                                                  |                                                                   |
| 4Q 2006                          | 184,000   | 68.02                                                       | 50.00                                        |                                               |                                     | No                |                                                  | 633                                                               |
| 1Q 2007                          | 360,000   | 78.53                                                       | 56.25                                        |                                               |                                     | No                |                                                  | 3,805                                                             |
| 2Q 2007                          | 364,000   | 78.53                                                       | 56.25                                        |                                               |                                     | No                |                                                  | 3,161                                                             |
| 3Q 2007                          | 368,000   | 78.53                                                       | 56.25                                        |                                               |                                     | No                |                                                  | 2,736                                                             |
| 4Q 2007                          | 368,000   | 78.53                                                       | 56.25                                        |                                               |                                     | No                |                                                  | 2,444                                                             |
| 1Q 2008                          | 273,000   | 77.60                                                       | 55.00                                        |                                               |                                     | No                |                                                  | 1,487                                                             |
| 2Q 2008                          | 273,000   | 77.60                                                       | 55.00                                        |                                               |                                     | No                |                                                  | 1,396                                                             |
| 3Q 2008                          | 276,000   | 77.60                                                       | 55.00                                        |                                               |                                     | No                |                                                  | 1,348                                                             |
| 4Q 2008                          | 276,000   | 77.60                                                       | 55.00                                        |                                               |                                     | No                |                                                  | 1,307                                                             |
| <b>Total Oil</b>                 |           |                                                             |                                              |                                               |                                     |                   |                                                  | 31,864                                                            |
| <b>Total Natural Gas and Oil</b> |           |                                                             |                                              |                                               |                                     |                   | \$ 17,283                                        | \$ 1,765,462                                                      |

We have established the fair value of all derivative instruments using estimates of fair value reported by our counterparties and subsequently evaluated internally using established index prices and other sources. The actual contribution to our future results of operations will be based on the market prices at the time of settlement and may be more or less than the fair value estimates used at September 30, 2006.

Based upon the market prices at September 30, 2006, we expect to transfer approximately \$530.2 million (net of income taxes) of the gain included in the balance in accumulated other comprehensive income to earnings during the next 12 months in the related month of production. All transactions hedged as of September 30, 2006 are expected to mature by December 31, 2009.

Additional information concerning the fair value of our oil and natural gas derivative instruments, including CNR derivatives assumed, is as follows:

|                                                                | 2006<br>(\$ in thousands) |
|----------------------------------------------------------------|---------------------------|
| Fair value of contracts outstanding, as of January 1           | \$ (945,814)              |
| Change in fair value of contracts during the period            | 3,261,182                 |
| Fair value of contracts when entered into during the period    | (32,300)                  |
| Contracts realized or otherwise settled during the period      | (807,074)                 |
| <b>Fair value of contracts outstanding, as of September 30</b> | <b>\$ 1,475,994</b>       |

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The change in the fair value of our derivative instruments since January 1, 2006 resulted from the settlement of derivatives for a realized gain, as well as a decrease in natural gas prices. Derivative instruments reflected as current in the condensed consolidated balance sheet represent the estimated fair value of derivative instrument settlements scheduled to occur over the subsequent twelve-month period based on market prices for oil and natural gas as of the condensed consolidated balance sheet date. The derivative settlement amounts are not due and payable until the month in which the related underlying hedged transaction occurs.

We assumed certain liabilities related to open derivative positions in connection with our acquisition of Columbia Natural Resources, LLC in November 2005. In accordance with SFAS 141, these derivative positions were recorded at fair value in the purchase price allocation as a liability of \$592 million. The recognition of the derivative liability and other assumed liabilities resulted in an increase in the total purchase price which was allocated to the assets acquired. Because of this accounting treatment, only cash settlements for changes in fair value subsequent to the acquisition date for the derivative positions assumed result in adjustments to our oil and natural gas revenues upon settlement. For example, if the fair value of the derivative positions assumed do not change then upon the sale of the underlying production and corresponding settlement of the derivative positions, cash would be paid to the counterparties and there would be no adjustment to oil and natural gas revenues related to the derivative positions. If, however, the actual sales price is different from the price assumed in the original fair value calculation, the difference would be reflected as either a decrease or increase in oil and natural gas revenues, depending upon whether the sales price was higher or lower, respectively, than the prices assumed in the original fair value calculation. For accounting purposes, the net effect of these acquired hedges is that we hedged the production volumes at market prices on the date of our acquisition of CNR.

Pursuant to Statement of Financial Accounting Standards No. 149, *Amendment of SFAS 133 on Derivative Instruments and Hedging Activities*, the derivative instruments assumed in connection with the CNR acquisition are deemed to contain a significant financing element and all cash flows associated with these positions are reported as financing activity in the statement of cash flows for the periods in which settlement occurs.

The following details the assumed CNR derivatives remaining as of September 30, 2006:

|                             |            |                                                                   |                                              |                                            |                   | Fair                                                          |
|-----------------------------|------------|-------------------------------------------------------------------|----------------------------------------------|--------------------------------------------|-------------------|---------------------------------------------------------------|
|                             |            | Weighted<br>Average<br>Fixed<br>Price to be<br>Received<br>(Paid) | Weighted<br>Average<br>Put<br>Fixed<br>Price | Weighted<br>Average<br>Call Fixed<br>Price | SFAS 133<br>Hedge | Value at<br>September 30,<br>2006<br><br>(\$ in<br>thousands) |
| <b>Natural Gas (mmbtu):</b> |            |                                                                   |                                              |                                            |                   |                                                               |
| Swaps:                      |            |                                                                   |                                              |                                            |                   |                                                               |
| 4Q 2006                     | 10,626,000 | \$ 4.86                                                           | \$                                           | \$                                         | Yes               | \$ (9,313)                                                    |
| 1Q 2007                     | 10,350,000 | 4.82                                                              |                                              |                                            | Yes               | (30,297)                                                      |
| 2Q 2007                     | 10,465,000 | 4.82                                                              |                                              |                                            | Yes               | (24,548)                                                      |
| 3Q 2007                     | 10,580,000 | 4.82                                                              |                                              |                                            | Yes               | (26,672)                                                      |
| 4Q 2007                     | 10,580,000 | 4.82                                                              |                                              |                                            | Yes               | (33,722)                                                      |
| 1Q 2008                     | 9,555,000  | 4.68                                                              |                                              |                                            | Yes               | (39,074)                                                      |
| 2Q 2008                     | 9,555,000  | 4.68                                                              |                                              |                                            | Yes               | (23,387)                                                      |
| 3Q 2008                     | 9,660,000  | 4.68                                                              |                                              |                                            | Yes               | (24,581)                                                      |
| 4Q 2008                     | 9,660,000  | 4.66                                                              |                                              |                                            | Yes               | (29,997)                                                      |
| 1Q 2009                     | 4,500,000  | 5.18                                                              |                                              |                                            | Yes               | (14,498)                                                      |
| 2Q 2009                     | 4,550,000  | 5.18                                                              |                                              |                                            | Yes               | (7,627)                                                       |
| 3Q 2009                     | 4,600,000  | 5.18                                                              |                                              |                                            | Yes               | (8,162)                                                       |
| 4Q 2009                     | 4,600,000  | 5.18                                                              |                                              |                                            | Yes               | (10,574)                                                      |
| Collars:                    |            |                                                                   |                                              |                                            |                   |                                                               |
| 1Q 2009                     | 900,000    |                                                                   | 4.50                                         | 6.00                                       | Yes               | (2,538)                                                       |
| 2Q 2009                     | 910,000    |                                                                   | 4.50                                         | 6.00                                       | Yes               | (1,268)                                                       |
| 3Q 2009                     | 920,000    |                                                                   | 4.50                                         | 6.00                                       | Yes               | (1,375)                                                       |
| 4Q 2009                     | 920,000    |                                                                   | 4.50                                         | 6.00                                       | Yes               | (1,835)                                                       |
| <b>Total Natural Gas</b>    |            |                                                                   |                                              |                                            |                   | <b>\$ (289,468)</b>                                           |

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Subsequent to September 30, 2006, Chesapeake lifted a portion of its fourth quarter 2006 and full-year 2007, 2008 and 2009 hedges and as a result received \$407 million in cash from its hedging counterparties. The gain will be recorded in accumulated other comprehensive income and in unrealized oil and natural gas sales based on the designation of the hedges. The gain will be recognized in realized oil and natural gas sales in the month of the hedged production.

*Interest Rate Risk*

The table below presents principal cash flows and related weighted average interest rates by expected maturity dates. As of September 30, 2006, the fair value of the fixed-rate long-term debt has been estimated based on quoted market prices.

|                       |                | 2006 | 2007 | 2008 | 2009 | Years of Maturity<br>2010    Thereafter<br>(\$ in billions) |       | Total    | Fair Value |
|-----------------------|----------------|------|------|------|------|-------------------------------------------------------------|-------|----------|------------|
| <b>Liabilities:</b>   |                |      |      |      |      |                                                             |       |          |            |
| Long-term debt        | fixed-rate (a) | \$   | \$   | \$   | \$   | \$                                                          | 6.525 | \$ 6.525 | \$ 6.317   |
| Average interest rate |                |      |      |      |      |                                                             | 6.4%  | 6.4%     | 6.4%       |
| Long-term debt        | variable rate  | \$   | \$   | \$   | \$   | \$                                                          | 1.464 | \$ 1.464 | \$ 1.464   |
| Average interest rate |                |      |      |      |      |                                                             | 6.5%  | 6.5%     | 6.5%       |

(a) This amount does not include the discount included in long-term debt of (\$103.9) million and the discount for interest rate swaps of (\$23.6) million.

Changes in interest rates affect the amount of interest we earn on our cash, cash equivalents and short-term investments and the interest rate we pay on borrowings under our revolving bank credit facility. All of our other long-term indebtedness is fixed rate and, therefore, does not expose us to the risk of earnings or cash flow loss due to changes in market interest rates. However, changes in interest rates do affect the fair value of our debt.

*Interest Rate Derivatives*

We use interest rate derivatives to mitigate our exposure to the volatility in interest rates. For interest rate derivative instruments designated as fair value hedges (in accordance with SFAS 133), changes in fair value are recorded on the condensed consolidated balance sheets as assets (liabilities), and the debt's carrying value amount is adjusted by the change in the fair value of the debt subsequent to the initiation of the derivative. Changes in the fair value of derivative instruments not qualifying as fair value hedges are recorded currently as adjustments to interest expense.

Gains or losses from certain derivative transactions are reflected as adjustments to interest expense on the condensed consolidated statements of operations. Realized gains (losses) included in interest expense were (\$1.6) million, \$0.8 million, \$0.9 million and \$2.6 million in the Current Quarter, Prior Quarter, Current Period and Prior Period, respectively. Pursuant to SFAS 133, certain derivatives do not qualify for designation as fair value hedges. Changes in the fair value of these non-qualifying derivatives that occur prior to their maturity (i.e., temporary fluctuations in value) are reported currently in the condensed consolidated statements of operations as unrealized gains (losses) within interest expense.

Unrealized gains (losses) included in interest expense were \$2.5 million, (\$1.2) million, \$0.8 million and \$1.9 million, in the Current Quarter, Prior Quarter, Current Period and Prior Period, respectively.

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As of September 30, 2006, the following interest rate swaps used to convert a portion of our long-term fixed-rate debt to floating-rate debt were outstanding:

| Term           |              | Notional<br>Amount | Fixed<br>Rate | Floating Rate                         | Fair Value<br>(\$ in thousands) |
|----------------|--------------|--------------------|---------------|---------------------------------------|---------------------------------|
| September 2004 | August 2012  | \$ 75,000,000      | 9.000%        | 6 month LIBOR plus 452 basis points   | \$ (2,919)                      |
| July 2005      | January 2015 | \$ 150,000,000     | 7.750%        | 6 month LIBOR plus 289 basis points   | (6,301)                         |
| July 2005      | June 2014    | \$ 150,000,000     | 7.500%        | 6 month LIBOR plus 282 basis points   | (6,456)                         |
| September 2005 | August 2014  | \$ 250,000,000     | 7.000%        | 6 month LIBOR plus 205.5 basis points | (7,305)                         |
| October 2005   | June 2015    | \$ 200,000,000     | 6.375%        | 6 month LIBOR plus 112 basis points   | (3,308)                         |
| October 2005   | January 2018 | \$ 250,000,000     | 6.250%        | 6 month LIBOR plus 99 basis points    | (7,124)                         |
| January 2006   | January 2016 | \$ 250,000,000     | 6.625%        | 6 month LIBOR plus 129 basis points   | (3,178)                         |
| March 2006     | January 2016 | \$ 250,000,000     | 6.875%        | 6 month LIBOR plus 120 basis points   | (172)                           |
|                |              |                    |               |                                       | \$ (36,763)                     |

In the Current Period, we closed three interest rate swaps for gains totaling \$3.0 million. These interest rate swaps were designated as fair value hedges, and the settlement amounts received will be amortized as a reduction to realized interest expense over the remaining terms of the related senior notes.

To mitigate our short-term exposure to rising interest rates on a portion of our long-term debt that has been converted to floating-rate, we have entered into zero-cost collar transactions. These collars contain a fixed floor rate (put) and fixed ceiling rate (call). If LIBOR exceeds the ceiling rate or falls below the floor rate, Chesapeake pays the fixed rate and receives LIBOR. If LIBOR is between the ceiling and floor rates, no payments are due from either party. As of September 30, 2006, we were a party to the following zero-cost interest rate collars:

| Payment Dates               | Notional Amount | LIBOR Floor | LIBOR Ceiling |
|-----------------------------|-----------------|-------------|---------------|
| July 2007 - January 2010    | \$150,000,000   | 4.53%       | 5.37%         |
| June 2007 - December 2009   | \$150,000,000   | 4.53%       | 5.37%         |
| August 2007 - February 2010 | \$250,000,000   | 4.53%       | 5.37%         |
| July 2007 - January 2010    | \$250,000,000   | 4.53%       | 5.37%         |

### ITEM 4. Controls and Procedures

We maintain disclosure controls and procedures designed to ensure that information required to be disclosed by Chesapeake in reports filed or submitted by it under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms, and that such information is accumulated and communicated to management, including our principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. At the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of Chesapeake management, including Chesapeake's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of Chesapeake's disclosure controls and procedures pursuant to Securities Exchange Act Rule 13a-15(b). Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective.

No changes in Chesapeake's internal control over financial reporting occurred during the Current Quarter that have materially affected, or are reasonably likely to materially affect, Chesapeake's internal control over financial reporting.

**Table of Contents****PART II. OTHER INFORMATION****Item 1. Legal Proceedings**

Chesapeake is currently involved in various disputes incidental to its business operations. Management is of the opinion that the final resolution of currently pending or threatened litigation is not likely to have a material adverse effect on our consolidated financial position, results of operations or cash flows.

**Item 1A. Risk Factors**

Our business has many risks. Factors that could materially adversely affect our business, financial condition, operating results or liquidity and the trading price of our common stock, preferred stock or senior notes are described under **Risk Factors** in Item 1A of our annual report on Form 10-K for the year ended December 31, 2005. This information should be considered carefully, together with other information in this report and other reports and materials we file with the Securities and Exchange Commission.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

On September 29, 2006, we issued 1,375,989 shares of our common stock to Altoma Energy, an Oklahoma general partnership, in exchange for 40,000 shares of common stock of Chaparral Energy, Inc. The Chesapeake shares were valued at \$40 million, based on the average closing price during a ten trading-day period beginning September 13, 2006, and were issued in a private offering without registration under the Securities Act of 1933 in reliance on the exemption provided in Section 4(2) of such Act.

The following table presents information about repurchases of our common stock during the three months ended September 30, 2006:

| Period                                       | Total Number of           |                                       |                                                       |                                                       |
|----------------------------------------------|---------------------------|---------------------------------------|-------------------------------------------------------|-------------------------------------------------------|
|                                              | Total Number<br>of Shares | Average<br>Price Paid<br>Per Share(a) | Shares                                                | Maximum Number                                        |
|                                              |                           |                                       | Purchased                                             | of Shares That May                                    |
|                                              |                           |                                       | as Part of Publicly<br>Announced Plans<br>or Programs | Yet Be Purchased<br>Under the Plans<br>or Programs(b) |
| July 1, 2006 through July 31, 2006           | 163,509                   | \$ 29.916                             |                                                       |                                                       |
| August 1, 2006 through August 31, 2006       | 14,645                    | 32.411                                |                                                       |                                                       |
| September 1, 2006 through September 30, 2006 | 2,338                     | 28.980                                |                                                       |                                                       |
| Total                                        | 180,492                   | \$ 30.106                             |                                                       |                                                       |

- (a) Includes 32 shares purchased in the open market for the matching contributions we make to our 401(k) plans, the deemed surrender to the company of 9,587 shares of common stock to pay the exercise price in connection with the exercise of employee stock options and the surrender to the company of 170,873 shares of common stock to pay withholding taxes in connection with the vesting of employee restricted stock.
- (b) We make matching contributions to our 401(k) plans and 401(k) make-up plan using Chesapeake common stock which is held in treasury or is purchased by the respective plan trustees in the open market. The plans contain no limitation on the number of shares that may be purchased for purposes of company contributions.

**Item 3. Defaults Upon Senior Securities**

Not applicable.

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### **Item 4. *Submission of Matters to a Vote of Security Holders***

Not applicable.

### **Item 5. *Other Information***

Not applicable.

### **Item 6. *Exhibits***

The following exhibits are filed as a part of this report:

#### **Exhibit**

| <b>Number</b> | <b>Description</b>                                                                                                                                                                                                                                                                                           |
|---------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 3.1.1         | Restated Certificate of Incorporation, as amended. Incorporated herein by reference to Exhibit 3.1.1 to Chesapeake's quarterly report on Form 10-Q for the quarter ended June 30, 2006.                                                                                                                      |
| 3.1.2         | Certificate of Designation for Series A Junior Participating Preferred Stock, as amended. Incorporated herein by reference to Exhibit 3.1.2 to Chesapeake's quarterly report on Form 10-Q for the quarter ended June 30, 2006.                                                                               |
| 3.1.3         | Certificate of Designation of 5% Cumulative Convertible Preferred Stock (Series 2003), as amended. Incorporated herein by reference to Exhibit 3.1.3 Chesapeake's quarterly report on Form 10-Q for the quarter ended June 30, 2006.                                                                         |
| 3.1.4         | Certificate of Designation of 4.125% Cumulative Convertible Preferred Stock, as amended. Incorporated herein by reference to Exhibit 3.1.4 to Chesapeake's quarterly report on Form 10-Q for the quarter ended June 30, 2006.                                                                                |
| 3.1.5         | Certificate of Designation of 5% Cumulative Convertible Preferred Stock (Series 2005B). Incorporated herein by reference to Exhibit 3.1 to Chesapeake's current report on Form 8-K filed November 9, 2005.                                                                                                   |
| 3.1.6         | Certificate of Designation of 5% Cumulative Convertible Preferred Stock (Series 2005), as amended. Incorporated herein by reference to Exhibit 3.1.6 to Chesapeake's Form 10-Q for the quarter ended March 31, 2005.                                                                                         |
| 3.1.7         | Certificate of Designation of 4.5% Cumulative Convertible Preferred Stock. Incorporated herein by reference to Exhibit 3.1 to Chesapeake's current report on Form 8-K filed September 15, 2005.                                                                                                              |
| 3.2           | Bylaws, as amended and restated. Incorporated herein by reference to Exhibit 3.2 to Chesapeake's annual report on Form 10-K for the year ended December 31, 2003.                                                                                                                                            |
| 4.1.1*        | Eighth Supplemental Indenture dated as of October 18, 2006 to Indenture dated as of May 27, 2004 among Chesapeake, as issuer, its subsidiaries signatory thereto, as Subsidiary Guarantors, and The Bank of New York Trust Company, N.A., as Trustee, with respect to the 7.50% senior notes due 2014.       |
| 4.2.1*        | Eighth Supplemental Indenture dated as of October 18, 2006 to Indenture dated as of August 2, 2004 among Chesapeake, as issuer, its subsidiaries signatory thereto, as Subsidiary Guarantors, and The Bank of New York Trust Company, N.A., as Trustee, with respect to the 7.00% senior notes due 2014.     |
| 4.3.1*        | Twelfth Supplemental Indenture dated as of October 18, 2006 to Indenture dated as of December 20, 2002 among Chesapeake, as issuer, its subsidiaries signatory thereto, as Subsidiary Guarantors, and The Bank of New York Trust Company, N.A., as Trustee, with respect to the 7.75% senior notes due 2015. |

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### **Exhibit**

| <b>Number</b> | <b>Description</b>                                                                                                                                                                                                                                                                                                                |
|---------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 4.5.1*        | Commitment Increase Agreement dated September 1, 2006, by and among Chesapeake Energy Corporation, Chesapeake Exploration Limited Partnership and Chesapeake Appalachia, L.L.C., as Co-Borrowers, Union Bank of California, N.A., as administrative agent and the several lenders party thereto.                                  |
| 4.6.1*        | Eleventh Supplemental Indenture dated as of October 18, 2006 to Indenture dated as of March 5, 2003 among Chesapeake, as issuer, its subsidiaries signatory thereto, as Subsidiary Guarantors, and The Bank of New York Trust Company, N.A., as Trustee, with respect to the 7.50% senior notes due 2013.                         |
| 4.7.1*        | Ninth Supplemental Indenture dated as of October 18, 2006 to Indenture dated as of November 26, 2003 among Chesapeake, as issuer, its subsidiaries signatory thereto, as Subsidiary Guarantors, and The Bank of New York Trust Company, N.A., as Trustee, with respect to the 6.875% senior notes due 2016.                       |
| 4.8.1*        | Seventh Supplemental Indenture dated as of October 18, 2006 to Indenture dated as of December 8, 2004 among Chesapeake, as issuer, its subsidiaries signatory thereto, as Subsidiary Guarantors, and The Bank of New York Trust Company, N.A., as Trustee, with respect to the 6.375% senior notes due 2015.                      |
| 4.9.1*        | Fifth Supplemental Indenture dated as of October 18, 2006 to Indenture dated as of April 19, 2005 among Chesapeake, as issuer, its subsidiaries signatory thereto, as Subsidiary Guarantors, and The Bank of New York Trust Company, N.A., as Trustee, with respect to the 6.625% senior notes due 2016.                          |
| 4.10.1*       | Fourth Supplemental Indenture dated as of October 18, 2006 to Indenture dated as of June 20, 2005 among Chesapeake, as issuer, its subsidiaries signatory thereto, as Subsidiary Guarantors, and The Bank of New York Trust Company, N.A., as Trustee, with respect to the 6.25% senior notes due 2018.                           |
| 4.11.1*       | Fifth Supplemental Indenture dated as of October 18, 2006 to Indenture dated as of August 16, 2005 among Chesapeake, as issuer, its subsidiaries signatory thereto, as Subsidiary Guarantors, and The Bank of New York Trust Company, N.A., as Trustee, with respect to the 6.50% senior notes due 2017.                          |
| 4.12.1*       | Fourth Supplemental Indenture dated as of October 18, 2006 to Indenture dated as of November 8, 2005 among Chesapeake, as issuer, its subsidiaries signatory thereto, as Subsidiary Guarantors, and The Bank of New York Trust Company, N.A., as Trustee, with respect to the 6.875% senior notes due 2020.                       |
| 4.13.1*       | Fourth Supplemental Indenture dated as of October 18, 2006 to Indenture dated as of November 8, 2005 among Chesapeake, as issuer, its subsidiaries signatory thereto, as Subsidiary Guarantors, and The Bank of New York Trust Company, N.A., as Trustee, with respect to the 2.75% contingent convertible senior notes due 2035. |
| 4.14.1*       | First Supplemental Indenture dated as of October 18, 2006 to Indenture dated as of June 30, 2006 among Chesapeake, as issuer, its subsidiaries signatory thereto, as Subsidiary Guarantors, and The Bank of New York Trust Company, N.A., as Trustee, with respect to the 7.625% senior notes due 2013.                           |
| 10.1.1 *      | Chesapeake s 2003 Stock Incentive Plan, as amended.                                                                                                                                                                                                                                                                               |
| 10.1.3 *      | Chesapeake s 1994 Stock Option Plan, as amended.                                                                                                                                                                                                                                                                                  |
| 10.1.4 *      | Chesapeake s 1996 Stock Option Plan, as amended.                                                                                                                                                                                                                                                                                  |
| 10.1.5 *      | Chesapeake s 1999 Stock Option Plan, as amended.                                                                                                                                                                                                                                                                                  |

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### **Exhibit**

| <b>Number</b> | <b>Description</b>                                                                                                                                                                                                                   |
|---------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 10.1.6 *      | Chesapeake s 2000 Employee Stock Option Plan, as amended.                                                                                                                                                                            |
| 10.1.8 *      | Chesapeake s 2001 Stock Option Plan, as amended.                                                                                                                                                                                     |
| 10.1.10 *     | Chesapeake s 2001 Nonqualified Stock Option Plan, as amended.                                                                                                                                                                        |
| 10.1.11 *     | Chesapeake s 2002 Stock Option Plan, as amended.                                                                                                                                                                                     |
| 10.1.13 *     | Chesapeake s 2002 Nonqualified Stock Option Plan, as amended.                                                                                                                                                                        |
| 10.2.2        | Employment Agreement dated as of October 1, 2006 between Marcus C. Rowland and Chesapeake Energy Corporation. Incorporated herein by reference to Exhibit 10.2.2 to Chesapeake s current report on Form 8-K filed October 5, 2006.   |
| 10.2.3        | Employment Agreement dated as of October 1, 2006 between Steven C. Dixon and Chesapeake Energy Corporation. Incorporated herein by reference to Exhibit 10.2.3 to Chesapeake s current report on Form 8-K filed October 5, 2006.     |
| 10.2.4        | Employment Agreement dated as of October 1, 2006 between J. Mark Lester and Chesapeake Energy Corporation. Incorporated herein by reference to Exhibit 10.2.4 to Chesapeake s current report on Form 8-K filed October 5, 2006.      |
| 10.2.5        | Employment Agreement dated as of October 1, 2006 between Douglas J. Jacobson and Chesapeake Energy Corporation. Incorporated herein by reference to Exhibit 10.2.5 to Chesapeake s current report on Form 8-K filed October 5, 2006. |
| 10.2.6        | Employment Agreement dated as of October 1, 2006 between Martha A. Burger and Chesapeake Energy Corporation. Incorporated herein by reference to Exhibit 10.2.6 to Chesapeake s current report on Form 8-K filed October 5, 2006.    |
| 10.2.7        | Employment Agreement dated as of October 1, 2006 between Henry J. Hood and Chesapeake Energy Corporation. Incorporated herein by reference to Exhibit 10.2.7 to Chesapeake s current report on Form 8-K filed October 5, 2006.       |
| 10.2.8        | Employment Agreement dated as of October 1, 2006 between Michael A. Johnson and Chesapeake Energy Corporation. Incorporated herein by reference to Exhibit 10.2.8 to Chesapeake s current report on Form 8-K filed October 5, 2006.  |
| 12*           | Computation of Ratios of Earnings to Combined Fixed Charges and Preferred Stock Dividends.                                                                                                                                           |
| 31.1*         | Aubrey K. McClendon, Chairman and Chief Executive Officer, Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.                                                                                                  |
| 31.2*         | Marcus C. Rowland, Executive Vice President and Chief Financial Officer, Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.                                                                                    |
| 32.1*         | Aubrey K. McClendon, Chairman and Chief Executive Officer, Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.                                                                                                  |
| 32.2*         | Marcus C. Rowland, Executive Vice President and Chief Financial Officer, Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.                                                                                    |

\* Filed herewith.  
Management contract or compensatory plan or arrangement

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**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  
(Registrant)

By: /s/ AUBREY K. McCLENDON  
Aubrey K. McClendon

**Chairman of the Board and**

**Chief Executive Officer**

By: /s/ MARCUS C. ROWLAND  
Marcus C. Rowland

**Executive Vice President and**

**Chief Financial Officer**

Date: November 7, 2006

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**INDEX TO EXHIBITS**

**Exhibit**

| <b>Number</b> | <b>Description</b>                                                                                                                                                                                                                                                                                           |
|---------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 3.1.1         | Restated Certificate of Incorporation, as amended. Incorporated herein by reference to Exhibit 3.1.1 to Chesapeake's quarterly report on Form 10-Q for the quarter ended June 30, 2006.                                                                                                                      |
| 3.1.2         | Certificate of Designation for Series A Junior Participating Preferred Stock, as amended. Incorporated herein by reference to Exhibit 3.1.2 to Chesapeake's quarterly report on Form 10-Q for the quarter ended June 30, 2006.                                                                               |
| 3.1.3         | Certificate of Designation of 5% Cumulative Convertible Preferred Stock (Series 2003), as amended. Incorporated herein by reference to Exhibit 3.1.3 Chesapeake's quarterly report on Form 10-Q for the quarter ended June 30, 2006.                                                                         |
| 3.1.4         | Certificate of Designation of 4.125% Cumulative Convertible Preferred Stock, as amended. Incorporated herein by reference to Exhibit 3.1.4 to Chesapeake's quarterly report on Form 10-Q for the quarter ended June 30, 2006.                                                                                |
| 3.1.5         | Certificate of Designation of 5% Cumulative Convertible Preferred Stock (Series 2005B). Incorporated herein by reference to Exhibit 3.1 to Chesapeake's current report on Form 8-K filed November 9, 2005.                                                                                                   |
| 3.1.6         | Certificate of Designation of 5% Cumulative Convertible Preferred Stock (Series 2005), as amended. Incorporated herein by reference to Exhibit 3.1.6 to Chesapeake's Form 10-Q for the quarter ended March 31, 2005.                                                                                         |
| 3.1.7         | Certificate of Designation of 4.5% Cumulative Convertible Preferred Stock. Incorporated herein by reference to Exhibit 3.1 to Chesapeake's current report on Form 8-K filed September 15, 2005.                                                                                                              |
| 3.2           | Bylaws, as amended and restated. Incorporated herein by reference to Exhibit 3.2 to Chesapeake's annual report on Form 10-K for the year ended December 31, 2003.                                                                                                                                            |
| 4.1.1*        | Eighth Supplemental Indenture dated as of October 18, 2006 to Indenture dated as of May 27, 2004 among Chesapeake, as issuer, its subsidiaries signatory thereto, as Subsidiary Guarantors, and The Bank of New York Trust Company, N.A., as Trustee, with respect to the 7.50% senior notes due 2014.       |
| 4.2.1*        | Eighth Supplemental Indenture dated as of October 18, 2006 to Indenture dated as of August 2, 2004 among Chesapeake, as issuer, its subsidiaries signatory thereto, as Subsidiary Guarantors, and The Bank of New York Trust Company, N.A., as Trustee, with respect to the 7.00% senior notes due 2014.     |
| 4.3.1*        | Twelfth Supplemental Indenture dated as of October 18, 2006 to Indenture dated as of December 20, 2002 among Chesapeake, as issuer, its subsidiaries signatory thereto, as Subsidiary Guarantors, and The Bank of New York Trust Company, N.A., as Trustee, with respect to the 7.75% senior notes due 2015. |
| 4.5.1*        | Commitment Increase Agreement dated September 1, 2006, by and among Chesapeake Energy Corporation, Chesapeake Exploration Limited Partnership and Chesapeake Appalachia, L.L.C., as Co-Borrowers, Union Bank of California, N.A., as administrative agent and the several lenders party thereto.             |
| 4.6.1*        | Eleventh Supplemental Indenture dated as of October 18, 2006 to Indenture dated as of March 5, 2003 among Chesapeake, as issuer, its subsidiaries signatory thereto, as Subsidiary Guarantors, and The Bank of New York Trust Company, N.A., as Trustee, with respect to the 7.50% senior notes due 2013.    |

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| <b>Exhibit</b> |                                                                                                                                                                                                                                                                                                                                   |
|----------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Number</b>  | <b>Description</b>                                                                                                                                                                                                                                                                                                                |
| 4.7.1*         | Ninth Supplemental Indenture dated as of October 18, 2006 to Indenture dated as of November 26, 2003 among Chesapeake, as issuer, its subsidiaries signatory thereto, as Subsidiary Guarantors, and The Bank of New York Trust Company, N.A., as Trustee, with respect to the 6.875% senior notes due 2016.                       |
| 4.8.1*         | Seventh Supplemental Indenture dated as of October 18, 2006 to Indenture dated as of December 8, 2004 among Chesapeake, as issuer, its subsidiaries signatory thereto, as Subsidiary Guarantors, and The Bank of New York Trust Company, N.A., as Trustee, with respect to the 6.375% senior notes due 2015.                      |
| 4.9.1*         | Fifth Supplemental Indenture dated as of October 18, 2006 to Indenture dated as of April 19, 2005 among Chesapeake, as issuer, its subsidiaries signatory thereto, as Subsidiary Guarantors, and The Bank of New York Trust Company, N.A., as Trustee, with respect to the 6.625% senior notes due 2016.                          |
| 4.10.1*        | Fourth Supplemental Indenture dated as of October 18, 2006 to Indenture dated as of June 20, 2005 among Chesapeake, as issuer, its subsidiaries signatory thereto, as Subsidiary Guarantors, and The Bank of New York Trust Company, N.A., as Trustee, with respect to the 6.25% senior notes due 2018.                           |
| 4.11.1*        | Fifth Supplemental Indenture dated as of October 18, 2006 to Indenture dated as of August 16, 2005 among Chesapeake, as issuer, its subsidiaries signatory thereto, as Subsidiary Guarantors, and The Bank of New York Trust Company, N.A., as Trustee, with respect to the 6.50% senior notes due 2017.                          |
| 4.12.1*        | Fourth Supplemental Indenture dated as of October 18, 2006 to Indenture dated as of November 8, 2005 among Chesapeake, as issuer, its subsidiaries signatory thereto, as Subsidiary Guarantors, and The Bank of New York Trust Company, N.A., as Trustee, with respect to the 6.875% senior notes due 2020.                       |
| 4.13.1*        | Fourth Supplemental Indenture dated as of October 18, 2006 to Indenture dated as of November 8, 2005 among Chesapeake, as issuer, its subsidiaries signatory thereto, as Subsidiary Guarantors, and The Bank of New York Trust Company, N.A., as Trustee, with respect to the 2.75% contingent convertible senior notes due 2035. |
| 4.14.1*        | First Supplemental Indenture dated as of October 18, 2006 to Indenture dated as of June 30, 2006 among Chesapeake, as issuer, its subsidiaries signatory thereto, as Subsidiary Guarantors, and The Bank of New York Trust Company, N.A., as Trustee, with respect to the 7.625% senior notes due 2013.                           |
| 10.1.1 *       | Chesapeake s 2003 Stock Incentive Plan, as amended.                                                                                                                                                                                                                                                                               |
| 10.1.3 *       | Chesapeake s 1994 Stock Option Plan, as amended.                                                                                                                                                                                                                                                                                  |
| 10.1.4 *       | Chesapeake s 1996 Stock Option Plan, as amended.                                                                                                                                                                                                                                                                                  |
| 10.1.5 *       | Chesapeake s 1999 Stock Option Plan, as amended.                                                                                                                                                                                                                                                                                  |
| 10.1.6 *       | Chesapeake s 2000 Employee Stock Option Plan, as amended.                                                                                                                                                                                                                                                                         |
| 10.1.8 *       | Chesapeake s 2001 Stock Option Plan, as amended.                                                                                                                                                                                                                                                                                  |
| 10.1.10 *      | Chesapeake s 2001 Nonqualified Stock Option Plan, as amended.                                                                                                                                                                                                                                                                     |
| 10.1.11 *      | Chesapeake s 2002 Stock Option Plan, as amended.                                                                                                                                                                                                                                                                                  |
| 10.1.13 *      | Chesapeake s 2002 Nonqualified Stock Option Plan, as amended.                                                                                                                                                                                                                                                                     |

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### **Exhibit**

| <b>Number</b> | <b>Description</b>                                                                                                                                                                                                                   |
|---------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 10.2.2        | Employment Agreement dated as of October 1, 2006 between Marcus C. Rowland and Chesapeake Energy Corporation. Incorporated herein by reference to Exhibit 10.2.2 to Chesapeake's current report on Form 8-K filed October 5, 2006.   |
| 10.2.3        | Employment Agreement dated as of October 1, 2006 between Steven C. Dixon and Chesapeake Energy Corporation. Incorporated herein by reference to Exhibit 10.2.3 to Chesapeake's current report on Form 8-K filed October 5, 2006.     |
| 10.2.4        | Employment Agreement dated as of October 1, 2006 between J. Mark Lester and Chesapeake Energy Corporation. Incorporated herein by reference to Exhibit 10.2.4 to Chesapeake's current report on Form 8-K filed October 5, 2006.      |
| 10.2.5        | Employment Agreement dated as of October 1, 2006 between Douglas J. Jacobson and Chesapeake Energy Corporation. Incorporated herein by reference to Exhibit 10.2.5 to Chesapeake's current report on Form 8-K filed October 5, 2006. |
| 10.2.6        | Employment Agreement dated as of October 1, 2006 between Martha A. Burger and Chesapeake Energy Corporation. Incorporated herein by reference to Exhibit 10.2.6 to Chesapeake's current report on Form 8-K filed October 5, 2006.    |
| 10.2.7        | Employment Agreement dated as of October 1, 2006 between Henry J. Hood and Chesapeake Energy Corporation. Incorporated herein by reference to Exhibit 10.2.7 to Chesapeake's current report on Form 8-K filed October 5, 2006.       |
| 10.2.8        | Employment Agreement dated as of October 1, 2006 between Michael A. Johnson and Chesapeake Energy Corporation. Incorporated herein by reference to Exhibit 10.2.8 to Chesapeake's current report on Form 8-K filed October 5, 2006.  |
| 12*           | Computation of Ratios of Earnings to Combined Fixed Charges and Preferred Stock Dividends.                                                                                                                                           |
| 31.1*         | Aubrey K. McClendon, Chairman and Chief Executive Officer, Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.                                                                                                  |
| 31.2*         | Marcus C. Rowland, Executive Vice President and Chief Financial Officer, Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.                                                                                    |
| 32.1*         | Aubrey K. McClendon, Chairman and Chief Executive Officer, Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.                                                                                                  |
| 32.2*         | Marcus C. Rowland, Executive Vice President and Chief Financial Officer, Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.                                                                                    |

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\* Filed herewith.  
Management contract or compensatory plan or arrangement

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**400,000,000**

**Chesapeake Energy Corporation**

**% Senior Notes due 2017**

\_\_\_\_\_  
PRELIMINARY PROSPECTUS

\_\_\_\_\_  
, 2006  
\_\_\_\_\_

*Joint Book-Running Managers*

**Barclays Capital**

**Credit Suisse**

**Deutsche Bank Securities**

**Goldman Sachs International**

\_\_\_\_\_  
*Senior Co-Managers*

**ABN AMRO**

**Banc of America Securities Limited**

**BNP PARIBAS**

**Fortis Securities**

**Lehman Brothers**

**The Royal Bank of Scotland plc**

**UBS Investment Bank**

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*Co-Managers*

**Bayerische Hypo- und Vereinsbank AG**

**BMO Capital Markets**

**Calyon Securities (USA)**

**DZ Financial Markets LLC**

**Natexis Bleichroeder Inc.**

**RBC Capital Markets**

**TD Securities**

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**Table of Contents****PART II****INFORMATION NOT REQUIRED IN PROSPECTUS****Item 14. Other Expenses of Issuance and Distribution.**

The following table sets forth all expenses payable by Chesapeake Energy Corporation (sometimes referred to as Chesapeake in this Part II of the registration statement) in connection with the issuance and distribution of the securities. All the amounts shown are estimates, except the registration fee.

|                                                     |                   |
|-----------------------------------------------------|-------------------|
| Securities and Exchange Commission registration fee | \$ 54,536         |
| Fees and expenses of accountants                    | 75,000            |
| Fees and expenses of legal counsel                  | 75,000            |
| Printing expenses                                   | 50,000            |
| Miscellaneous                                       |                   |
| <b>Total</b>                                        | <b>\$ 254,536</b> |

**Item 15. Indemnification of Directors and Officers.**

Section 1031 of the Oklahoma General Corporation Act, under which Chesapeake is incorporated, authorizes the indemnification of directors and officers under certain circumstances. Article VIII of the Certificate of Incorporation of Chesapeake and Article VI of the Bylaws of Chesapeake also provide for indemnification of directors and officers under certain circumstances. These provisions, together with Chesapeake's indemnification obligations under individual indemnity agreements with its directors and officers, may be sufficiently broad to indemnify such persons for liabilities under the Securities Act of 1933 (the "Securities Act"), as amended. In addition, Chesapeake maintains insurance, which insures its directors and officers against certain liabilities.

The Oklahoma General Corporation Act provides for indemnification of each of Chesapeake's officers and directors against (a) expenses, including attorneys' fees, judgments, fines and amounts paid in settlement actually and reasonably incurred by them in connection with any action, suit or proceeding brought by reason of such person being or having been a director, officer, employee or agent of Chesapeake, or of any other corporation, partnership, joint venture, trust or other enterprise at the request of Chesapeake, other than an action by or in the right of Chesapeake. To be entitled to indemnification, the individual must have acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interest of Chesapeake, and with respect to any criminal action, the person seeking indemnification had no reasonable cause to believe that the conduct was unlawful and (b) expenses, including attorneys' fees, actually and reasonably incurred in connection with the defense or settlement of any action or suit by or in the right of Chesapeake brought by reason of the person seeking indemnification being or having been a director, officer, employee or agent of Chesapeake, or any other corporation, partnership, joint venture, trust or other enterprise at the request of Chesapeake, provided the actions were in good faith and were reasonably believed to be in or not opposed to the best interest of Chesapeake, except that no indemnification shall be made in respect of any claim, issue or matter as to which the individual shall have been adjudged liable to Chesapeake, unless and only to the extent that the court in which such action was decided has determined that the person is fairly and reasonably entitled to indemnity for such expenses which the court deems proper. Article VIII of Chesapeake's Certificate of Incorporation provides for indemnification of Chesapeake's directors and

officers. The Oklahoma General Corporation Act also permits Chesapeake to purchase and maintain insurance on behalf of Chesapeake's directors and officers against any liability arising out of their status as such, whether or not Chesapeake would have the power to indemnify them against such liability. These provisions may be sufficiently broad to indemnify such persons for liabilities arising under the Securities Act.

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Chesapeake has entered into indemnity agreements with each of its directors and executive officers. Under each indemnity agreement, Chesapeake will pay on behalf of the indemnitee any amount which he is or becomes legally obligated to pay because of (a) any claim or claims from time to time threatened or made against him by any person because of any act or omission or neglect or breach of duty, including any actual or alleged error or misstatement or misleading statement, which he commits or suffers while acting in his capacity as a director and/or officer of Chesapeake or an affiliate or (b) being a party, or being threatened to be made a party, to any threatened, pending or contemplated action, suit or proceeding, whether civil, criminal, administrative or investigative, by reason of the fact that he is or was an officer, director, employee or agent of Chesapeake or an affiliate or is or was serving at the request of Chesapeake as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise. The payments which Chesapeake would be obligated to make under an indemnification agreement could include damages, charges, judgments, fines, penalties, settlements and costs, cost of investigation and cost of defense of legal, equitable or criminal actions, claims or proceedings and appeals therefrom, and costs of attachment, supersedeas, bail, surety or other bonds. Chesapeake also provides liability insurance for each of its directors and executive officers.

**Item 16. Exhibits.**

(a) Exhibits.

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

| <b>Exhibit No.</b> | <b>Description</b>                                                                                                                                                                                                          |
|--------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 1.1*               | Form of Underwriting Agreement.                                                                                                                                                                                             |
| 4.1*               | Form of Indenture.                                                                                                                                                                                                          |
| 5.1*               | Opinion of Vinson & Elkins L.L.P. as to the legality of the securities being registered.                                                                                                                                    |
| 12                 | Computation of Ratios of Earnings to Combined Fixed Charges and Preferred Dividends. Incorporated herein by reference to Exhibit 12 to Chesapeake's quarterly report on Form 10-Q for the quarter ended September 30, 2006. |
| 23.1*              | Consent of PricewaterhouseCoopers LLP.                                                                                                                                                                                      |
| 23.2*              | Consent of Ernst & Young LLP.                                                                                                                                                                                               |
| 23.3*              | Consent of Netherland, Sewell & Associates, Inc.                                                                                                                                                                            |
| 23.4*              | Consent of Schlumberger Data and Consulting Services.                                                                                                                                                                       |
| 23.5*              | Consent of Lee Keeling and Associates, Inc.                                                                                                                                                                                 |
| 23.6*              | Consent of Ryder Scott Company, L.P.                                                                                                                                                                                        |
| 23.7*              | Consent of Laroche Petroleum Consultants, Ltd.                                                                                                                                                                              |
| 23.8*              | Consent of H.J. Gruy and Associates, Inc.                                                                                                                                                                                   |
| 23.9*              | Consent of Miller and Lents, Ltd.                                                                                                                                                                                           |
| 23.10*             | Consent of Vinson & Elkins L.L.P. (included in Exhibit 5.1).                                                                                                                                                                |
| 24.1*              | Power of Attorney (included in the signature page of this Registration Statement).                                                                                                                                          |
| 25.1*              | Form T-1 Statement of Eligibility and Qualification.                                                                                                                                                                        |

\* Filed herewith.

(b) Financial Statement Schedules. Incorporated herein by reference to Item 8 of Chesapeake's annual report on Form 10-K for the year ended December 31, 2005.

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**Item 17. Undertakings.**

The undersigned registrant hereby undertakes:

(1) To file, during any period in which offers or sales are being made, a post-effective amendment to this registration statement:

(i) To include any prospectus required by section 10(a)(3) of the Securities Act of 1933;

(ii) To reflect in the prospectus any facts or events arising after the effective date of the registration statement (or the most recent post-effective amendment thereof) which, individually or in the aggregate, represent a fundamental change in the information set forth in the registration statement. Notwithstanding the foregoing, any increase or decrease in volume of securities offered (if the total dollar value of securities offered would not exceed that which was registered) and any deviation from the low or high end of the estimated maximum offering range may be reflected in the form of prospectus filed with the Commission pursuant to Rule 424(b) if, in the aggregate, the changes in volume and price represent no more than 20% change in the maximum aggregate offering price set forth in the Calculation of Registration Fee table in the effective registration statement;

(iii) To include any material information with respect to the plan of distribution not previously disclosed in the registration statement or any material change to such information in the registration statement.

provided, however, that paragraphs (1)(i) and (1)(ii) do not apply if information required to be included in a post-effective amendment by those paragraphs is contained in periodic reports filed by registrants pursuant to section 13 or section 15(d) of the Securities Exchange Act of 1934 that are incorporated by reference in the registration statement, or is contained in a form of prospectus filed pursuant to Rule 424(b) that is part of the registration statement.

(2) That, for the purpose of determining any liability under the Securities Act of 1933, each such post-effective amendment shall be deemed to be a new registration statement relating to the securities offered therein, and the offering of such securities at that time shall be deemed to be the initial bona fide offering thereof.

(3) To remove from registration by means of a post-effective amendment any of the securities being registered which remain unsold at the termination of the offering.

(4) That, for purposes of determining any liability under the Securities Act of 1933, each filing of Registrant's annual report pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 (and, where applicable, each filing of an employee benefit plan's annual report pursuant to Section 15(d) of the Securities Exchange Act of 1934) that is incorporated by reference in the registration statement shall be deemed to be a new registration statement relating to the securities offered therein, and the offering of such securities at that time shall be deemed to be the initial bona fide offering thereof.

(5) Insofar as indemnification for liabilities arising under the Securities Act of 1933 may be permitted to directors, officers and controlling persons of each Registrant pursuant to the foregoing provisions, or otherwise, each Registrant has been advised that in the opinion of the Securities and Exchange Commission such indemnification is against public policy as expressed in the Securities Act of 1933 and is, therefore, unenforceable. In the event that a claim for indemnification against such liabilities (other than the payment by a Registrant of expenses incurred or paid by a director, officer or controlling person of a Registrant in the successful defense of any action, suit or proceeding) is asserted by such director, officer or controlling person in connection with the securities being registered, that Registrant will, unless in the opinion of its counsel the has been settled by controlling precedent, submit to a court of appropriate jurisdiction the question whether such indemnification by it is against public policy as expressed in the Securities Act of 1933 and will be governed by the final adjudication of such issue.

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(6) That, for the purpose of determining liability under the Securities Act of 1933 to any purchaser:

- (A) Each prospectus filed by a Registrant pursuant to Rule 424(b)(3) shall be deemed to be part of the registration statement as of the date the filed prospectus was deemed part of and included in the registration statement; and
- (B) Each prospectus required to be filed pursuant to Rule 424(b)(2), (b)(5) or (b)(7) as part of a registration statement in reliance on Rule 430B relating to an offering made pursuant to Rule 415(a)(1)(i), (vii) or (x) for the purpose of providing the information required by Section 10(a) of the Securities Act of 1933 shall be deemed to be part of and included in the registration statement as of the earlier of the date such form of prospectus is first used after effectiveness or the date of the first contract of sale of securities in the offering described in the prospectus. As provided in Rule 430B, for liability purposes of the issuer and any person that is at that date an underwriter, such date shall be deemed to be a new effective date of the registration statement relating to the securities in the registration statement to which the prospectus relates, and the offering of such securities at that time shall be deemed to be the initial bona fide offering thereof. Provided, however, that no statement made in a registration statement or prospectus that is part of the registration statement or made in a document incorporated or deemed incorporated by reference into the registration statement or prospectus that is part of the registration statement will, as to a purchaser with a time of contract of sale prior to such effective date, supersede or modify any statement that was made in the registration statement or prospectus that was part of the registration statement or made in any such document immediately prior to such effective date.

(7) That, for the purpose of determining liability of a Registrant under the Securities Act of 1933 to any purchaser in the initial distribution of the securities, each undersigned Registrant undertakes that in a primary offering of securities of an undersigned Registrant pursuant to this registration statement, regardless of the underwriting method used to sell the securities to the purchaser, if the securities are offered or sold to such purchaser by means of any of the following communications, the undersigned Registrant will be a seller to the purchaser and will be considered to offer or sell such securities to such purchaser:

- (i) Any preliminary prospectus or prospectus of an undersigned Registrant relating to the offering required to be filed pursuant to Rule 424;
- (ii) Any free writing prospectus relating to the offering prepared by or on behalf of an undersigned Registrant or used or referred to by an undersigned Registrant;
- (iii) The portion of any other free writing prospectus relating to the offering containing material information about an undersigned Registrant or its securities provided by or on behalf of an undersigned Registrant; and
- (iv) Any other communication that is an offer in the offering made by an undersigned Registrant to the purchaser.

Table of Contents**SIGNATURES**

Pursuant to the requirements of the Securities Act of 1933, the Registrant has duly caused this Registration Statement to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Oklahoma City, State of Oklahoma on November 27, 2006.

**CHESAPEAKE ENERGY CORPORATION**

By: /s/ **AUBREY K. McCLENDON**  
**Aubrey K. McClendon**  
**Chairman of the Board and**  
**Chief Executive Officer**

Each person whose signature appears below authorizes Aubrey K. McClendon and Marcus C. Rowland, and each of them, each of whom may act without joinder of the other, to execute in the name of each such person who is then an officer or director of the company and to file any amendments to this registration statement necessary or advisable to enable the company to comply with the Securities Act of 1933, as amended, and any rules, regulations and requirements of the Securities and Exchange Commission in respect thereof, in connection with the registration of the securities which are the subject of this registration statement, which amendments may make such changes in the registration statement as such attorney may deem appropriate. Pursuant to the requirements of the Securities Act of 1933, this registration statement has been signed by the following persons in the capacities and on the date indicated.

| <u>Signature</u>                                          | <u>Capacity</u>                                                                                          | <u>Date</u>       |
|-----------------------------------------------------------|----------------------------------------------------------------------------------------------------------|-------------------|
| /s/ AUBREY K. McCLENDON<br><br><b>Aubrey K. McClendon</b> | Chairman of the Board, Chief Executive Officer and Director (Principal Executive Officer)                | November 27, 2006 |
| /s/ MARCUS C. ROWLAND<br><br><b>Marcus C. Rowland</b>     | Executive Vice President and Chief Financial Officer (Principal Financial Officer)                       | November 27, 2006 |
| /s/ MICHAEL A. JOHNSON<br><br><b>Michael A. Johnson</b>   | Senior Vice President Accounting, Controller and Chief Accounting Officer (Principal Accounting Officer) | November 27, 2006 |
| /s/ FRANK KEATING<br><br><b>Frank Keating</b>             | Director                                                                                                 | November 27, 2006 |
| /s/ BREENE M. KERR<br><br><b>Breene M. Kerr</b>           | Director                                                                                                 | November 27, 2006 |
| /s/ CHARLES T. MAXWELL<br><br><b>Charles T. Maxwell</b>   | Director                                                                                                 | November 27, 2006 |



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/s/ DON NICKLES

Director

November 27, 2006

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**Don Nickles**

/s/ FREDERICK B. WHITTEMORE

Director

November 27, 2006

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**Frederick B. Whittemore**

/s/ RICHARD K. DAVIDSON

Director

November 27, 2006

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**Richard K. Davidson**

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Table of Contents**SIGNATURES**

Pursuant to the requirements of the Securities Act of 1933, each Registrant has duly caused this Registration Statement to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Oklahoma City, State of Oklahoma on November 27, 2006.

CHESAPEAKE EAGLE CANADA CORP.

CHESAPEAKE ENERGY LOUISIANA CORPORATION

CHESAPEAKE OPERATING, INC.

CHESAPEAKE SOUTH TEXAS CORP.

NOMAC DRILLING CORPORATION

By: /s/ MARCUS C. ROWLAND

**Name:** **Marcus C. Rowland**  
**Title:** **Executive Vice President**

**Finance and Chief Financial Officer**

Each person whose signature appears below authorizes Aubrey K. McClendon and Marcus C. Rowland, and each of them, each of whom may act without joinder of the other, to execute in the name of each such person who is then an officer or director of the company and to file any amendments to this registration statement necessary or advisable to enable the company to comply with the Securities Act of 1933, as amended, and any rules, regulations and requirements of the Securities and Exchange Commission in respect thereof, in connection with the registration of the securities which are the subject of this registration statement, which amendments may make such changes in the registration statement as such attorney may deem appropriate. Pursuant to the requirements of the Securities Act of 1933, this registration statement has been signed by the following persons in the capacities and on the date indicated.

| <u>Signature</u>               | <u>Capacity</u>                                                                                                 | <u>Date</u>       |
|--------------------------------|-----------------------------------------------------------------------------------------------------------------|-------------------|
| <u>/s/ AUBREY K. McCLENDON</u> | Chief Executive Officer and Director<br>(Principal Executive Officer)                                           | November 27, 2006 |
| <b>Aubrey K. McClendon</b>     |                                                                                                                 |                   |
| <u>/s/ MARCUS C. ROWLAND</u>   | Executive Vice President Finance and Chief<br>Financial Officer (Principal Financial and<br>Accounting Officer) | November 27, 2006 |
| <b>Marcus C. Rowland</b>       |                                                                                                                 |                   |

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**SIGNATURES**

Pursuant to the requirements of the Securities Act of 1933, each Registrant has duly caused this Registration Statement to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Oklahoma City, State of Oklahoma on November 27, 2006.

CARMEN ACQUISITION, L.L.C.

CHESAPEAKE ACQUISITION, L.L.C.

CHESAPEAKE APPALACHIA, L.L.C.

CHESAPEAKE LAND COMPANY, L.L.C.

CHESAPEAKE ORC, L.L.C.

CHESAPEAKE ROYALTY, L.L.C.

GOTHIC PRODUCTION, L.L.C.

HAWG HAULING & DISPOSAL, LLC

HODGES TRUCKING COMPANY, L.L.C.

MC MINERAL COMPANY, L.L.C.

W.W. REALTY, L.L.C.

By: /s/ MARCUS C. ROWLAND

**Name: Marcus C. Rowland**  
**Title: Executive Vice President**

**Finance and Chief Financial Officer**

Each person whose signature appears below authorizes Aubrey K. McClendon and Marcus C. Rowland, and each of them, each of whom may act without joinder of the other, to execute in the name of each such person who is then an officer or manager of the company and to file any amendments to this registration statement necessary or advisable to enable the company to comply with the Securities Act of 1933, as amended, and any rules, regulations and requirements of the Securities and Exchange Commission in respect thereof, in connection with the registration of the securities which are the subject of this registration statement, which amendments may make such changes in the registration statement as such attorney may deem appropriate. Pursuant to the requirements of the Securities Act of 1933, this registration statement has been signed by the following persons in the capacities and on the date indicated.

| <b><u>Signature</u></b> | <b><u>Capacity</u></b> | <b><u>Date</u></b> |
|-------------------------|------------------------|--------------------|
| /s/ AUBREY K. MCCLENDON |                        | November 27, 2006  |

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**Aubrey K. McClendon**

Chief Executive Officer and Manager  
(Principal Executive Officer)

/s/ **MARCUS C. ROWLAND**

Executive Vice President Finance and Chief  
Financial Officer (Principal Financial and  
Accounting Officer)

November 27, 2006

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**Marcus C. Rowland**

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Table of Contents**SIGNATURES**

Pursuant to the requirements of the Securities Act of 1933, each Registrant has duly caused this Registration Statement to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Oklahoma City, State of Oklahoma on November 27, 2006.

CHESAPEAKE ENERGY MARKETING, INC.

By: /s/ MARCUS C. ROWLAND

**Name: Marcus C. Rowland**  
**Title: Executive Vice President**

**Finance and Chief Financial Officer**

Each person whose signature appears below authorizes Aubrey K. McClendon and Marcus C. Rowland, and each of them, each of whom may act without joinder of the other, to execute in the name of each such person who is then an officer or director of the company and to file any amendments to this registration statement necessary or advisable to enable the company to comply with the Securities Act of 1933, as amended, and any rules, regulations and requirements of the Securities and Exchange Commission in respect thereof, in connection with the registration of the securities which are the subject of this registration statement, which amendments may make such changes in the registration statement as such attorney may deem appropriate. Pursuant to the requirements of the Securities Act of 1933, this registration statement has been signed by the following persons in the capacities and on the date indicated.

| <u>Signature</u>                                             | <u>Capacity</u>                                                                                                 | <u>Date</u>       |
|--------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------|-------------------|
| <u>/s/ AUBREY K. McCLENDON</u><br><b>Aubrey K. McClendon</b> | Chief Executive Officer and Director<br>(Principal Executive Officer)                                           | November 27, 2006 |
| <u>/s/ MARCUS C. ROWLAND</u><br><b>Marcus C. Rowland</b>     | Executive Vice President Finance and Chief<br>Financial Officer (Principal Financial and<br>Accounting Officer) | November 27, 2006 |

Table of Contents**SIGNATURES**

Pursuant to the requirements of the Securities Act of 1933, each Registrant has duly caused this Registration Statement to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Oklahoma City, State of Oklahoma on November 27, 2006.

MAYFIELD PROCESSING, L.L.C.

By:                     /s/          MARCUS C. ROWLAND                    

**Name:                                          Marcus C. Rowland**  
**Title:                                          Executive Vice President**

**Finance and Chief Financial Officer**

Each person whose signature appears below authorizes Aubrey K. McClendon and Marcus C. Rowland, and each of them, each of whom may act without joinder of the other, to execute in the name of each such person who is then an officer or director of the company and to file any amendments to this registration statement necessary or advisable to enable the company to comply with the Securities Act of 1933, as amended, and any rules, regulations and requirements of the Securities and Exchange Commission in respect thereof, in connection with the registration of the securities which are the subject of this registration statement, which amendments may make such changes in the registration statement as such attorney may deem appropriate. Pursuant to the requirements of the Securities Act of 1933, this registration statement has been signed by the following persons in the capacities and on the date indicated.

| <u>Signature</u>                                                                                              | <u>Capacity</u>                                                                                                 | <u>Date</u>       |
|---------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------|-------------------|
| <u>                    /s/          AUBREY K. McCLENDON                    </u><br><b>Aubrey K. McClendon</b> | Chief Executive Officer and Manager<br>(Principal Executive Officer)                                            | November 27, 2006 |
| <u>                    /s/          MARCUS C. ROWLAND                    </u><br><b>Marcus C. Rowland</b>     | Executive Vice President Finance and Chief<br>Financial Officer (Principal Financial and<br>Accounting Officer) | November 27, 2006 |

Table of Contents**SIGNATURES**

Pursuant to the requirements of the Securities Act of 1933, each Registrant has duly caused this Registration Statement to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Oklahoma City, State of Oklahoma on November 27, 2006.

CHESAPEAKE EXPLORATION LIMITED  
PARTNERSHIP

CHESAPEAKE LOUISIANA, L.P.

CHESAPEAKE SIGMA, L.P.

By: Chesapeake Operating, Inc., as general  
partner of each respective entity

By: /s/ MARCUS C. ROWLAND

**Name:** Marcus C. Rowland  
**Title:** Executive Vice President Finance and

Chief Financial Officer

Each person whose signature appears below authorizes Aubrey K. McClendon and Marcus C. Rowland, and each of them, each of whom may act without joinder of the other, to execute in the name of each such person who is then an officer or director of the company and to file any amendments to this registration statement necessary or advisable to enable the company to comply with the Securities Act of 1933, as amended, and any rules, regulations and requirements of the Securities and Exchange Commission in respect thereof, in connection with the registration of the securities which are the subject of this registration statement, which amendments may make such changes in the registration statement as such attorney may deem appropriate. Pursuant to the requirements of the Securities Act of 1933, this registration statement has been signed by the following persons in the capacities and on the date indicated.

| <u>Signature</u>           | <u>Capacity</u>                                                                                                                                  | <u>Date</u>       |
|----------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------|-------------------|
| /s/ AUBREY K. McCLENDON    | Chief Executive Officer and Director of<br>Chesapeake Operating, Inc. (Principal<br>Executive Officer)                                           | November 27, 2006 |
| <b>Aubrey K. McClendon</b> |                                                                                                                                                  |                   |
| /s/ MARCUS C. ROWLAND      | Executive Vice President Finance and Chief<br>Financial Officer of Chesapeake Operating,<br>Inc. (Principal Financial and Accounting<br>Officer) | November 27, 2006 |
| <b>Marcus C. Rowland</b>   |                                                                                                                                                  |                   |

Table of Contents**SIGNATURES**

Pursuant to the requirements of the Securities Act of 1933, each Registrant has duly caused this Registration Statement to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Oklahoma City, State of Oklahoma on November 27, 2006.

MIDCON COMPRESSION, L.P.

By: Chesapeake Energy Marketing, Inc., as  
general partner

By: /s/ MARCUS C. ROWLAND

**Name:** **Marcus C. Rowland**  
**Title:** **Executive Vice President**

**Finance and Chief Financial Officer**

Each person whose signature appears below authorizes Aubrey K. McClendon and Marcus C. Rowland, and each of them, each of whom may act without joinder of the other, to execute in the name of each such person who is then an officer or director of the company and to file any amendments to this registration statement necessary or advisable to enable the company to comply with the Securities Act of 1933, as amended, and any rules, regulations and requirements of the Securities and Exchange Commission in respect thereof, in connection with the registration of the securities which are the subject of this registration statement, which amendments may make such changes in the registration statement as such attorney may deem appropriate. Pursuant to the requirements of the Securities Act of 1933, this registration statement has been signed by the following persons in the capacities and on the date indicated.

| <u>Signature</u>           | <u>Capacity</u>                                                                                                 | <u>Date</u>       |
|----------------------------|-----------------------------------------------------------------------------------------------------------------|-------------------|
| /s/ AUBREY K. McCLENDON    | Chief Executive Officer and Director of<br>Chesapeake Energy Marketing, Inc.<br>(Principal Executive Officer)   | November 27, 2006 |
| <b>Aubrey K. McClendon</b> |                                                                                                                 |                   |
| /s/ MARCUS C. ROWLAND      | Executive Vice President Finance and Chief<br>Financial Officer (Principal Financial and<br>Accounting Officer) | November 27, 2006 |
| <b>Marcus C. Rowland</b>   |                                                                                                                 |                   |