CHESAPEAKE ENERGY CORP
Form 10-Q
November 06, 2013

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, 2013
[ ] Transition Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the transition period from to
Commission File No. 1-13726
Chesapeake Energy Corporation
(Exact name of registrant as specified in its charter)

Oklahoma	73-1395733
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
6100 North Western Avenue Oklahoma City, Oklahoma	73118
(Address of principal executive offices)	(Zip Code)

(405) 848-8000
(Registrant's telephone number, including area code)

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

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

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

Large Accelerated Filer [X] Accelerated Filer [ ] Non-accelerated Filer [ ] Smaller Reporting Company [ ]

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES [ ] NO [X]

As of November 4, 2013, there were 665,098,207 shares of our $0.01 par value common stock outstanding.

CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES
INDEX TO FORM 10-Q FOR THE QUARTER ENDED SEPTEMBER 30, 2013

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

	September 30, 2013	December 31, 2012
	($ in millions)	
CURRENT ASSETS:		
Cash and cash equivalents ($1 and $1 attributable to our VIE)	$987	$287
Restricted cash	75	111
Accounts receivable	2,440	2,245
Short-term derivative assets	11	58
Deferred income tax asset	185	90
Other current assets	296	153
Current assets held for sale	—	4
Total Current Assets	3,994	2,948
PROPERTY AND EQUIPMENT:		
Natural gas and oil properties, at cost based on full cost accounting:		
Evaluated natural gas and oil properties ($488 and $488 attributable to our VIE)	55,175	50,172
Unevaluated properties	12,282	14,755
Oilfield services equipment	2,179	2,130
Other property and equipment	3,360	3,778
Total Property and Equipment, at Cost	72,996	70,835
Less: accumulated depreciation, depletion and amortization (($151) and ($58) attributable to our VIE)	(36,472)	(34,302)
Property and equipment held for sale, net	597	634
Total Property and Equipment, Net	37,121	37,167
LONG-TERM ASSETS:		
Investments	615	728
Long-term derivative assets	2	2
Other long-term assets	556	766
TOTAL ASSETS	$42,288	$41,611

The accompanying notes are an integral part of these condensed consolidated financial statements.
2

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

	September 30, 2013	December 31, 2012
	($ in millions)	
CURRENT LIABILITIES:		
Accounts payable	$1,730	$1,710
Short-term derivative liabilities ($7 and $4 attributable to our VIE)	170	105
Accrued interest	153	226
Current maturities of long-term debt, net	—	463
Other current liabilities ($24 and $21 attributable to our VIE)	3,625	3,741
Current liabilities held for sale	—	21
Total Current Liabilities	5,678	6,266
LONG-TERM LIABILITIES:		
Long-term debt, net	12,736	12,157
Deferred income tax liabilities	3,423	2,807
Long-term derivative liabilities ($1 and $3 attributable to our VIE)	519	934
Asset retirement obligations	404	375
Other long-term liabilities	1,180	1,176
Total Long-Term Liabilities	18,262	17,449
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: 667,472,869 and 666,467,664 shares issued	7	7
Paid-in capital	12,443	12,293
Retained earnings	905	437
Accumulated other comprehensive loss	(169)	(182)
Less: treasury stock, at cost; 2,246,069 and 2,147,724 common shares	(52)	(48)
Total Chesapeake Stockholders' Equity	16,196	15,569
Noncontrolling interests	2,152	2,327
Total Equity	18,348	17,896
TOTAL LIABILITIES AND EQUITY	$42,288	$41,611

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

3

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

	Three Months Ended September 30, 2013	Three Months Ended September 30, 2012	Nine Months Ended September 30, 2013	Nine Months Ended September 30, 2012
	($ in millions except per share data)			
REVENUES:				
Natural gas, oil and NGL	$1,586	$1,437	$5,444	$4,622
Marketing, gathering and compression	3,032	1,381	6,871	3,710
Oilfield services	249	152	650	446
Total Revenues	4,867	2,970	12,965	8,778
OPERATING EXPENSES:				
Natural gas, oil and NGL production	282	320	877	1,005
Production taxes	62	53	173	141
Marketing, gathering and compression	3,009	1,339	6,781	3,631
Oilfield services	211	116	543	321
General and administrative	120	145	336	436
Restructuring and other termination benefits	63	3	203	4
Natural gas, oil and NGL depreciation, depletion and amortization	652	762	1,945	1,856
Depreciation and amortization of other assets	79	66	234	233
Impairment of natural gas and oil properties	—	3,315	—	3,315
Impairments of fixed assets and other	85	38	343	281
Net (gains) losses on sales of fixed assets	(132)	7	(290)	5
Total Operating Expenses	4,431	6,164	11,145	11,228
INCOME (LOSS) FROM OPERATIONS	436	(3,194)	1,820	(2,450)
OTHER INCOME (EXPENSE):				
Interest expense	(40)	(36)	(164)	(63)
Losses on investments	(22)	(23)	(26)	(87)
Impairment of investment	—	—	(10)	—
Gains (losses) on sales of investments	3	31	(7)	1,061
Losses on purchases of debt	—	—	(70)	—
Other income (expense)	10	(9)	18	2
Total Other Income (Expense)	(49)	(37)	(259)	913
INCOME (LOSS) BEFORE INCOME TAXES	387	(3,231)	1,561	(1,537)
INCOME TAX EXPENSE (BENEFIT):				
Current income taxes	7	22	9	24
Deferred income taxes	140	(1,282)	585	(623)
Total Income Tax Expense (Benefit)	147	(1,260)	594	(599)
NET INCOME (LOSS)	240	(1,971)	967	(938)
Net income attributable to noncontrolling interests	(38)	(41)	(127)	(131)
NET INCOME (LOSS) ATTRIBUTABLE TO CHESAPEAKE	202	(2,012)	840	(1,069)
Preferred stock dividends	(43)	(43)	(128)	(128)
Premium on purchase of preferred shares of a subsidiary	—	—	(69)	—
Earnings allocated to participating securities	(3)	—	(14)	—
	$156	$(2,055)	$629	$(1,197)

NET INCOME (LOSS) AVAILABLE TO COMMON STOCKHOLDERS				
EARNINGS (LOSS) PER COMMON SHARE:				
Basic	$0.24	$(3.19)	$0.96	$(1.86)
Diluted	$0.24	$(3.19)	$0.96	$(1.86)
CASH DIVIDEND DECLARED PER COMMON SHARE	$0.0875	$0.0875	$0.2625	$0.2625
WEIGHTED AVERAGE COMMON AND COMMON EQUIVALENT SHARES OUTSTANDING (in millions):				
Basic	656	644	654	643
Diluted	656	644	654	643

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
	($ in millions)			
NET INCOME (LOSS)	$240	$(1,971)	$967	$(938)
OTHER COMPREHENSIVE INCOME (LOSS), NET OF INCOME TAX:				
Unrealized gain on derivative instruments, net of income tax expense of $1 million, $1 million, $1 million and $1 million	2	3	2	3
Reclassification of (gain) loss on settled derivative instruments, net of income tax expense (benefit) of $1 million, ($3) million, $8 million and ($10) million	2	(6)	13	(18)
Unrealized loss on investments, net of income tax benefit of ($1) million, ($2) million, ($4) million and ($4) million	(1)	(3)	(6)	(7)
Reclassification of (gain) loss on investment, net of income tax expense (benefit) of ($1) million, $0, $3 million and $0	(2)	—	4	—
Other Comprehensive Income (Loss)	1	(6)	13	(22)
COMPREHENSIVE INCOME (LOSS)	241	(1,977)	980	(960)
COMPREHENSIVE INCOME ATTRIBUTABLE TO NONCONTROLLING INTERESTS	(38)	(41)	(127)	(131)
COMPREHENSIVE INCOME (LOSS) ATTRIBUTABLE TO CHESAPEAKE	$203	$(2,018)	$853	$(1,091)

The accompanying notes are an integral part of these condensed consolidated financial statements.
5

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

	Nine Months Ended September 30, 2013	2012
	($ in millions)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
NET INCOME (LOSS)	$967	$(938)
ADJUSTMENTS TO RECONCILE NET INCOME TO CASH PROVIDED BY OPERATING ACTIVITIES:		
Depreciation, depletion and amortization	2,179	2,089
Deferred income tax expense (benefit)	585	(623)
Derivative (income) expense	(90)	(828)
Cash (payments) receipts on derivative settlements, net	(91)	388
Stock-based compensation	78	93
Net (gains) losses on sales of fixed assets	(290)	6
Impairment of natural gas and oil properties	—	3,315
Impairments of fixed assets and other	317	256
Losses on investments	30	147
(Gains) losses on sales of investments	7	(1,061)
Losses on purchases of debt	12	—
Impairment of investment	10	—
Restructuring and other termination benefits	164	4
Other	35	76
Changes in assets and liabilities	(352)	(946)
Net Cash Provided By Operating Activities	3,561	1,978
CASH FLOWS FROM INVESTING ACTIVITIES:		
Drilling and completion costs	(4,470)	(7,525)
Acquisitions of proved and unproved properties	(811)	(2,813)
Proceeds from divestitures of proved and unproved properties	2,789	2,445
Additions to other property and equipment	(639)	(1,916)
Proceeds from sales of other assets	796	219
Additions to investments	(8)	(261)
Proceeds from sales of investments	115	2,000
(Increase) decrease in restricted cash	177	(280)
Other	4	(23)
Net Cash Used In Investing Activities	(2,047)	(8,154)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from credit facilities borrowings	7,136	13,986
Payments on credit facilities borrowings	(7,268)	(13,614)
Proceeds from issuance of senior notes, net of discount and offering costs	2,274	1,263
Proceeds from issuance of term loans, net of discount and offering costs	—	3,789
Cash paid to purchase debt	(2,116)	—
Cash paid for common stock dividends	(175)	(170)
Cash paid for preferred stock dividends	(128)	(128)
Cash paid on financing derivatives	(62)	(36)
Cash paid for prepayment of mortgage	(55)	—
Proceeds from sales of noncontrolling interests	5	1,056

Proceeds from other financings	22	225
Cash paid to purchase preferred shares of a subsidiary	(212)	—
Distributions to noncontrolling interest owners	(164)	(163)
Other	(71)	(227)
Net Cash Provided By (Used In) Financing Activities	(814)	5,981
Change in cash and cash equivalents classified as current assets held for sale	—	(14)
Net increase (decrease) in cash and cash equivalents	700	(209)
Cash and cash equivalents, beginning of period	287	351
Cash and cash equivalents, end of period	$987	$142

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

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

Supplemental disclosures to the condensed consolidated statements of cash flows are presented below:

	Nine Months Ended September 30,	
	2013	2012
	($ in millions)	
SUPPLEMENTAL CASH FLOW INFORMATION:		
Interest, net of capitalized interest	$62	$—
Income taxes, net of refunds received	$14	$31
SUPPLEMENTAL DISCLOSURE OF SIGNIFICANT NON-CASH INVESTING AND FINANCING ACTIVITIES:		
Change in accrued drilling and completion costs	$(97)	$(103)
Change in accrued acquisitions of proved and unproved properties	$(1)	$60
Change in accrued additions to other property and equipment	$(80)	$57

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

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

	Nine Months Ended September 30,	
	2013	2012
	($ in millions)	
PREFERRED STOCK:		
Balance, beginning and end of period	$3,062	$3,062
COMMON STOCK:		
Balance, beginning and end of period	7	7
PAID-IN CAPITAL:		
Balance, beginning of period	12,293	12,146
Stock-based compensation	156	116
Reduction in tax benefit from stock-based compensation	(10)	(18)
Exercise of stock options	4	2
Balance, end of period	12,443	12,246
RETAINED EARNINGS:		
Balance, beginning of period	437	1,608
Net income (loss) attributable to Chesapeake	840	(1,069)
Dividends on common stock	(175)	(170)
Dividends on preferred stock	(128)	(128)
Premium on purchase of preferred shares of a subsidiary	(69)	—
Balance, end of period	905	241
ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS):		
Balance, beginning of period	(182)	(166)
Hedging activity	15	(15)
Investment activity	(2)	(7)
Balance, end of period	(169)	(188)
TREASURY STOCK – COMMON:		
Balance, beginning of period	(48)	(33)
Purchase of 249,498 and 357,565 shares for company benefit plans	(6)	(9)
Release of 151,153 and 49,591 shares from company benefit plans	2	1
Balance, end of period	(52)	(41)
TOTAL CHESAPEAKE STOCKHOLDERS' EQUITY	16,196	15,327
NONCONTROLLING INTERESTS:		
Balance, beginning of period	2,327	1,337
Sales of noncontrolling interests	5	1,056
Net income attributable to noncontrolling interests	127	131
Distributions to noncontrolling interest owners	(164)	(160)
Purchase of preferred shares of a subsidiary	(143)	—
Balance, end of period	2,152	2,364
TOTAL EQUITY	$18,348	$17,691

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

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, 2013 (the "Current Quarter" and the "Current Period", respectively) and the three and nine months ended September 30, 2012 (the "Prior Quarter" and the "Prior Period", respectively). Chesapeake's annual report on Form 10-K for the year ended December 31, 2012 ("2012 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 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 variable interest entities, natural gas and oil properties, derivatives and income taxes to be critical policies. These policies are summarized in Item 7 of our 2012 Form 10-K.

Risks and Uncertainties

Our primary business strategy over the last few years was to continue growing our reserves and production while transitioning from an asset base primarily focused on natural gas to an asset base more balanced between natural gas and liquids production. This was a capital-intensive strategy, and we made capital expenditures historically and in the Current Period that exceeded our cash flow from operations, supplementing such cash flows with borrowings, proceeds from strategic joint ventures and sales of assets that we determined were noncore or did not fit our long-term plans. The full year 2013 gap between forecasted capital expenditures and expected cash flow from operations is approximately $3.5 billion; however, this expected spending gap has been fully covered by joint venture and asset sales proceeds received year to date. We are working to execute our business with greater financial discipline and are targeting to balance capital expenditures with cash flow from operations over time. We expect to have the flexibility to fund any short-term disparities using our $4.0 billion corporate revolving credit facility, which was undrawn at September 30, 2013. As we apply available cash from future asset sales and operations towards reducing our financial leverage and complexity, we may incur various cash and noncash charges including but not limited to impairments of fixed assets, lease termination charges or financing extinguishment costs.

We continue to have significant exposure to natural gas prices. Approximately 70% of our estimated proved reserve volumes as of December 31, 2012 were natural gas, and natural gas represented approximately 73% and 80% of our natural gas, oil and NGL sales volumes for the Current Quarter and the year ended December 31, 2012, respectively. To add more certainty to our future estimated cash flows, we currently have downside price protection, in the form of over-the-counter derivative contracts, on approximately 80% of our remaining 2013 estimated natural gas production at an average price of $3.69 per mcf and 91% of our remaining 2013 estimated oil production at an average price of $95.59 per bbl. We also have derivative contracts providing downside price protection in 2014 on 251 bcf of natural gas at an average price of $4.22 per mcf and 22 mmbbls of oil at an average price of $93.79 per bbl. While our use of derivative contracts allows us to reduce our exposure to price volatility on our cash flows and EBITDA (defined as earnings before interest, taxes, depreciation, depletion and amortization), the derivative contracts we elect to enter into for any period depend on our outlook on future prices and our risk assessment. Low natural gas, oil and NGL prices can reduce our estimate of proved reserves, potentially resulting in a future write-down of the carrying value of our natural gas and oil properties. In 2012, when natural gas prices reached 10-year lows, we reduced our estimate of proved reserves by 3.1 tcfe, or 17%, primarily due to the impact of downward natural gas price revisions, and we incurred a $3.3 billion write-down of the carrying value of our natural gas and oil properties. 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.

CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)
(unaudited)

Assets and Liabilities Held for Sale
In the Current Period, we determined we would sell certain of our buildings and land (other than our core campus) in the Oklahoma City area. In addition, as of September 30, 2013, we were continuing to pursue the sale of various land and buildings located in the Fort Worth, Texas area. The land and buildings in both the Oklahoma City and Fort Worth areas are reported under our other segment. We are also pursuing the sale of various other property and equipment, including certain drilling rigs, compressors and gathering systems. The drilling rigs are reported under our oilfield services operating segment and the compressors and gathering systems are reported under our marketing, gathering and compression operating segment. These assets are being actively marketed, and we believe it is probable they will be sold over the next 12 months. As a result, these assets qualified as held for sale as of September 30, 2013. Natural gas and oil properties that we intend to sell are not presented as held for sale pursuant to the rules governing full cost accounting for oil and gas properties. A summary of the assets and liabilities held for sale on our condensed consolidated balance sheets as of September 30, 2013 and December 31, 2012 is detailed below.

	September 30, 2013	December 31, 2012
	($ in millions)	
Accounts receivable	$—	$4
Current assets held for sale	$—	$4
Natural gas gathering systems and treating plants, net of accumulated depreciation	$10	$352
Oilfield services equipment, net of accumulated depreciation	26	27
Compressors, net of accumulated depreciation	242	—
Buildings and land, net of accumulated depreciation	319	255
Property and equipment held for sale, net	$597	$634
Accounts payable	$—	$4
Accrued liabilities	—	17
Current liabilities held for sale	$—	$21

CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)
(unaudited)

Accumulated Other Comprehensive Income (Loss)

For the Current Period, changes in accumulated other comprehensive income (loss) by component, net of tax, are detailed below.

	Net Gains (Losses) on Cash Flow Hedges