

CHESAPEAKE ENERGY CORP

Form 10-Q

November 09, 2012

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the Quarterly Period Ended September 30, 2012

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

Commission File No. 1-13726

Chesapeake Energy Corporation

(Exact name of registrant as specified in its charter)

Oklahoma

73-1395733

(State or other jurisdiction of incorporation or
organization)

(I.R.S. Employer Identification No.)

6100 North Western Avenue

Oklahoma City, Oklahoma

73118

(Address of principal executive offices)

(Zip Code)

(405) 848-8000

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

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

As of November 2, 2012, there were 664,655,404 shares of our common stock, \$0.01 par value, outstanding.

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CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES

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 CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES
 CONDENSED CONSOLIDATED BALANCE SHEETS
 (Unaudited)

	September 30, 2012	December 31, 2011
	(\$ in millions)	
CURRENT ASSETS:		
Cash and cash equivalents (\$1 and \$1 attributable to our VIEs)	\$ 142	\$ 351
Restricted cash	156	44
Accounts receivable	2,291	2,505
Short-term derivative assets	31	13
Deferred income tax asset	692	139
Other current assets	188	125
Current assets held for sale (\$14 and \$0 attributable to our VIEs)	111	—
Total Current Assets	3,611	3,177
PROPERTY AND EQUIPMENT:		
Natural gas and oil properties, at cost based on full cost accounting:		
Evaluated natural gas and oil properties (\$488 and \$498 attributable to our VIEs)	51,014	41,723
Unevaluated properties	15,254	16,685
Natural gas gathering systems and treating plants	—	1,455
Oilfield services equipment	1,972	1,611
Other property and equipment	3,629	3,555
Total Property and Equipment, at Cost	71,869	65,029
Less: accumulated depreciation, depletion and amortization (((\$43) and (\$6) attributable to our VIEs)	(33,573	) (28,290
Property and equipment held for sale, net (\$121 and \$0 attributable to our VIEs)	2,307	—
Total Property and Equipment, Net	40,603	36,739
LONG-TERM ASSETS:		
Investments	647	1,531
Long-term derivative assets	6	—
Other long-term assets	681	388
Long-term assets held for sale	123	—
TOTAL ASSETS	\$45,671	\$41,835
CURRENT LIABILITIES:		
Accounts payable	\$2,357	\$3,311
Short-term derivative liabilities (\$5 and \$9 attributable to our VIEs)	150	191
Accrued interest	213	183
Current maturities of long-term debt, net	463	—
Other current liabilities (\$20 and \$23 attributable to our VIEs)	3,097	3,397
Current liabilities held for sale (\$31 and \$0 attributable to our VIEs)	176	—
Total Current Liabilities	6,456	7,082
LONG-TERM LIABILITIES:		
Long-term debt, net	15,755	10,626
Deferred income tax liabilities	3,418	3,484
Long-term derivative liabilities (\$3 and \$10 attributable to our VIEs)	999	1,541
Asset retirement obligations	353	323
Other long-term liabilities	997	818
Long-term liabilities held for sale	2	—

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Total Long-Term Liabilities	21,524	16,792
CONTINGENCIES AND COMMITMENTS (Note 4)		
EQUITY:		
Chesapeake Stockholders' Equity:		
Preferred stock, \$0.01 par value, 20,000,000 shares authorized:		
7,251,515 shares outstanding	3,062	3,062
Common stock, \$0.01 par value, 1,000,000,000 shares authorized:		
666,955,284 and 660,888,159 shares issued	7	7
Paid-in capital	12,246	12,146
Retained earnings	241	1,608
Accumulated other comprehensive income (loss)	(188	) (166
Less: treasury stock, at cost; 1,860,507 and 1,552,533 common shares	(41	) (33
Total Chesapeake Stockholders' Equity	15,327	16,624
Noncontrolling interests	2,364	1,337
Total Equity	17,691	17,961
TOTAL LIABILITIES AND EQUITY	\$45,671	\$41,835

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

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CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES
 CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
 (Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(\$ in millions, except per share data)			
REVENUES:				
Natural gas, oil and NGL	\$1,437	\$2,402	\$4,622	\$4,688
Marketing, gathering and compression	1,381	1,422	3,710	3,844
Oilfield services	152	153	446	376
Total Revenues	2,970	3,977	8,778	8,908
OPERATING EXPENSES:				
Natural gas, oil and NGL production	320	282	1,005	782
Production taxes	53	50	141	140
Marketing, gathering and compression	1,339	1,392	3,631	3,744
Oilfield services	116	118	321	287
General and administrative	148	151	440	410
Natural gas, oil and NGL depreciation, depletion and amortization	762	423	1,856	1,147
Depreciation and amortization of other assets	66	75	233	206
Impairment of natural gas and oil properties	3,315	—	3,315	—
Losses on sales and impairments of fixed assets and other	45	3	286	7
Total Operating Expenses	6,164	2,494	11,228	6,723
INCOME (LOSS) FROM OPERATIONS	(3,194	) 1,483	(2,450	) 2,185
OTHER INCOME (EXPENSE):				
Interest expense	(36	) (4	) (63	) (37
Earnings (losses) on investments	(23	) 28	(87	) 100
Gains on sales of investments	31	—	1,061	—
Losses on purchases or exchanges of debt	—	—	—	(176
Other income (expense)	(9	) 4	2	9
Total Other Income (Expense)	(37	) 28	913	(104
INCOME (LOSS) BEFORE INCOME TAXES	(3,231	) 1,511	(1,537	) 2,081
INCOME TAX EXPENSE (BENEFIT):				
Current income taxes	22	(1	) 24	11
Deferred income taxes	(1,282	) 590	(623	) 801
Total Income Tax Expense (Benefit)	(1,260	) 589	(599	) 812
NET INCOME (LOSS)	(1,971	) 922	(938	) 1,269
Net income attributable to noncontrolling interests	(41	) —	(131) —
NET INCOME (LOSS) ATTRIBUTABLE TO CHESAPEAKE	(2,012	) 922	(1,069	) 1,269
Preferred stock dividends	(43	) (43	) (128	) (128
NET INCOME (LOSS) AVAILABLE TO COMMON STOCKHOLDERS	\$(2,055	) \$879	\$(1,197	) \$1,141
EARNINGS (LOSS) PER COMMON SHARE:				
Basic	\$(3.19	) \$1.38	\$(1.86	) \$1.79
Diluted	\$(3.19	) \$1.23	\$(1.86	) \$1.69
CASH DIVIDEND DECLARED PER COMMON SHARE	0.0875	0.0875	0.2625	0.25

WEIGHTED AVERAGE COMMON AND COMMON
EQUIVALENT SHARES OUTSTANDING (in millions):

Basic	644	638	643	636
Diluted	644	753	643	752

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

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CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES
 CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
 (Unaudited)

	Three Months Ended September 30, 2012		2011		Nine Months Ended September 30, 2012		2011	
	(\$ in millions)							
NET INCOME (LOSS)	\$ (1,971		) \$922		\$ (938		) \$1,269	
Other comprehensive income (loss), net of income tax:								
Unrealized gain (loss) on derivative instruments, net of income taxes	3		72		3		218	
of \$1 million, \$44 million, \$1 and \$133 million								
Reclassification of gain on settled derivative instruments, net of income taxes of (\$3) million, (\$49) million, (\$10) million and (\$88) million	(6		) (80		) (18		) (144	
Ineffective portion of derivatives designated as cash flow hedges, net of income taxes of \$0, \$2 million, \$0 and (\$5) million	—		3		—		(8	
Unrealized gain (loss) on investments, net of income taxes of (\$2) million, (\$1) million, (\$4) million and (\$2) million	(3		) (1		) (7		) (4	
Other comprehensive income (loss)	(6		) (6		) (22		) 62	
COMPREHENSIVE INCOME (LOSS)	(1,977		) 916		(960		) 1,331	
COMPREHENSIVE INCOME ATTRIBUTABLE TO NONCONTROLLING INTERESTS	(41		) —		(131) —	
COMPREHENSIVE INCOME (LOSS) ATTRIBUTABLE TO CHESAPEAKE	\$(2,018		) \$916		\$(1,091		) \$1,331	

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

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CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
 (Unaudited)

	Nine Months Ended September 30,	
	2012	2011
	(\$ in millions)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
NET INCOME (LOSS)	\$(938	) \$1,269
ADJUSTMENTS TO RECONCILE NET INCOME (LOSS) TO CASH PROVIDED BY OPERATING ACTIVITIES:		
Depreciation, depletion and amortization	2,089	1,353
Deferred income tax expense (benefit)	(623	) 801
Unrealized (gains) losses on derivatives	(440	) 456
Stock-based compensation	93	119
Losses on sales and impairments of fixed assets	262	7
Impairment of natural gas and oil properties	3,315	—
(Gains) losses on investments	147	(19
Gains on sales of investments	(1,061) —
Other	80	12
Changes in assets and liabilities	(946	) (274
Cash provided by operating activities	1,978	3,724
CASH FLOWS FROM INVESTING ACTIVITIES:		
Drilling and completion costs	(7,525	) (5,345
Acquisitions of proved and unproved properties	(2,813	) (3,773
Proceeds from divestitures of proved and unproved properties	2,445	6,357
Additions to other property and equipment	(1,916	) (1,416
Proceeds from sales of other assets	219	682
Proceeds from (additions to) investments	(261	) 126
Proceeds from sale of midstream investment	2,000	—
Acquisition of drilling company	—	(339
Increase in restricted cash	(280) —
Other	(23	) (7
Cash used in investing activities	(8,154	) (3,715
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from credit facilities borrowings	13,986	11,914
Payments on credit facilities borrowings	(13,614	) (12,057
Proceeds from issuance of term loans, net of discount and offering costs	3,789	—
Proceeds from issuance of senior notes, net of discount and offering costs	1,263	977
Cash paid to purchase debt	—	(2,015
Cash paid for common stock dividends	(170	) (151
Cash paid for preferred stock dividends	(128	) (128
Cash (paid) received on financing derivatives	(36	) 1,085
Proceeds from sales of noncontrolling interests	1,056	—
Proceeds from other financings	225	—
Distributions to noncontrolling interest owners	(163) —
Net increase (decrease) in outstanding payments in excess of cash balance	(159) 489
Other	(68) (114

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Cash provided by financing activities	5,981	—
Change in cash and cash equivalents classified as current assets held for sale	(14) —
Net increase (decrease) in cash and cash equivalents	(209	) 9
Cash and cash equivalents, beginning of period	351	102
Cash and cash equivalents, end of period	\$142	\$111

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

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CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS – (Continued)
 (Unaudited)

Nine Months Ended
 September 30,
 2012 2011
 (\$ in millions)

SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION OF NET
 CASH PAYMENTS (REFUNDS) FOR:

Interest, net of capitalized interest	\$—	\$18
Income taxes, net of refunds received	\$31	\$(25)

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

Dividends payable on our common and preferred stock were \$99 million as of September 30, 2012 and 2011.

For the nine months ended September 30, 2012 and 2011, natural gas and oil properties decreased by \$103 million and increased by \$148 million, respectively, as a result of an increase or decrease in accrued acquisition, drilling and completion costs.

For the nine months ended September 30, 2012 and 2011, other property and equipment was adjusted by \$57 million and \$90 million, respectively, as a result of an increase in accrued costs.

As of September 30, 2012 and 2011, we recorded \$60 million and \$173 million, respectively, of various liabilities related to the purchase of proved and unproved properties and other assets.

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

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CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES
 CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
 (Unaudited)

	Nine Months Ended September 30,	
	2012	2011
	(\$ in millions)	
PREFERRED STOCK:		
Balance, beginning and end of period	\$3,062	\$3,065
Exchange of 0 and 3,000 shares of preferred stock for common stock	—	(3)
Balance, end of period	3,062	3,062
COMMON STOCK:		
Balance, beginning and end of period	7	7
PAID-IN CAPITAL:		
Balance, beginning of period	12,146	12,194
Stock-based compensation	116	120
Exchange of 0 and 3,000 shares of preferred stock for common stock	—	3
Purchase of contingent convertible notes	—	(123)
Reduction in tax benefit from stock-based compensation	(18)	(5)
Dividends on common stock	—	(48)
Dividends on preferred stock	—	(15)
Exercise of stock options	2	2
Balance, end of period	12,246	12,128
RETAINED EARNINGS:		
Balance, beginning of period	1,608	190
Net income (loss) attributable to Chesapeake	(1,069)	1,269
Dividends on common stock	(170)	(112)
Dividends on preferred stock	(128)	(113)
Balance, end of period	241	1,234
ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS):		
Balance, beginning of period	(166)	(168)
Hedging activity	(15)	66
Investment activity	(7)	(4)
Balance, end of period	(188)	(106)
TREASURY STOCK – COMMON:		
Balance, beginning of period	(33)	(24)
Purchase of 357,565 and 191,153 shares for company benefit plans	(9)	(5)
Release of 49,591 and 74,004 shares from company benefit plans	1	2
Balance, end of period	(41)	(27)
TOTAL CHESAPEAKE STOCKHOLDERS' EQUITY	15,327	16,298
NONCONTROLLING INTERESTS:		
Balance, beginning of period	1,337	—
Sales of noncontrolling interests	1,056	—
Net income attributable to noncontrolling interests	131	—
Distributions to noncontrolling interest owners	(160)	—
Balance, end of period	2,364	—
TOTAL EQUITY	\$17,691	\$16,298

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 (“Chesapeake” or the “Company”) and its subsidiaries have been prepared in accordance with the instructions to Form 10-Q as prescribed by the Securities and Exchange Commission (SEC). This Form 10-Q relates to the three and nine months ended September 30, 2012 (the “Current Quarter” and the “Current Period”, respectively) and three and nine months ended September 30, 2011 (the “Prior Quarter” and the “Prior Period”, respectively). Chesapeake’s annual report on Form 10-K for the year ended December 31, 2011 (2011 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 presentation of the results for the interim periods have been reflected. The accompanying condensed consolidated financial statements of Chesapeake include the accounts of our direct and indirect wholly owned subsidiaries and entities in which Chesapeake holds a controlling interest. All significant intercompany accounts and transactions have been eliminated. The results for the Current Quarter and the Current Period are not necessarily indicative of the results to be expected for the full year.

Critical Accounting Policies

We consider accounting policies related to derivatives, variable interest entities, natural gas and oil properties and income taxes to be critical policies. These policies are summarized in Management’s Discussion and Analysis of Financial Condition and Results of Operations in our 2011 Form 10-K.

Risks and Uncertainties

Our business strategy is to continue our reserves and production growth and transition our asset base from an exclusive focus on natural gas production to a focus that is, and in the future will remain, more balanced between natural gas and liquids production. This is a capital-intensive strategy, and we made capital expenditures in the Current Period that exceeded our cash flow from operations, filling this gap with borrowings and proceeds from sales of assets that we determined were non-core or did not fit our long-term plans. See Notes 8 and 16 for a description of our completed 2012 asset sales. We project that our capital expenditures will continue to exceed our operating cash flow through 2013; however, we expect to see a much smaller gap between our cash flow from operations and capital expenditures in 2013 than we have experienced in 2012.

As part of our asset sales planning and capital expenditure budgeting process, we closely monitor the resulting effects on the amounts and timing of our sources and uses of funds, particularly as they affect our ability to maintain compliance with the financial covenants of our corporate revolving bank credit facility. While asset sales enhance our ability to reduce debt, sales of producing natural gas and oil properties may adversely affect the amount of cash flow and earnings before interest, taxes, depreciation, depletion and amortization (EBITDA) we generate and reduce the amount and value of collateral available to secure our obligations, both of which can be exacerbated by low prices received for our production. Thus, the assets we select and schedule for sales, our budgeted capital expenditures and our natural gas, oil and NGL price forecasts are carefully considered as we project our future ability to comply with the financial covenant maintenance requirements of our corporate revolving bank credit facility. In September 2012, the existing leverage ratio covenant was increased through an amendment to the credit facility agreement. See Note 3 for discussion of the terms of the amendment. We would have been unable to meet the required ratio as of September 30, 2012 without this amendment primarily because the closing of asset sales transactions occurred in the fourth quarter and not in September as we had anticipated. As a result, without the amendment, we would have been unable to reduce our indebtedness sufficiently as of September 30, 2012 to maintain our covenant compliance. The amendment relaxes our required indebtedness to EBITDA ratio for the quarter ended September 30, 2012 and the four subsequent quarters. Failure to maintain compliance with the covenants of our revolving bank credit facility would,

absent a waiver or amendment, allow lenders to declare an event of default and cause any outstanding indebtedness under the facility to become immediately due and payable. Such action could also lead to cross defaults under our senior note and contingent convertible senior note indentures. See Note 3 for further discussion of our debt instruments.

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CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Unaudited)

Based on ongoing reductions in our capital expenditures, expected commodity prices as reflected in futures prices and prices for our currently hedged production, our forecasted drilling and production, projected levels of indebtedness and certain asset sales presently being negotiated, we believe we will be in compliance with the financial maintenance covenants, including the amended leverage ratios, of our corporate revolving bank credit facility through 2013. We believe the assumptions underlying our budget for this period are reasonable and that we have adequate flexibility, including the ability to adjust discretionary capital expenditures, to adapt to potential negative developments if needed to maintain covenant compliance. Our ability to generate operating cash flow and close asset sales in order to manage debt, however, are subject to all the risks and uncertainties that exist in our industry, some of which we may not be able to anticipate at this time. We do not have binding agreements for all of our planned asset sales and our ability to consummate each of these transactions is subject to changes in market conditions and other factors beyond our control. If one or more of the transactions is not completed in the anticipated time frame, or at all, or for less proceeds than anticipated, our ability to fund budgeted capital expenditures, reduce our indebtedness as planned and maintain our compliance with revolving bank credit facility covenants could be adversely affected.

We have a material exposure to natural gas prices, which reached 10-year lows in the Current Period. Approximately 70% and 83% of our estimated proved reserves volumes as of September 30, 2012 and December 31, 2011, respectively, were natural gas, and natural gas represented approximately 80% and 84% of our natural gas, oil and NGL sales volumes for the Current Period and the full year 2011, respectively. Although our natural gas derivative arrangements serve to mitigate a portion of the effect of price volatility on our cash flows, none of our 2013 natural gas production is currently protected by derivative instruments against downward price movement. Sustained low natural gas prices, and volatile natural gas, oil and NGL prices in general could have a material adverse effect on our financial position, results of operations and cash flows. In addition, lower natural gas, oil and NGL prices could result in a further reduction in the estimated quantity of proved reserves we report and in the estimated future net cash flows expected to be generated from our proved reserves.

In the Current Period, we reduced our estimate of proved reserves by 5.5 tcf primarily due to the impact of downward natural gas price revisions. Natural gas prices used in estimating proved reserves decreased by 31% from \$4.12 per mcf for the 12 months ended December 31, 2011 to \$2.83 per mcf for the 12 months ended September 30, 2012 using 12-month average prices required by the SEC. The reserve reductions primarily involved the loss of significant proved undeveloped reserves, largely in the Barnett Shale and the Haynesville Shale plays, for which future development is uneconomic at the natural gas prices used in the reserves estimates. As a result of lower estimated reserves, as of September 30, 2012, we were required to impair the carrying value of our natural gas and oil properties and, if the trailing 12-month average natural gas prices are lower in subsequent periods, we could have additional impairments in the future. See Natural Gas and Oil Properties below for further discussion of our impairment of the carrying value of our natural gas and oil properties as of September 30, 2012. An impairment of this type is a non-cash charge that does not impact our liquidity or our ability to comply with financial covenants. Future impairments of the carrying value of our natural gas and oil properties, if any, will be dependent on many factors, including natural gas, oil and NGL prices, production rates, levels of reserves, the evaluation of costs excluded from amortization, the timing and impact of asset sales, future development costs and service costs.

Natural Gas and Oil Properties

On a quarterly basis, we analyze our unevaluated leasehold and transfer to evaluated properties leasehold that can be associated with reserves, leasehold that expired in the quarter or leasehold that is not a part of our development strategy and will be abandoned. As our strategic focus is shifting from a natural gas asset base to a more balanced natural gas and liquids asset base, and as our budgeted capital expenditures are being reduced in the Current Quarter, we identified undeveloped leasehold having a cost of \$1.684 billion that would not be a part of our development strategy going forward. The acreage was primarily located in the Williston and DJ Basins, as well as other non-core leasehold located throughout our operating areas.

We also review, on a quarterly basis, the carrying value of our natural gas and oil properties under the full cost accounting rules of the SEC. This quarterly 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 (adjusted for cash flow hedges) less estimated future expenditures to be incurred in developing and producing the proved reserves, less any related income tax effects. In the Current Quarter, capitalized costs of natural gas and oil properties exceeded the estimated present value calculation of future net revenues from our proved reserves, net of related income tax considerations, resulting in an impairment in the carrying value of natural gas and oil properties of \$3.315 billion. For the ceiling test calculation, costs used are those

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CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Unaudited)

as of the end of the appropriate quarterly period. In calculating estimated future net revenues, current prices are calculated as the unweighted arithmetic average of natural gas and oil prices on the first day of each month within the 12-month period prior to the ending date of the 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 designated as cash flow hedges. Cash flow hedges locked in prior to September 30, 2012 which relate to future production periods increased the ceiling test impairment by \$279 million. As of September 30, 2012, none of our open derivative instruments were designated as cash flow hedges. Our natural gas and oil hedging activities are discussed in Note 7 of these condensed consolidated financial statements. See Risks and Uncertainties above for a discussion of the reduction in our estimated proved reserves in the Current Period and factors that could impact a future ceiling test impairment.

Held for Sale Assets and Liabilities

We are currently pursuing the sale of substantially all of our midstream business in order to narrow our strategic focus, and we expect to complete the sale in the 2012 fourth quarter. Substantially all of the associated assets and liabilities qualified as held for sale as of September 30, 2012 are reported under our marketing, gathering and compression operating segment. In addition, we are pursuing the sale within the next 12 months of various other property and equipment, including certain drilling rigs and land and buildings primarily in the Fort Worth, Texas area. The drilling rigs are reported under our oilfield services operating segment, and the land and buildings are reported under our other operating segment. Natural gas and oil properties that we intend to sell are not presented as held for sale pursuant to the rules governing oil and gas accounting. A summary of the assets and liabilities held for sale on our condensed consolidated balance sheet as of September 30, 2012 is detailed below.

	September 30, 2012 (\$ in millions)
Cash	\$ 14
Accounts receivable	90
Other assets	7
Current assets held for sale	\$ 111
Natural gas gathering systems and treating plants, net of accumulated depreciation	\$2,027
Oilfield services equipment, net of accumulated depreciation	24
Other property and equipment, net of accumulated depreciation and amortization	256
Property and equipment held for sale, net	\$2,307
Investments	\$ 123
Long-term assets held for sale	\$ 123
Accounts payable	\$ 33
Accrued liabilities	143
Current liabilities held for sale	\$ 176
Asset retirement obligations	\$ 2
Long-term liabilities held for sale	\$ 2

Cash and Cash Equivalents and Restricted Cash

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. Restricted cash consists of balances required to be maintained by the terms of agreements governing the activities of CHK Utica, L.L.C. (CHK Utica) and CHK Cleveland Tonkawa, L.L.C. (CHK C-T). For CHK Utica, we must retain a minimum cash balance equal to two quarterly dividend payments. In addition, cash proceeds received from CHK Utica asset

sales must be used to pay for CHK Utica's capital expenditures or to redeem its preferred shares. For CHK C-T, we must retain an amount of cash (remeasured quarterly) equal to (i) the next two quarters of preferred dividend payments plus (ii) the projected capital and operating expenditures for the next six months (net of its projected net revenues during such six-month period). See Note 6 for further discussion of these transactions.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Unaudited)

2. Net Income Per Share

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

For the Current Quarter and the Current Period, the following shares of unvested restricted stock and cumulative convertible preferred stock and associated adjustments to net income, consisting of dividends on such shares, were not included in the calculation of diluted EPS, as the effect was antidilutive:

	Net Income Adjustments (\$ in millions)	Shares (in millions)
Three Months Ended September 30, 2012:		
Common stock equivalent of our preferred stock outstanding:		
5.75% cumulative convertible preferred stock	\$21	56
5.75% cumulative convertible preferred stock (series A)	\$16	39
5.00% cumulative convertible preferred stock (series 2005B)	\$3	5
4.50% cumulative convertible preferred stock	\$3	6
Unvested restricted stock	\$—	3
Nine Months Ended September 30, 2012:		
Common stock equivalent of our preferred stock outstanding:		
5.75% cumulative convertible preferred stock	\$64	56
5.75% cumulative convertible preferred stock (series A)	\$47	39
5.00% cumulative convertible preferred stock (series 2005B)	\$8	5
4.50% cumulative convertible preferred stock	\$9	6
Unvested restricted stock	\$—	4

As a result of the net loss to common stockholders in the Current Quarter and the Current Period, basic weighted average shares outstanding, which is used in computing basic EPS, and diluted weighted average shares outstanding, which is used in computing diluted EPS, were the same in both periods: 644 million shares in the Current Quarter and 643 million shares in the Current Period. The basic and diluted loss per common share was \$3.19 and \$1.86 in the Current Quarter and the Current Period, respectively.

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(Unaudited)

For the Prior Quarter and the Prior Period, all outstanding securities that were convertible into common stock were included in the calculation of diluted EPS. A reconciliation of basic EPS and diluted EPS for the Prior Quarter and the Prior Period is as follows:

	Income (Numerator)	Weighted Average Shares (Denominator)	Per Share Amount
	(in millions, except per share data)		
Three Months Ended September 30, 2011:			
Basic EPS	\$879	638	\$ 1.38
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 5.75% cumulative convertible preferred stock	21	56	
Common shares assumed issued for 5.75% cumulative convertible preferred stock (series A)	16	39	
Common shares assumed issued for 5.00% cumulative convertible preferred stock (series 2005B)	3	5	
Common shares assumed issued for 4.50% cumulative convertible preferred stock	3	6	
Unvested restricted stock	—	8	
Outstanding stock options	—	1	
Diluted EPS	\$922	753	\$ 1.23
Nine Months Ended September 30, 2011:			
Basic EPS	\$1,141	636	\$ 1.79
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 5.75% cumulative convertible preferred stock	64	56	
Common shares assumed issued for 5.75% cumulative convertible preferred stock (series A)	47	39	
Common shares assumed issued for 5.00% cumulative convertible preferred stock (series 2005B)	8	5	
Common shares assumed issued for 4.50% cumulative convertible preferred stock	9	6	
Unvested restricted stock	—	9	
Outstanding stock options	—	1	
Diluted EPS	\$1,269	752	\$ 1.69

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CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Unaudited)