CHESAPEAKE ENERGY CORP
Form 10-Q
August 06, 2014

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 June 30, 2014
[ ] 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 August 1, 2014, there were 665,775,653 shares of our $0.01 par value common stock outstanding.

CHESAPEAKE ENERGY CORPORATION AND SUBSIDIARIES
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PART I. FINANCIAL INFORMATION

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

	June 30, 2014	December 31, 2013
	($ in millions)	
CURRENT ASSETS:		
Cash and cash equivalents ($1 and $1 attributable to our VIE)	$1,462	$837
Restricted cash	75	75
Accounts receivable, net	2,310	2,222
Short-term derivative assets	1	—
Deferred income tax asset	205	223
Other current assets	317	299
Total Current Assets	4,370	3,656
PROPERTY AND EQUIPMENT:		
Natural gas and oil properties, at cost based on full cost accounting:		
Proved natural gas and oil properties ($488 and $488 attributable to our VIE)	58,914	56,157
Unproved properties	11,389	12,013
Oilfield services equipment	—	2,192
Other property and equipment	3,150	3,203
Total Property and Equipment, at Cost	73,453	73,565
Less: accumulated depreciation, depletion and amortization (($201) and ($168) attributable to our VIE)	(37,689)	(37,161)
Property and equipment held for sale, net	247	730
Total Property and Equipment, Net	36,011	37,134
LONG-TERM ASSETS:		
Investments	264	477
Long-term derivative assets	7	4
Other long-term assets	475	511
TOTAL ASSETS	$41,127	$41,782

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

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

	June 30, 2014	December 31, 2013
	($ in millions)	
CURRENT LIABILITIES:		
Accounts payable	$1,930	$1,596
Short-term derivative liabilities ($9 and $5 attributable to our VIE)	417	208
Accrued interest	152	200
Other current liabilities ($20 and $22 attributable to our VIE)	3,293	3,511
Total Current Liabilities	5,792	5,515
LONG-TERM LIABILITIES:		
Long-term debt, net	11,549	12,886
Deferred income tax liabilities	3,773	3,407
Long-term derivative liabilities ($1 and $0 attributable to our VIE)	389	445
Asset retirement obligations	431	405
Other long-term liabilities	868	984
Total Long-Term Liabilities	17,010	18,127
CONTINGENCIES AND COMMITMENTS (Note 5)		
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: 665,440,807 and 666,192,371 shares issued	7	7
Paid-in capital	12,495	12,446
Retained earnings	833	688
Accumulated other comprehensive loss	(154)	(162)
Less: treasury stock, at cost; 1,717,527 and 2,002,029 common shares	(41)	(46)
Total Chesapeake Stockholders' Equity	16,202	15,995
Noncontrolling interests	2,123	2,145
Total Equity	18,325	18,140
TOTAL LIABILITIES AND EQUITY	$41,127	$41,782

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

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
	($ in millions except per share data)			
REVENUES:				
Natural gas, oil and NGL	$1,704	$2,406	$3,471	$3,858
Marketing, gathering and compression	3,167	2,057	6,182	3,838
Oilfield services	281	212	545	402
Total Revenues	5,152	4,675	10,198	8,098
OPERATING EXPENSES:				
Natural gas, oil and NGL production	282	288	570	595
Production taxes	72	59	122	112
Marketing, gathering and compression	3,166	2,028	6,147	3,772
Oilfield services	212	177	431	332
General and administrative	90	106	169	216
Restructuring and other termination costs	33	7	26	140
Natural gas, oil and NGL depreciation, depletion and amortization	661	645	1,288	1,293
Depreciation and amortization of other assets	79	76	157	154
Impairments of fixed assets and other	40	231	60	258
Net gains on sales of fixed assets	(93)	(109)	(115)	(158)
Total Operating Expenses	4,542	3,508	8,855	6,714
INCOME FROM OPERATIONS	610	1,167	1,343	1,384
OTHER INCOME (EXPENSE):				
Interest expense	(27)	(104)	(66)	(124)
Earnings (losses) on investments	(24)	23	(45)	(14)
Net gain (loss) on sales of investments	—	(10)	67	(10)
Losses on purchases of debt	(195)	(70)	(195)	(70)
Other income	7	3	13	8
Total Other Expense	(239)	(158)	(226)	(210)
INCOME BEFORE INCOME TAXES	371	1,009	1,117	1,174
INCOME TAX EXPENSE				
Current income taxes	5	2	8	3
Deferred income taxes	136	382	413	443
Total Income Tax Expense	141	384	421	446
NET INCOME	230	625	696	728
Net income attributable to noncontrolling interests	(39)	(45)	(80)	(89)
NET INCOME ATTRIBUTABLE TO CHESAPEAKE	191	580	616	639
Preferred stock dividends	(43)	(43)	(86)	(86)
Premium on purchase of preferred shares of a subsidiary	—	(69)	—	(69)
Earnings allocated to participating securities	(3)	(11)	(12)	(11)
NET INCOME AVAILABLE TO COMMON STOCKHOLDERS	$145	$457	$518	$473
EARNINGS PER COMMON SHARE:				
Basic	$0.22	$0.70	$0.79	$0.72
Diluted	$0.22	$0.66	$0.78	$0.72

CASH DIVIDEND DECLARED PER COMMON SHARE	$0.0875	$0.0875	$0.1750	$0.1750
WEIGHTED AVERAGE COMMON AND COMMON EQUIVALENT SHARES OUTSTANDING (in millions):				
Basic	659	653	658	653
Diluted	659	760	760	653

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 June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
	($ in millions)			
NET INCOME	$230	$625	$696	$728
OTHER COMPREHENSIVE INCOME, NET OF INCOME TAX:				
Unrealized gain on derivative instruments, net of income tax expense of $1, $1, $3 and $0	—	1	3	—
Reclassification of (gain) loss on settled derivative instruments, net of income tax expense of $4, $0, $10 and $7	(1)	(1)	10	11
Unrealized loss on investments, net of income tax benefit of $0, $0, $0 and ($3)	—	—	—	(5)
Reclassification of (gain) loss on investment, net of income tax expense (benefit) of $0, $0, ($3) and $4	—	—	(5)	6
Other Comprehensive Income	(1)	—	8	12
COMPREHENSIVE INCOME	229	625	704	740
COMPREHENSIVE INCOME ATTRIBUTABLE TO NONCONTROLLING INTERESTS	(39)	(45)	(80)	(89)
COMPREHENSIVE INCOME ATTRIBUTABLE TO CHESAPEAKE	$190	$580	$624	$651

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

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

	Six Months Ended June 30,	
	2014	2013
	($ in millions)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
NET INCOME	$696	$728
ADJUSTMENTS TO RECONCILE NET INCOME (LOSS) TO CASH PROVIDED BY OPERATING ACTIVITIES:		
Depreciation, depletion and amortization	1,445	1,447
Deferred income tax expense	413	443
Derivative (gains) losses, net	542	(323)
Cash payments on derivative settlements, net	(323)	(49)
Stock-based compensation	40	56
Net gains on sales of fixed assets	(115)	(158)
Impairments of fixed assets and other	51	258
Losses on investments	45	7
Net (gains) losses on sales of investments	(67)	10
Restructuring and other termination costs	24	104
Losses on purchases of debt	61	17
Other	71	6
Changes in assets and liabilities	(240)	(341)
Net Cash Provided By Operating Activities	2,643	2,205
CASH FLOWS FROM INVESTING ACTIVITIES:		
Drilling and completion costs	(1,996)	(3,145)
Acquisitions of proved and unproved properties	(356)	(550)
Proceeds from divestitures of proved and unproved properties	248	1,895
Additions to other property and equipment	(620)	(506)
Proceeds from sales of other assets	713	459
Additions to investments	(5)	(4)
Proceeds from sales of investments	239	102
Decrease in restricted cash	—	170
Other	(3)	4
Net Cash Used In Investing Activities	(1,780)	(1,575)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from credit facilities borrowings	857	6,559
Payments on credit facilities borrowings	(1,239)	(6,578)
Proceeds from issuance of senior notes, net of discount and offering costs	2,966	2,274
Proceeds from issuance of oilfield services senior notes, net of discount and offering costs	494	—
Proceeds from issuance of oilfield services term loan, net of issuance costs	394	—
Cash paid to purchase debt	(3,362)	(1,874)
Cash paid for common stock dividends	(117)	(116)
Cash paid for preferred stock dividends	(86)	(86)
Cash paid on financing derivatives	(32)	(25)
Cash paid for prepayment of mortgage	—	(55)

Proceeds from sales of noncontrolling interests	—	5
Proceeds from other financings	—	22
Cash paid to purchase preferred shares of a subsidiary	—	(212)
Cash held and retained by SSE at spin-off	(8)	—
Distributions to noncontrolling interest owners	(105)	(111)
Other	—	(43)
Net Cash Used In Financing Activities	(238)	(240)
Net increase in cash and cash equivalents	625	390
Cash and cash equivalents, beginning of period	837	287
Cash and cash equivalents, end of period	$1,462	$677

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)

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

	Six Months Ended June 30,	
	2014	2013
	($ in millions)	
SUPPLEMENTAL CASH FLOW INFORMATION:		
Interest paid, net of capitalized interest	$88	$—
Income taxes paid, net of refunds received	$13	$13
SUPPLEMENTAL DISCLOSURE OF SIGNIFICANT NON-CASH INVESTING AND FINANCING ACTIVITIES:		
Change in accrued drilling and completion costs	$(125)	$(60)
Change in accrued acquisitions of proved and unproved properties	$(60)	$54
Change in accrued additions to other property and equipment	$—	$(58)

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)

	Six Months Ended June 30,	
	2014	2013
	($ 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	12,446	12,293
Stock-based compensation	23	99
Tax benefit (reduction in tax benefit) from stock-based compensation	3	(12)
Exercise of stock options	23	3
Balance, end of period	12,495	12,383
RETAINED EARNINGS:		
Balance, beginning of period	688	437
Net income attributable to Chesapeake	616	639
Dividends on common stock	(117)	(116)
Dividends on preferred stock	(86)	(86)
Spin-off of oilfield services business (Note 2)	(268)	—
Premium on purchase of preferred shares of a subsidiary	—	(69)
Balance, end of period	833	805
ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS):		
Balance, beginning of period	(162)	(182)
Hedging activity	13	11
Investment activity	(5)	1
Balance, end of period	(154)	(170)
TREASURY STOCK – COMMON:		
Balance, beginning of period	(46)	(48)
Purchase of 10,191 and 247,183 shares for company benefit plans	—	(5)
Release of 300,034 and 106,458 shares from company benefit plans	5	1
Balance, end of period	(41)	(52)
TOTAL CHESAPEAKE STOCKHOLDERS' EQUITY	16,202	16,035
NONCONTROLLING INTERESTS:		
Balance, beginning of period	2,145	2,327
Sales of noncontrolling interests	—	5
Net income attributable to noncontrolling interests	80	89
Distributions to noncontrolling interest owners	(102)	(109)
Purchase of preferred shares of a subsidiary	—	(143)
Balance, end of period	2,123	2,169
TOTAL EQUITY	$18,325	$18,204

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

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of Chesapeake Energy Corporation ("Chesapeake" or the "Company") and its subsidiaries are prepared in accordance with accounting principles generally accepted in the United States ("U.S. GAAP") and include the accounts of our direct and indirect wholly owned subsidiaries and entities in which Chesapeake has a controlling financial interest. Intercompany accounts and balances have been eliminated. These financial statements have been prepared in accordance with the instructions to Form 10-Q and, therefore, do not include all disclosures required for financial statements prepared in conformity with U.S. GAAP.

This Form 10-Q relates to the three and six months ended June 30, 2014 (the "Current Quarter" and the "Current Period", respectively) and the three and six months ended June 30, 2013 (the "Prior Quarter" and the "Prior Period", respectively). Chesapeake's annual report on Form 10-K for the year ended December 31, 2013 ("2013 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 results for the Current Quarter and the Current Period are not necessarily indicative of the results to be expected for the full year.

Risks and Uncertainties

Through our oilfield services spin-off (see Note 2), other divestitures and various other strategic transactions, we have taken steps to reduce financial leverage and complexity and further enhance our liquidity. While executing our strategic priorities, including financial discipline and profitable and efficient growth from captured resources, we have incurred certain cash outflows related to these transactions, including contract termination charges, financing extinguishment costs and charges for unused natural gas transportation and gathering capacity. As we continue to focus on our strategic priorities, certain actions that may reduce financial leverage and complexity could negatively impact our future results of operations and/or liquidity, and we may incur additional cash and noncash charges.

2. Spin-Off of Oilfield Services Business

On June 30, 2014, we completed the spin-off of our oilfield services business, which we previously conducted through our indirect, wholly owned subsidiary Chesapeake Oilfield Operating, L.L.C. (COO), into an independent, publicly traded company called Seventy Seven Energy Inc. (SSE). Following the close of business on June 30, 2014, we distributed to Chesapeake shareholders one share of SSE common stock and cash in lieu of fractional shares for every 14 shares of Chesapeake common stock held on June 19, 2014, the record date for the distribution.

Prior to the completion of the spin-off, we and COO and its affiliates engaged in the following series of transactions:

- COO and certain of its subsidiaries entered into a $275 million senior secured revolving credit facility and a $400 million secured term loan, the proceeds of which were used to repay in full and terminate COO's existing credit facility.
- COO distributed to us its compression unit manufacturing business, its geosteering business and the proceeds from the sale of substantially all of its crude oil hauling business. See Note 13 for further discussion of the sale.
- We transferred certain of our buildings and land to a subsidiary of COO, most of which COO had been leasing from us prior to the spin-off, at carrying value.
- COO issued $500 million of 6.5% Senior Notes due 2022 in a private placement and used the net proceeds to make a cash distribution of approximately $391 million to us, to repay a portion of outstanding indebtedness under the new revolving credit facility and for general corporate purposes.
- COO converted from a limited liability company into a corporation named Seventy Seven Energy Inc.
- We distributed all of SSE's outstanding shares to our shareholders, which resulted in SSE becoming an independent, publicly traded company.

As of June 30, 2014, following the spin-off, we have no ownership interest in SSE. Therefore, we no longer consolidate SSE's assets and liabilities as of June 30, 2014. Because we expect to have continuing cash flows associated with SSE's future operations through various agreements described below, our former oilfield services segment's historical financial results for periods up to the spin-off date will continue to be included in our historical financial results as a component of continuing operations. For segment disclosures, we have labeled our oilfield services segment as "former oilfield services". See Note 17 for additional information regarding our segments.

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

In connection with the spin-off, we entered into several agreements to define the terms and conditions of the spin-off and our ongoing relationship with SSE after the spin-off, including a master separation agreement, a tax sharing agreement, an employee matters agreement, a transition services agreement, a services agreement and certain commercial agreements. These agreements, among other things, allocate responsibility for obligations arising before and after the distribution date, including obligations relating to taxes, employees, various transition services and oilfield services.

- The master separation agreement sets forth the agreements between SSE and Chesapeake regarding the principal transactions that were necessary to effect the spin-off and also sets forth other agreements that govern certain aspects of SSE's relationship with Chesapeake after the completion of the spin-off.
- The tax sharing agreement governs the respective rights, responsibilities and obligations of SSE and Chesapeake with respect to tax liabilities and benefits, tax attributes, the preparation and filing of tax returns, the control of audits and other tax proceedings, and certain other matters regarding taxes.
- The employee matters agreement addresses employee compensation and benefit plans and programs, and other related matters in connection with the spin-off, including the treatment of holders of Chesapeake common stock options, restricted stock awards, restricted stock units and performance share units, and the cooperation between SSE and Chesapeake in the sharing of employee information and maintenance of confidentiality. See Note 8 for additional information regarding the effect of the spin-off on outstanding equity compensation.
- The transition services agreement sets forth the terms on which we will provide SSE certain services. Transition services include marketing and corporate communication, human resources, information technology, security, legal, risk management, tax, environmental health and safety, maintenance, internal audit, accounting, treasury and certain other services specified in the agreement. In consideration for such services, SSE will pay Chesapeake a negotiated fee for providing those services.
- The services agreement requires us to utilize, at market-based pricing, the lesser of (i) seven, five and three pressure pumping crews in years one, two and three of the agreement, respectively, or (ii) 50% of the total number of all pressure pumping crews working for us in all of our operating regions during the respective year. We are also required to utilize SSE pressure pumping services for a minimum number of fracture stages as set forth in the agreement. We are entitled to terminate the agreement in certain situations, including if SSE fails to materially comply with the overall quality of service provided by similar service providers. As of June 30, 2014, the aggregate undiscounted minimum future payments under this agreement were approximately $283 million.
- We have also entered into drilling agreements that are rig-specific daywork drilling contracts with terms ranging from three months to three years and at market-based rates. We have the right to terminate a drilling agreement in certain circumstances. As of June 30, 2014, the aggregate undiscounted minimum future payments under these drilling agreements were approximately $393 million.

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

Our stockholders’ equity decreased by $268 million as a result of the spin-off. The following table shows the components of the decrease, which consisted of the book value of the assets and liabilities of COO as of the spin-off date of June 30, 2014. The spin-off is reflected on our condensed consolidated statement of cash flows primarily as non-cash activity.

	June 30, 2014 ($ in millions)
Assets	
Cash and cash equivalents	$8
Accounts receivable, net[(a)]	378
Other current assets	46
Total current assets	432
Oilfield services equipment	2,632
Accumulated depreciation	(900)
Investments	8
Deferred income tax asset	8
Other long-term assets	68
Total assets	$2,248
Liabilities	
Accounts payable[(a)]	$62
Accrued interest	6
Other current liabilities	180
Total current liabilities	248
Long-term debt, net	1,568
Deferred income tax liabilities	160
Asset retirement obligations	1
Other long-term liabilities	3
Total long-term liabilities	1,732
Spin-Off of Oilfield Services Business	$268

(a) Includes affiliate receivables and payables of $309 million and $8 million, respectively, that were previously eliminated in consolidation.

In the Current Quarter, we recognized $12 million of charges associated with the spin-off that are included in restructuring and other termination costs on our condensed consolidated statement of operations. See Note 15 for further details regarding these charges.

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

3. Earnings Per Share

Basic earnings per share (EPS) is calculated using the weighted average number of common shares outstanding during the period and includes the effect of any participating securities as appropriate. Participating securities consist of unvested restricted stock issued to our employees and non-employee directors that provide dividend rights.

Diluted EPS is calculated assuming the issuance of common shares for all potentially dilutive securities, provided the effect is not antidilutive. For the Current Quarter, the Prior Quarter, the Current Period and the Prior Period, our contingent convertible senior notes did not have a dilutive effect and therefore were excluded from the calculation of diluted EPS. See Note 4 for further discussion of our contingent convertible senior notes.

For the Current Quarter, the Current Period and the Prior Period, the following securities and associated adjustments to net income, representing dividends on such shares, were excluded from the calculation of diluted EPS as the effect was antidilutive. The impact of our stock options was immaterial in the calculation of diluted EPS for these periods.

	Net Income Adjustments ($ in millions)	Shares (in millions)
Three Months Ended June 30, 2014:		
Common stock equivalent of our preferred stock outstanding:		
5.75% cumulative convertible preferred stock	$22	59
5.75% cumulative convertible preferred stock (series A)	$16	42
5.00% cumulative convertible preferred stock (series 2005B)	$3	6
4.50% cumulative convertible preferred stock	$3	6
Unvested restricted stock	$3	3
Six Months Ended June 30, 2014:		
Common stock equivalent of our preferred stock outstanding:		
5.00% cumulative convertible preferred stock (series 2005B)	$5	6
4.50% cumulative convertible preferred stock	$6	6
Unvested restricted stock	$11	3
Six Months Ended June 30, 2013:		
Common stock equivalent of our preferred stock outstanding:		
5.75% cumulative convertible preferred stock	$43	56
5.75% cumulative convertible preferred stock (series A)	$32	39
5.00% cumulative convertible preferred stock (series 2005B)	$5	5
4.50% cumulative convertible preferred stock	$6	6
Unvested restricted stock	$11	5

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

For the Prior Quarter and the Current Period, the following securities and adjustments to net income, representing dividends on such shares, were included in the calculation of diluted EPS as the effect was dilutive. A reconciliation of basic EPS and diluted EPS for these periods is as follows:

	Net Income Available to Common Stockholders (Numerator)	Weighted Average Shares (Denominator)	Per Share Amount
	(in millions, except per share data)		
Three Months Ended June 30, 2013:			
Basic EPS	$457	653	$0.70
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	40	
Common shares assumed issued for 4.50% cumulative convertible preferred stock	3	6	
Common shares assumed issued for 5.00% cumulative convertible preferred stock (series 2005B)	3	5	
Diluted EPS	$500	760	$0.66
Six Months Ended June 30, 2014:			
Basic EPS	$518	658	$0.79
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	43	59	
Common shares assumed issued for 5.75% cumulative convertible preferred stock (series A)	32	42	
Outstanding stock options	—	1	
Diluted EPS	$593	760	$0.78

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4. Debt

Our long-term debt consisted of the following as of June 30, 2014 and December 31, 2013:

	June 30, 2014	December 31, 2013
	($ in millions)	
Term loan due 2017[a]	$—	$2,000
9.5% senior notes due 2015[b]	—	1,265
3.25% senior notes due 2016	500	500
6.25% euro-denominated senior notes due 2017[c]	471	473
6.5% senior notes due 2017	660	660
6.875% senior notes due 2018[d]	—	97
7.25% senior notes due 2018	669	669
Floating rate senior notes due 2019	1,500	—
6.625% senior notes due 2019[e]	—	650
6.625% senior notes due 2020	1,300	1,300
6.875% senior notes due 2020	500	500
6.125% senior notes due 2021	1,000	1,000
5.375% senior notes due 2021	700	700
4.875% senior notes due 2022	1,500	—
5.75% senior notes due 2023	1,100	1,100
2.75% contingent convertible senior notes due 2035[f]	396	396
2.5% contingent convertible senior notes due 2037[f]	1,168	1,168
2.25% contingent convertible senior notes due 2038[f]	347	347
Corporate revolving bank credit facility	—	—
Oilfield services revolving bank credit facility[g]	—	405
Discount on senior notes and term loan[h]	(272)	(357)
Interest rate derivatives[i]	10	13
Total long-term debt, net	$11,549	$12,886

(a) In the Current Quarter, we repaid the borrowings outstanding under the term loan due 2017 with a portion of the net proceeds from our offering of $3.0 billion in aggregate principal amount of senior notes issued in the Current Quarter.

(b) In the Current Quarter, we completed a tender offer for and redemption of the 9.5% Senior Notes due 2015.

(c) The principal amount shown is based on the exchange rate of $1.3692 to €1.00 and $1.3743 to €1.00 as of June 30, 2014 and December 31, 2013, respectively. See Note 9 for information on our related foreign currency derivatives.

(d) In the Current Quarter, we redeemed all outstanding 6.875% Senior Notes due 2018.

(e) Initial issuers were COO and Chesapeake Oilfield Finance, Inc., a wholly owned subsidiary of COO. Chesapeake Energy Corporation is the issuer of all other senior notes and the contingent convertible senior notes. In the Current Quarter, in connection with the spin-off of our oilfield services business, the obligations with respect to the COO senior notes were removed from our condensed consolidated balance sheet as of June 30, 2014. See Note 2 for further discussion of the spin-off.

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(f) The holders of our contingent convertible senior notes may require us to repurchase, in cash, all or a portion of their notes at 100% of the principal amount of the notes on any of four dates that are five, ten, fifteen and twenty years before the maturity date. 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. One such triggering circumstance is when the price of our common stock exceeds a threshold amount during a specified period in a fiscal quarter. Convertibility based on common stock price is measured quarterly. In the second quarter of 2014, the price of our common stock was below the threshold level for each series of the contingent convertible senior notes during the specified period and, as a result, the holders do not have the option to convert their notes into cash and common stock in the third quarter of 2014 under this provision. The notes are also convertible, at the holder's option, during specified five-day periods if the trading price of the notes is below certain levels determined by reference to the trading price of our common stock. The notes were not convertible under this provision in the Current Quarter or the Prior Quarter. In general, upon conversion of a contingent 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. Under certain conditions, we will pay contingent interest on the convertible senior notes after they have been outstanding at least ten years. We may redeem the convertible senior notes once they have been outstanding for ten years at a redemption price of 100% of the principal amount of the notes, payable in cash. The optional repurchase dates, the common stock price conversion threshold amounts (as adjusted to give effect to the dividend of SSE common stock paid in the spin-off of our oilfield services business and cash dividends on our common stock) and the ending date of the first six-month period in which contingent interest may be payable for the contingent convertible senior notes are as follows:

Contingent Convertible Senior Notes	Repurchase Dates	Common Stock Price Conversion Thresholds	Contingent Interest First Payable (if applicable)
2.75% due 2035	November 15, 2015, 2020, 2025, 2030	$45.22	May 14, 2016
2.5% due 2037	May 15, 2017, 2022, 2027, 2032	$59.71	November 14, 2017
2.25% due 2038	December 15, 2018, 2023, 2028, 2033	$100.45	June 14, 2019

(g) In the Current Quarter, in connection with the spin-off of our oilfield services business, we terminated our oilfield services credit facility. See Note 2 for further discussion of the spin-off.

(h) Discount as of June 30, 2014 and December 31, 2013 included $264 million and $303 million, respectively, associated with the equity component of our contingent convertible senior notes. This discount is amortized based on an effective yield method. Discount also included $33 million as of December 31, 2013 associated with our term loan discussed further below.

(i) See Note 9 for further discussion related to these instruments.

Term Loan

In November 2012, we established an unsecured five-year term loan credit facility in an aggregate principal amount of $2.0 billion for net proceeds of $1.935 billion. The term loan provided that it could be voluntarily repaid before November 9, 2015 at par plus a specified premium and at any time thereafter at par. The maturity date of the term loan was December 2, 2017. In the Current Quarter, the Company used a portion of the net proceeds from its offering of $3.0 billion in aggregate principal amount of senior notes to repay the borrowings under, and terminate, the term loan. We recorded a loss of $90 million, consisting of $40 million in premiums, $30 million of unamortized discount and $20 million of unamortized deferred charges, in connection with the termination.

Chesapeake Senior Notes and Contingent Convertible Senior Notes

The Chesapeake senior notes and the contingent convertible senior notes are unsecured senior obligations of Chesapeake and rank equally in right of payment with all of our other existing and future senior unsecured indebtedness and rank senior in right of payment to all of our future subordinated indebtedness. Chesapeake is a holding company and owns no operating assets and has no significant operations independent of its subsidiaries. Chesapeake's obligations under the senior notes and the contingent convertible senior notes are jointly and severally, fully and unconditionally guaranteed by certain of our direct and indirect 100% owned subsidiaries. See Note 18 for condensed consolidating financial information regarding our guarantor and non-guarantor subsidiaries.

We may redeem the senior notes, other than the contingent convertible senior notes, at any time at specified make-whole or redemption prices. Our senior notes are governed by indentures containing covenants that may limit our ability and our subsidiaries' ability to incur certain secured indebtedness, enter into sale/leaseback transactions, and consolidate, merge or transfer assets. The indentures governing the senior notes and the contingent convertible senior notes do not have any financial or restricted payment covenants. The senior notes and contingent convertible senior notes indentures have cross default provisions that apply to other indebtedness the Company or any guarantor subsidiary may have from time to time with an outstanding principal amount of at least $50 million or $75 million, depending on the indenture.

We are required to account for the liability and equity components of our convertible debt instruments separately and to reflect interest expense at the interest rate of similar nonconvertible debt at the time of issuance. The applicable rates for our 2.75% Contingent Convertible Senior Notes due 2035, our 2.5% Contingent Convertible Senior Notes due 2037 and our 2.25% Contingent Convertible Senior Notes due 2038 are 6.86%, 8.0% and 8.0%, respectively.

During the Current Quarter, we issued $3.0 billion in aggregate principal amount of senior notes at par. The offering included two series of notes: $1.5 billion in aggregate principal amount of Floating Rate Senior Notes due 2019 and $1.5 billion in aggregate principal amount of 4.875% Senior Notes due 2022. We used a portion of the net proceeds of $2.966 billion to repay the borrowings under, and terminate, our term loan credit facility. We used the remaining proceeds along with cash on hand to redeem the remaining $97 million principal amount of the 6.875% Senior Notes due 2018 and to purchase and redeem the remaining $1.265 billion principal amount of the 9.5% Senior Notes due 2015 for $1.454 billion. We recorded a loss of approximately $6 million associated with the redemption of the 6.875% Senior Notes due 2018, which consisted of $5 million in premiums and $1 million of unamortized deferred charges. We recorded a loss of approximately $99 million associated with the purchase and redemption of the 9.5% Senior Notes due 2015, which consisted of $87 million in premiums, $9 million of unamortized discount and $3 million of unamortized deferred charges.

During the Prior Period, we issued $2.3 billion in aggregate principal amount of senior notes at par. The offering included three series of notes: $500 million in aggregate principal amount of 3.25% Senior Notes due 2016; $700 million in aggregate principal amount of 5.375% Senior Notes due 2021; and $1.1 billion in aggregate principal amount of 5.75% Senior Notes due 2023. We used a portion of the net proceeds of $2.274 billion to repay outstanding indebtedness under our corporate revolving bank credit facility and purchase certain senior notes. We purchased $217 million in aggregate principal amount of our 7.625% Senior Notes due 2013 for $221 million and $377 million in aggregate principal amount of our 6.875% Senior Notes due 2018 for $405 million pursuant to tender offers during the Prior Period. We recorded a loss of approximately $37 million associated with the tender offers, including $32 million in premiums and $5 million of unamortized deferred charges. During the Prior Period, we also redeemed $1.3 billion in aggregate principal amount of our 6.775% Senior Notes due 2019 (the "2019 Notes") at par pursuant to notice of special early redemption. We recorded a loss of approximately $33 million associated with the redemption, including $19 million of unamortized deferred charges and $14 million of discount. As described in the following paragraph, our redemption of the 2019 notes has been the subject of litigation. On July 15, 2013, we retired at maturity the remaining $247 million aggregate principal amount outstanding of our 7.625% Senior Notes due 2013.

In March 2013, the Company brought suit in the U.S. District Court for the Southern District of New York (the "Court") against The Bank of New York Mellon Trust Company, N.A. ("BNY Mellon"), the indenture trustee for the 2019 Notes. The Company sought a declaration that the notice it issued to redeem all of the 2019 Notes at par (plus accrued interest through the redemption date) was timely and effective pursuant to the special early redemption provision of the supplemental indenture governing the 2019 Notes. BNY Mellon asserted that the notice was not effective to redeem the 2019 Notes at par because it was not timely for that purpose and because of the specific phrasing in the notice that provided it would not be effective unless the Court concluded it was timely. The Court conducted a trial on

the matter and ruled in the Company’s favor in May 2013. BNY Mellon filed notice of an appeal of the decision with the United States Court of Appeals for the Second Circuit and the appeal is currently pending.

No scheduled principal payments are required on our senior notes until 2016.

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Bank Credit Facilities
During the Current Period, we had the following two revolving bank credit facilities as sources of liquidity:

	Corporate Credit Facility[(a)]	Oilfield Services Credit Facility[(b)]
	($ in millions)	
Facility structure	Senior secured revolving	Senior secured revolving
Maturity date	December 2015	November 2016
Borrowing capacity	$4,000	$500
Amount outstanding as of June 30, 2014	$—	$—
Letters of credit outstanding as of June 30, 2014	$20	$—

(a) Co-borrowers are Chesapeake Exploration, L.L.C., Chesapeake Appalachia, L.L.C. and Chesapeake Louisiana, L.P.
(b) Borrower was COO. We terminated our oilfield services credit facility in the Current Quarter in connection with the spin-off of our oilfield services business. See Note 2 for further discussion of the spin-off.

Our $4.0 billion syndicated revolving bank credit facility is used for general corporate purposes. Borrowings under the facility are secured by proved reserves and bear interest at our option at either (i) the greater of the reference rate of Union Bank, N.A. or the federal funds effective rate plus 0.50%, both of which are subject to a margin that varies from 0.50% to 1.25% per annum according to our senior unsecured long-term debt ratings, or (ii) the Eurodollar rate, which is based on LIBOR, plus a margin that varies from 1.50% to 2.25% per annum 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 of 0.50% per annum. Interest is payable quarterly or, if LIBOR applies, it may be payable at more frequent intervals. Although the applicable interest rates under our corporate credit facility fluctuate based on our long-term senior unsecured credit ratings, our credit facility does not contain provisions which would trigger an acceleration of amounts due under the facility or a requirement to post additional collateral in the event of a downgrade of our credit ratings.

Our corporate credit facility agreement contains various covenants and restrictive provisions which limit our ability to incur additional indebtedness, make investments or loans and create liens and require us to maintain an indebtedness to total capitalization ratio and an indebtedness to EBITDA ratio, in each case as defined in the agreement. We were in compliance with all covenants under our corporate credit facility agreement as of June 30, 2014.

Our corporate credit facility is fully and unconditionally guaranteed, on a joint and several basis, by Chesapeake and certain of our wholly owned subsidiaries. If we should fail to perform our obligations under the credit facility agreement, 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 $50 million or more, would constitute an event of default under our senior note and contingent convertible senior note indentures, which could in turn result in the acceleration of a significant portion of such indebtedness. The credit facility agreement also has cross default provisions that apply to our secured hedging facility, equipment master lease agreements and other indebtedness of Chesapeake and its restricted subsidiaries with an outstanding principal amount in excess of $125 million. In addition, the facility contains a restriction on our ability to declare and pay cash dividends on our common or preferred stock if an event of default has occurred.

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Spin-Off Debt Transactions

Prior to the spin-off of our oilfield services business, COO or its subsidiaries completed the following debt transactions:

- Entered into a five-year senior secured revolving credit facility with total commitments of $275 million and incurred approximately $3 million in financing costs related to entering into the facility.
- Entered into a $400 million seven-year secured term loan and used the net proceeds of approximately $394 million and borrowings under the new revolving credit facility to repay and terminate COO's existing credit facility.
- Issued $500 million in aggregate principal amount of 6.5% Senior Notes due 2022 in a private placement and used the net proceeds of approximately $494 million to make a cash distribution of approximately $391 million to us, to repay a portion of outstanding indebtedness under the new revolving credit facility discussed above and for general corporate purposes.

All deferred charges and debt balances related to these transactions were removed from our condensed consolidated balance sheet as of June 30, 2014. See Note 2 for further discussion of the spin-off.

Fair Value of Debt

We estimate the fair value of our exchange-traded debt using quoted market prices (Level 1). The fair value of all other debt, which consists of our credit facility and term loan, is estimated using our credit default swap rate (Level 2). Fair value is compared to the carrying value, excluding the impact of interest rate derivatives, in the table below.

	June 30, 2014		December 31, 2013	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
		($ in millions)		
Long-term debt (Level 1)	$11,539	$12,802	$10,501	$11,557
Long-term debt (Level 2)	$—	$—	$2,372	$2,369

5. Contingencies and Commitments

Contingencies

Litigation and Regulatory Proceedings

The Company is involved in a number of litigation and regulatory proceedings (including those described below). Many of these proceedings are in early stages, and many of them seek or may seek damages and penalties, the amount of which is indeterminate. We estimate and provide for potential losses that may arise out of litigation and regulatory proceedings to the extent that such losses are probable and can be reasonably estimated. Significant judgment is required in making these estimates and our final liabilities may ultimately be materially different. Our total estimated liability in respect of litigation and regulatory proceedings is determined on a case-by-case basis and represents an estimate of probable losses after considering, among other factors, the progress of each case or proceeding, our experience and the experience of others in similar cases or proceedings, and the opinions and views of legal counsel. We account for legal defense costs in the period the costs are incurred.

July 2008 Common Stock Offering. On February 25, 2009, a putative class action was filed in the U.S. District Court for the Southern District of New York against the Company and certain of its officers and directors along with certain underwriters of the Company's July 2008 common stock offering. The plaintiff filed an amended complaint on September 11, 2009 alleging that the registration statement for the offering contained material misstatements and omissions and seeking damages under Sections 11, 12 and 15 of the Securities Act of 1933 of an unspecified amount and rescission. The action was transferred to the U.S. District Court for the Western District of Oklahoma on October 13, 2009. Chesapeake and the officer and director defendants moved for summary judgment on grounds of loss causation and materiality on December 28, 2011, and the motion was granted as to all claims as a matter of law on March 29, 2013. Final judgment in favor of Chesapeake and the officer and director defendants was entered on

June 21, 2013, and the plaintiff filed a notice of appeal on July 19, 2013 in the U.S. Court of Appeals for the Tenth Circuit. The appeal has been fully briefed and oral argument was held on May 14, 2014. We are currently unable to assess the probability of loss or estimate a range of potential loss associated with this matter.
A derivative action relating to the July 2008 offering filed in the U.S. District Court for the Western District of Oklahoma on September 6, 2011 is pending. Following the denial on September 28, 2012 of its motion to dismiss and pursuant to court order, nominal defendant Chesapeake filed an answer in the case on October 12, 2012. By stipulation between the parties, the case is stayed pending resolution of the Tenth Circuit appeal of the 2009 securities class action.
2012 Securities and Shareholder Litigation. A putative class action was filed in the U.S. District Court for the Western District of Oklahoma on April 26, 2012 against the Company and its former Chief Executive Officer (CEO), Aubrey K. McClendon. On July 20, 2012, the court appointed a lead plaintiff, which filed an amended complaint on October 19, 2012 against the Company, Mr. McClendon and certain other officers. The amended complaint asserted claims under Sections 10(b) (and Rule 10b-5 promulgated thereunder) and 20(a) of the Securities Exchange Act of 1934 based on alleged misrepresentations regarding the Company’s asset monetization strategy, including liabilities associated with its volumetric production payment (VPP) transactions, as well as Mr. McClendon’s personal loans and the Company’s internal controls. On December 6, 2012, the Company and other defendants filed a motion to dismiss the action. On April 10, 2013, the Court granted the motion, and on April 16, 2013, entered judgment against the plaintiff and dismissed the complaint with prejudice. The U.S. Court of Appeals for the Tenth Circuit affirmed the dismissal on July 8, 2014, and the time for further appeal has expired.
A related federal consolidated derivative action and an Oklahoma state court derivative action were stayed pursuant to the parties' stipulation pending resolution of the appeal in the 2012 federal securities class action. Following the affirmance of the dismissal of the 2012 securities class action, plaintiffs in the consolidated federal derivative action and Oklahoma state court derivative action advised the Company that they intend to proceed with their claims. The Company anticipates that plaintiffs will jointly file an amended consolidated complaint in the federal action, and that the stay of the Oklahoma state court action will remain in place.
On May 8, 2012, a derivative action was filed in the District Court of Oklahoma County, Oklahoma against the Company's directors alleging, among other things, breaches of fiduciary duties and corporate waste related to the Company's officers and directors' use of the Company's fractionally owned corporate jets. On August 21, 2012, the District Court granted the Company's motion to dismiss for lack of derivative standing, and the plaintiff appealed the ruling on December 6, 2012. On May 16, 2014, the Court of Civil Appeals for the State of Oklahoma affirmed the dismissal. On July 7, 2014, plaintiffs filed a petition for writ of certiorari in the Oklahoma Supreme Court seeking review of the Court of Civil Appeals’ decision.
2014 Shareholder Litigation. On April 10, 2014, a derivative action was filed in the District Court of Oklahoma County, Oklahoma against current and former directors and officers of the Company alleging, among other things, breach of fiduciary duties, waste of corporate assets, gross mismanagement and unjust enrichment related to the Company’s payment of shareholder dividends since October 2012. On July 2, 2014, the Company filed its motion to dismiss.
Regulatory Proceedings. The Company has received, from the Antitrust Division of the U.S. Department of Justice (DOJ) and certain state governmental agencies, subpoenas and demands for documents, information and testimony in connection with investigations into possible violations of federal and state laws relating to our purchase and lease of oil and gas rights in various states. Chesapeake has engaged in discussions with the DOJ and state agencies and continues to respond to such subpoenas and demands.
On March 5, 2014, the Attorney General of the State of Michigan filed a criminal complaint against Chesapeake in Michigan state court alleging misdemeanor antitrust violations and attempted antitrust violations under state law arising out of the Company’s leasing activities in Michigan during 2010. On July 9, 2014, following a preliminary hearing on the complaint, as amended, the 89th District Court for Cheboygan County, Michigan ruled that one count alleging a bid-rigging conspiracy between Chesapeake and Encana Oil & Gas USA, Inc. regarding the October 2010 state lease auction would proceed to trial and dismissed claims alleging a second antitrust violation and an attempted antitrust violation. The Michigan Attorney General filed a second criminal complaint against Chesapeake on June 5, 2014 which, as amended, alleges that Chesapeake’s conduct in canceling lease offers to Michigan landowners in 2010 violated the state’s criminal enterprises and false pretenses felony statutes. The Court has set a preliminary hearing on

this matter starting August 18, 2014.

Business Operations. Chesapeake is involved in various other lawsuits and disputes incidental to its business operations, including commercial disputes, personal injury claims, royalty claims, property damage claims and contract actions. With regard to contract actions, various mineral or leasehold owners have filed lawsuits against us seeking specific performance to require us to acquire their natural gas and oil interests and pay acreage bonus payments, damages based on breach of contract and/or, in certain cases, punitive damages based on alleged fraud. The Company has successfully defended a number of these failure-to-close cases in various courts, has settled and resolved other such cases and disputes and believes that its remaining loss exposure for these claims is immaterial to its consolidated financial statements.

Regarding royalty claims, Chesapeake and other natural gas producers have been named in various lawsuits alleging royalty underpayment. The suits against us allege, among other things, that we used below-market prices, made improper deductions, used improper measurement techniques and/or entered into arrangements with affiliates that resulted in underpayment of royalties in connection with the production and sale of natural gas and NGL. The Company has resolved a number of these claims through negotiated settlements of past and future royalties and has prevailed in various other lawsuits. We are currently defending lawsuits seeking damages for royalty underpayment in various states, including cases filed by individual royalty owners and putative class actions, some of which seek to certify a statewide class.

We believe losses are reasonably possible in certain of the pending royalty cases for which we have not made a loss accrual, but we are currently unable to estimate an amount or range of loss or the impact the actions could have on our future results of operations or cash flows. Plaintiffs have varying royalty provisions in their respective leases and oil and gas law varies from state to state. Royalty owners and producers differ in their interpretation of the legal effect of lease provisions governing royalty calculations, an issue in a class action filed in 2010 on behalf of Oklahoma royalty owners asserting claims dating back to 2004. In July 2014, this case was remanded to the trial court for further proceedings following the reversal on appeal of certification of a statewide class. In Pennsylvania, two putative statewide class actions and one purported class arbitration were filed in 2014 on behalf of royalty owners asserting various claims for damages related to alleged underpayment of royalties as a result of the Company's divestiture of substantially all of its midstream business and most of its gathering assets in 2012 and 2013. These Pennsylvania cases include claims for violation of and conspiracy to violate the federal Racketeer Influenced and Corrupt Organizations Act. Uncertainties in pending royalty cases generally include the complex nature of the claims and defenses, the potential size of the class in class actions, the scope and types of the properties and agreements involved, and the applicable production years.

Based on management's current assessment, we are of the opinion that no pending or threatened lawsuit or dispute relating to the Company's business operations is likely to have a material adverse effect on its consolidated financial position, results of operations or cash flows. The final resolution of such matters could exceed amounts accrued, however, and actual results could differ materially from management's estimates.

Environmental Proceedings

The nature of the natural gas and oil business carries with it certain environmental risks for Chesapeake and its subsidiaries. Chesapeake has implemented various policies, procedures, training and auditing to reduce and mitigate such environmental risks. Chesapeake conducts periodic reviews, on a company-wide basis, to assess changes in our environmental risk profile. Environmental reserves are established for environmental liabilities for which economic losses are probable and reasonably estimable. We manage our exposure to environmental liabilities in acquisitions by using an evaluation process that seeks to identify pre-existing contamination or compliance concerns and address the potential liability. Depending on the extent of an identified environmental concern, Chesapeake may, among other things, exclude a property from the transaction, require the seller to remediate the property to our satisfaction in an acquisition or agree to assume liability for the remediation of the property.

Commitments

Compressor Leases

As of June 30, 2014, we leased 205 compressors under master lease agreements with an aggregate undiscounted future lease commitment of $33 million. The lease commitments are guaranteed by Chesapeake and certain of its subsidiaries. Under the leases, we can exercise an early purchase option or we can purchase the compressors at the expiration of the lease for the fair market value at the time. In addition, in most cases we have the option to renew a

lease for negotiated new terms at the expiration of the lease. Commitments related to compressor lease payments are not recorded in the accompanying condensed consolidated balance sheets. During the Current Period, we purchased 1,574 leased compressor units from various lessors for an aggregate purchase price of approximately $290 million, lowering our minimum aggregate undiscounted future compressor lease payments by approximately $202 million.

Gathering, Processing and Transportation Agreements

We have contractual commitments with midstream service companies and pipeline carriers for future gathering, processing and transportation of natural gas and liquids to move certain of our production to market. Working interest owners and royalty interest owners, where appropriate, will be responsible for their proportionate share of these costs. Commitments related to gathering, processing and transportation agreements are not recorded in the accompanying condensed consolidated balance sheets; however, they are reflected as adjustments to natural gas, oil and NGL sales prices used in our proved reserves estimates.

The aggregate undiscounted commitments under our gathering, processing and transportation agreements, excluding any reimbursement from working interest and royalty interest owners or credits for third-party volumes, are presented below.

	June 30, 2014
	($ in millions)
2014	$1,234
2015	1,883
2016	1,964
2017	1,971
2018	1,760
2019 - 2099	7,822
Total	$16,634

Drilling Contracts

We have contracts with various drilling contractors, including those entered into with SSE as discussed in Note 2, to utilize drilling services with terms ranging from three months to three years. These commitments are not recorded in the accompanying condensed consolidated balance sheets. As of June 30, 2014, the aggregate undiscounted minimum future payments under these drilling service commitments were approximately $501 million.

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Pressure Pumping Contracts

In April 2011, we entered into a master frac service agreement with our equity affiliate, FTS International, Inc. (FTS), which expires on December 31, 2014. Pursuant to this agreement, we are committed to enter into a predetermined number of backstop contracts, providing at least a 10% gross margin to FTS, if utilization of FTS fleets falls below a certain level. To date, we have not been required to enter into any backstop contracts. In addition, we have an agreement with a subsidiary of SSE related to pressure pumping services, which is discussed in Note 2.

Drilling Commitments

In December 2011, as part of our Utica joint venture development agreement with Total (see Note 10), we committed to spud no less than 90 cumulative Utica wells by December 31, 2012, 270 cumulative wells by December 31, 2013 and 540 cumulative wells by July 31, 2015. Through June 30, 2014, we had spud 550 cumulative Utica wells and had met our drilling commitment under the agreement.

We have also committed to drill wells in conjunction with our CHK Utica and CHK C-T financial transactions and in conjunction with the formation of the Chesapeake Granite Wash Trust. See Noncontrolling Interests in Note 7 for discussion of these transactions and commitments.

Natural Gas and Liquids Purchase Commitments

We regularly commit to purchase natural gas and liquids from other owners in the properties we operate, including owners associated with our VPP transactions. Production purchased under these arrangements is based on market prices at the time of production, and the purchased natural gas and liquids are resold at market prices. See Note 10 for further discussion of our VPP transactions.

Net Acreage Maintenance Commitments

Under the terms of our joint venture agreements with Total and Sinopec (see Note 10), we are required to extend, renew or replace expiring joint leasehold, at our cost, to ensure that the net acreage is maintained in certain designated areas. To date, we have satisfied our replacement commitments under the Sinopec agreement. We have settled a dispute with Total regarding our acreage maintenance obligation as of December 31, 2012 for $50 million. The payment, which was made to Total on July 31, 2014, was based on a shortfall of approximately 20,800 net acres.

Other Commitments

In July 2011, we agreed to invest $155 million in preferred equity securities of Sundrop Fuels, Inc., a privately held cellulosic biofuels company based in Longmont, Colorado. We also provided Sundrop with a one-time option to require us to purchase up to $25 million in additional preferred equity securities following the full payment of the initial investment, subject to the occurrence of specified milestones. As of June 30, 2014, we had funded our $155 million commitment in full and the milestones related to Sundrop's preferred equity call option had not been met. See Note 11 for further discussion of this investment.

As part of our normal course of business, we enter into various agreements providing, or otherwise arranging, financial or performance assurances to third parties on behalf of our wholly owned guarantor subsidiaries. These agreements may include future payment obligations or commitments regarding operational performance that effectively guarantee our subsidiaries' future performance.

In connection with divestitures, our purchase and sale agreements generally provide indemnification to the counterparty for liabilities incurred as a result of a breach of a representation or warranty by the indemnifying party. These indemnifications generally have a discrete term and are intended to protect the parties against risks that are difficult to predict or cannot be quantified at the time of the consummation of a particular transaction. In divestitures of oil and gas properties, our purchase and sale agreements may require the return of a portion of the proceeds we received as a result of uncured title defects.

Certain of our natural gas and oil properties are burdened by non-operating interests such as royalty and overriding royalty interests, including overriding royalty interests sold through our VPP transactions. As the holder of the working interest from which such interests have been created, we have the responsibility to bear the cost of developing and producing the reserves attributable to such interests. See Note 10 for further discussion of our VPP transactions.

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6. Other Liabilities

Other current liabilities as of June 30, 2014 and December 31, 2013 are detailed below.

	June 30, 2014	December 31, 2013
	($ in millions)	
Revenues and royalties due others	$1,426	$1,409
Accrued natural gas, oil and NGL drilling and production costs	326	457
Joint interest prepayments received	625	464
Accrued compensation and benefits	230	320
Other accrued taxes	104	161
Accrued dividends	102	101
Other	480	599
Total other current liabilities	$3,293	$3,511

Other long-term liabilities as of June 30, 2014 and December 31, 2013 are detailed below.

	June 30, 2014	December 31, 2013
	($ in millions)	
CHK Utica ORRI conveyance obligation(a)	$235	$250
CHK C-T ORRI conveyance obligation(b)	142	149
Financing obligations	30	31
Unrecognized tax benefits	201	317
Other	260	237
Total other long-term liabilities	$868	$984

(a) $16 million and $13 million of the total $251 million and $263 million obligations are recorded in other current liabilities as of June 30, 2014 and December 31, 2013, respectively. See Noncontrolling Interests in Note 7 for further discussion of the transaction.

(b) $18 million and $12 million of the total $160 million and $161 million obligations are recorded in other current liabilities as of June 30, 2014 and December 31, 2013, respectively. See Noncontrolling Interests in Note 7 for further discussion of the transaction.

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7. Equity

Common Stock

The following is a summary of the changes in our common shares issued during the Current Period and the Prior Period:

	Six Months Ended June 30,	
	2014	2013
	(in thousands)	
Shares issued as of January 1	666,192	666,468
Restricted stock issuances (net of forfeitures)[(a)]	(2,019)	2,138
Stock option exercises	1,268	313
Shares issued as of June 30	665,441	668,919

(a) In the second quarter of 2013, we began granting restricted stock units (RSUs) in lieu of restricted stock awards (RSAs) to non-employee directors and employees. Shares of common stock underlying RSUs are issued when the units vest, whereas restricted shares of common stock are issued on the grant date of RSAs. We refer to RSAs and RSUs collectively as restricted stock.

Preferred Stock

The following reflects the shares outstanding during the Current Period and the Prior Period, the liquidation preferences and the conversion prices of our cumulative convertible preferred stock:

	5.75%	5.75% (A)	4.50%	5.00% (2005B)
Shares outstanding as of January 1, 2014 and 2013 and June 30, 2014 and 2013 (in thousands)	1,497	1,100	2,559	2,096
Liquidation preference per share	$1,000	$1,000	$100	$100
Conversion price per share[(a)]	$25.2617	$26.1412	$40.9011	$36.2077

(a) As a result of the spin-off of our oilfield services business, conversion price adjustments were made as of the distribution date to give effect to the dividend of SSE common stock and cash dividends paid on our common stock.

Dividends

Dividends declared on our common stock and preferred stock are reflected as adjustments to retained earnings to the extent a surplus of retained earnings will exist after giving effect to the dividends. To the extent retained earnings are insufficient to fund the distributions, such payments constitute a return of contributed capital rather than earnings and are accounted for as a reduction to paid-in capital.

Dividends on our outstanding preferred stock are payable quarterly. We may pay dividends on our 5.00% Cumulative Convertible Preferred Stock (Series 2005B) and our 4.50% Cumulative Convertible Preferred Stock in cash, common stock or a combination thereof, at our option. Dividends on both series of our 5.75% Cumulative Convertible Non-Voting Preferred Stock are payable only in cash.

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Accumulated Other Comprehensive Income (Loss)
For the Current Period and the Prior Period, changes in accumulated other comprehensive income (loss) by component, net of tax, are detailed below.

	Net Gains (Losses) on Cash Flow Hedges	Net Gains (Losses) on Investments	Total
	($ in millions)		
Balance, December 31, 2013	$(167)	$5	$(162)
Other comprehensive income before reclassifications	3	—	3
Amounts reclassified from accumulated other comprehensive income	10	(5)	5
Net other comprehensive income	13	(5)	8
Balance, June 30, 2014	$(154)	$—	$(154)

	Net Gains (Losses) on Cash Flow Hedges	Net Gains (Losses) on Investments	Total
	($ in millions)		
Balance, December 31, 2012	$(189)	$7	$(182)
Other comprehensive income before reclassifications	—	(5)	(5)
Amounts reclassified from accumulated other comprehensive income	11	6	17
Net other comprehensive income	11	1	12
Balance, June 30, 2013	$(178)	$8	$(170)

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For the Current Quarter, the Prior Quarter, the Current Period and the Prior Period, amounts reclassified from accumulated other comprehensive income (loss), net of tax, into the condensed consolidated statements of operations are detailed below.

Details About Accumulated Other Comprehensive Income (Loss) Components	Affected Line Item in the Statement Where Net Income is Presented	Three Months Ended June 30, 2014	2013
		($ in millions)	
Net losses on cash flow hedges:			
Commodity contracts	Natural gas, oil and NGL revenues	$(1)	$(1)
Total reclassifications for the period, net of tax		$(1)	$(1)

Details About Accumulated Other Comprehensive Income (Loss) Components	Affected Line Item in the Statement Where Net Income is Presented	Six Months Ended June 30, 2014	2013
		($ in millions)	
Net losses on cash flow hedges:			
Commodity contracts	Natural gas, oil and NGL revenues	$10	$11
Investments:			
Impairment of investment	Losses on investments	—	6
Sale of investment	Net gain on sale of investment	(5)	—
Total reclassifications for the period, net of tax		$5	$17

Noncontrolling Interests

Cleveland Tonkawa Financial Transaction. We formed CHK Cleveland Tonkawa, L.L.C. (CHK C-T) in March 2012 to continue development of a portion of our natural gas and oil assets in our Cleveland and Tonkawa plays. CHK C-T is an unrestricted subsidiary under our corporate credit facility agreement and is not a guarantor of, or otherwise liable for, any of our indebtedness or other liabilities, including indebtedness under our indentures. In exchange for all of the common shares of CHK C-T, we contributed to CHK C-T approximately 245,000 net acres of leasehold and the existing wells within an area of mutual interest in the plays between the top of the Tonkawa and the top of the Big Lime formations covering Ellis and Roger Mills counties in western Oklahoma. In March 2012, in a private placement, third-party investors contributed $1.25 billion in cash to CHK C-T in exchange for (i) 1.25 million preferred shares, and (ii) our obligation to deliver a 3.75% overriding royalty interest (ORRI) in the existing wells and up to 1,000 future net wells to be drilled on the contributed play leasehold. Subject to customary minority interest protections afforded the investors by the terms of the CHK C-T limited liability company agreement (the CHK C-T LLC Agreement), as the holder of all the common shares and the sole managing member of CHK C-T, we maintain voting and managerial control of CHK C-T and therefore include it in our condensed consolidated financial statements. Of the $1.25 billion of investment proceeds, we allocated $225 million to the ORRI obligation and $1.025 billion to the preferred shares based on estimates of fair values. The remaining ORRI obligation is included in other current and long-term liabilities and the preferred shares are included in noncontrolling interests on our condensed consolidated balance sheets. Pursuant to the CHK C-T LLC Agreement, CHK C-T is required to retain an amount of cash equal to the next two quarters of preferred dividend payments and, until December 31, 2013, it was also required to retain an amount of cash equal to its projected operating funding shortfall for the next six months. The amount reserved, approximately $38 million as of June 30, 2014 and December 31, 2013, was reflected as restricted cash on our condensed consolidated balance sheets.

Dividends on the preferred shares are payable on a quarterly basis at a rate of 6% per annum based on $1,000 per share. This dividend rate is subject to increase in limited circumstances in the event that, and only for so long as, any

dividend amount is not paid in full for any quarter. As the managing member of CHK C-T, we may, at our sole discretion and election at any time after March 31, 2014, distribute certain excess cash of CHK C-T, as determined in accordance with the CHK C-T LLC Agreement. Any such optional distribution of excess cash is allocated 75% to the preferred shares (which is applied toward redemption of the preferred shares) and 25% to the common shares unless we have not met our drilling commitment at such time, in which case an optional distribution would be allocated 100%

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to the preferred shares (and applied toward redemption thereof). We may also, at our sole discretion and election, in accordance with the CHK C-T LLC Agreement, cause CHK C-T to redeem all or a portion of the CHK C-T preferred shares for cash. The preferred shares may be redeemed at a valuation equal to the greater of a 9% internal rate of return or a return on investment of 1.35x, in each case inclusive of dividends paid through redemption at the rate of 6% per annum and optional distributions made through the applicable redemption date. In the event that redemption does not occur on or prior to March 31, 2019, the optional redemption valuation will increase to provide a 15% internal rate of return to the investors. The preferred shares can be redeemed on a pro-rata basis in accordance with the then-applicable redemption valuation formula. As of June 30, 2014 and December 31, 2013, the redemption price and the liquidation preference were each approximately $1,215 and $1,245, respectively, per preferred share.
We initially committed to drill and complete, for the benefit of CHK C-T in the area of mutual interest, a minimum of 37.5 net wells per six-month period through 2013, inclusive of wells drilled in 2012, and 25 net wells per six-month period in 2014 through 2016, up to a minimum cumulative total of 300 net wells. In April 2014, the drilling commitment was amended to require us only to drill and complete 12.5 net wells in each of the six-month periods ending June 30, 2014 and December 31, 2014. If we fail to meet the then-current cumulative drilling commitment in any six-month period, any optional cash distributions would be distributed 100% to the investors. If we fail to meet the then-current cumulative drilling commitment in two consecutive six-month periods, the then-applicable internal rate of return to investors at redemption would increase by 3% per annum. In addition, if we fail to meet the then-current cumulative drilling commitment in four consecutive six-month periods, the then-applicable internal rate of return to investors at redemption would be increased by an additional 3% per annum. Any such increase in the internal rate of return would be effective only until the end of the first succeeding six-month period in which we have met our then-current cumulative drilling commitment. CHK C-T is responsible for all capital and operating costs of the wells drilled for the benefit of the entity. Under the development agreement, approximately 7 and 49 qualified net wells were added in the Current Period and the Prior Period, respectively. Through June 30, 2014, we had met all current drilling commitments associated with the CHK C-T transaction.
The CHK C-T investors' right to receive, proportionately, a 3.75% ORRI in the contributed wells and up to 1,000 future net wells on our contributed leasehold is subject to an increase to 5% on net wells earned in any year following a year in which we do not meet our net well commitment under the ORRI obligation, which runs from 2012 through the first quarter of 2025. However, in no event would we be required to deliver to investors more than a total ORRI of 3.75% in existing wells and 1,000 future net wells. If at any time CHK C-T holds fewer net acres than would enable us to drill all then-remaining net wells on 160-acre spacing, the investors have the right to require us to repurchase their right to receive ORRIs in the remaining net wells at the then-current fair market value of such remaining ORRIs. CHK C-T retains the right to repurchase the investors' right to receive ORRIs in the remaining net wells at the then-current fair market value of such remaining ORRIs once we have drilled a minimum of 867 net wells. The obligation to deliver future ORRIs has been recorded as a liability which will be settled through the conveyance of the underlying ORRIs to the investors on a net-well basis, at which time the associated liability will be reversed and the sale of the ORRIs reflected as an adjustment to the capitalized cost of our natural gas and oil properties. We had met our ORRI conveyance commitment as of December 31, 2013, but we do not anticipate meeting the 2014 ORRI conveyance commitment.
As of June 30, 2014 and December 31, 2013, $1.015 billion of noncontrolling interests on our condensed consolidated balance sheets were attributable to CHK C-T. In the Current Quarter, the Prior Quarter, the Current Period and the Prior Period, income of $19 million, $19 million, $38 million and $38 million, respectively, was attributable to the noncontrolling interests of CHK C-T.
Utica Financial Transaction. We formed CHK Utica, L.L.C. (CHK Utica) in October 2011 to develop a portion of our Utica Shale natural gas and oil assets. CHK Utica is an unrestricted subsidiary under our corporate credit facility

agreement and is not a guarantor of, or otherwise liable for, any of our indebtedness or other liabilities, including indebtedness under our indentures. In exchange for all of the common shares of CHK Utica, we contributed to CHK Utica approximately 700,000 net acres of leasehold and the existing wells within an area of mutual interest in the Utica Shale play covering 13 counties located primarily in eastern Ohio. During November and December 2011, in private placements, third-party investors contributed $1.25 billion in cash to CHK Utica in exchange for (i) 1.25 million preferred shares, and (ii) our obligation to deliver a 3% ORRI in 1,500 net wells to be drilled on certain of our Utica Shale leasehold. Subject to customary minority interest protections afforded the investors by the terms of the CHK Utica limited liability company agreement (the CHK Utica LLC Agreement), as the holder of all the common shares and the sole managing member of CHK Utica, we maintain voting and managerial control of CHK Utica and therefore include it in our condensed consolidated financial statements. Of the $1.25 billion of investment proceeds, we allocated $300 million to the ORRI

obligation and $950 million to the preferred shares based on estimates of fair values. The remaining ORRI obligation is included in other current and long-term liabilities and the preferred shares are included in noncontrolling interests on our condensed consolidated balance sheets. Pursuant to the CHK Utica LLC Agreement, CHK Utica is required to retain a cash balance equal to the next two quarters of preferred dividend payments. The amount reserved for paying such dividends, approximately $37 million as of June 30, 2014 and December 31, 2013, was reflected as restricted cash on our condensed consolidated balance sheets. In addition, pursuant to the CHK Utica LLC Agreement, with respect to any divestiture proceeds as defined by the agreement, CHK Utica is required to separately account for, and dedicate all of such divestiture proceeds to either (i) capital expenditures made by CHK Utica or (ii) the redemption of CHK Utica preferred shares.

Dividends on the preferred shares are payable on a quarterly basis at a rate of 7% per annum based on $1,000 per share. This dividend rate is subject to increase in limited circumstances in the event that, and only for so long as, any dividend amount is not paid in full for any quarter. As the managing member of CHK Utica, we may, at our sole discretion and election at any time after December 31, 2013, distribute certain excess cash of CHK Utica, as determined in accordance with the CHK Utica LLC Agreement. Any such optional distribution of excess cash is allocated 70% to the preferred shares (which is applied toward redemption of the preferred shares) and 30% to the common shares. We may also, at our sole discretion and election, in accordance with the CHK Utica LLC Agreement, cause CHK Utica to redeem the CHK Utica preferred shares for cash, in whole or in part. The preferred shares may be redeemed at a valuation equal to the greater of a 10% internal rate of return or a return on investment of 1.4x, in each case inclusive of dividends paid at the rate of 7% per annum and optional distributions made through the applicable redemption date. In the event that redemption does not occur on or prior to October 31, 2018, the optional redemption valuation will increase to provide the investors the greater of a 17.5% internal rate of return or a return on investment of 2.0x. The preferred shares can be redeemed on a pro-rata basis in accordance with the then-applicable redemption valuation formula. As of June 30, 2014 and December 31, 2013, the redemption price and the liquidation preference were each approximately $1,217 and $1,252, respectively, per preferred share.

We have committed to drill and complete, for the benefit of CHK Utica in the area of mutual interest, a minimum of 50 net wells per year from 2012 through 2016, up to a minimum cumulative total of 250 net wells. CHK Utica is responsible for all capital and operating costs of the wells drilled for the benefit of the entity. If we fail to meet the then-current drilling commitment in any year, we must pay CHK Utica $5 million for each well we are short of such drilling commitment. CHK Utica also receives its proportionate share of the benefit of the drilling carry associated with our joint venture with Total in the Utica Shale. See Note 10 for further discussion of the joint venture. Under the development agreement, approximately 60 and 57 qualified net wells were added in the Current Period and the Prior Period, respectively. Through June 30, 2014, we had met all current drilling commitments associated with the CHK Utica transaction.

The CHK Utica investors' right to receive, proportionately, a 3% ORRI in the first 1,500 net wells drilled on our Utica Shale leasehold is subject to an increase to 4% on net wells earned in any year following a year in which we do not meet our net well commitment under the ORRI obligation, which runs from 2012 through 2023. However, in no event would we be required to deliver to investors more than a total ORRI of 3% in 1,500 net wells. If at any time we hold fewer net acres than would enable us to drill all then-remaining net wells on 150-acre spacing, the investors have the right to require us to repurchase their right to receive ORRIs in the remaining net wells at the then-current fair market value of such remaining ORRIs. We retain the right to repurchase the investors' right to receive ORRIs in the remaining net wells at the then-current fair market value of such remaining ORRIs once we have drilled a minimum of 1,300 net wells. The obligation to deliver future ORRIs has been recorded as a liability which will be settled through the future conveyance of the underlying ORRIs to the investors on a net-well basis, at which time the associated liability will be reversed and the sale of the ORRIs reflected as an adjustment to the capitalized cost of our natural gas

and oil properties. Because we did not meet our ORRI commitment in 2012, the ORRI increased to 4% for wells earned in 2013, and the ultimate number of wells in which we must assign an interest will be reduced accordingly. We met the 2013 ORRI conveyance commitment as of December 31, 2013 and through June 30, 2014, we were on target to meet the 2014 ORRI conveyance commitments associated with the CHK Utica transaction.

As of June 30, 2014 and December 31, 2013, $807 million of noncontrolling interests on our condensed consolidated balance sheets was attributable to CHK Utica. In the Current Quarter, the Prior Quarter, the Current Period and the Prior Period, income of approximately $19 million, $20 million, $37 million and $42 million, respectively, was attributable to the noncontrolling interests of CHK Utica.

On July 29, 2014, we repurchased all of the outstanding preferred shares of CHK Utica from third-party preferred shareholders. See Note 20 for additional information on this repurchase.

Chesapeake Granite Wash Trust. In November 2011, Chesapeake Granite Wash Trust (the “Trust”) sold 23,000,000 common units representing beneficial interests in the Trust at a price of $19.00 per common unit in its initial public offering. The common units are listed on the New York Stock Exchange and trade under the symbol “CHKR”. We own 12,062,500 common units and 11,687,500 subordinated units, which in the aggregate represent an approximate 51% beneficial interest in the Trust. The Trust has a total of 46,750,000 units outstanding.

In connection with the initial public offering of the Trust, we conveyed royalty interests to the Trust that entitle the Trust to receive (i) 90% of the proceeds (after deducting certain post-production expenses and any applicable taxes) that we receive from the production of hydrocarbons from 69 producing wells, and (ii) 50% of the proceeds (after deducting certain post-production expenses and any applicable taxes) in 118 development wells that have been or will be drilled on approximately 45,400 gross acres (29,000 net acres) in the Colony Granite Wash play in Washita County in the Anadarko Basin of western Oklahoma. Pursuant to the terms of a development agreement with the Trust, we are obligated to drill, or cause to be drilled, the development wells at our own expense prior to June 30, 2016, and the Trust will not be responsible for any costs related to the drilling of the development wells or any other operating or capital costs of the Trust properties. In addition, we granted to the Trust a lien on our remaining interests in the undeveloped properties that are subject to the development agreement in order to secure our drilling obligation to the Trust, although the maximum amount that may be recovered by the Trust under such lien could not exceed $263 million initially and is proportionately reduced as we fulfill our drilling obligation over time. As of June 30, 2014 and 2013, we had drilled or caused to be drilled approximately 93 and 73 development wells, respectively, as calculated under the development agreement, and the maximum amount recoverable under the drilling support lien was approximately $55 million and $102 million, respectively.

The subordinated units we hold in the Trust are entitled to receive pro rata distributions from the Trust each quarter if and to the extent there is sufficient cash to provide a cash distribution on the common units that is not less than the applicable subordination threshold for such quarter. If there is not sufficient cash to fund such a distribution on all of the Trust units, the distribution to be made with respect to the subordinated units will be reduced or eliminated for such quarter in order to make a distribution, to the extent possible, of up to the subordination threshold amount on the common units. The distribution made with respect to the subordinated units to Chesapeake was either reduced or eliminated for each of the most recent seven quarters of distributions paid. In exchange for agreeing to subordinate a portion of our Trust units, and in order to provide additional financial incentive to us to satisfy our drilling obligation and perform operations on the underlying properties in an efficient and cost-effective manner, Chesapeake is entitled to receive incentive distributions equal to 50% of the amount by which the cash available for distribution on the Trust units in any quarter exceeds the applicable incentive threshold for such quarter. The remaining 50% of cash available for distribution in excess of the applicable incentive threshold will be paid to Trust unitholders, including Chesapeake, on a pro rata basis. At the end of the fourth full calendar quarter following our satisfaction of our drilling obligation with respect to the development wells, the subordinated units will automatically convert into common units on a one-for-one basis and our right to receive incentive distributions will terminate. After such time, the common units will no longer have the protection of the subordination threshold, and all Trust unitholders will share in the Trust’s distributions on a pro rata basis.

For the Current Period and the Prior Period, the Trust declared and paid the following distributions:

Production Period	Distribution Date	Cash Distribution per Common Unit	Cash Distribution per Subordinated Unit
December 2013 - February 2014	May 30, 2014	$0.6454	$—

September 2013 - November 2013	March 3, 2014	$0.6624	$—
December 2012 - February 2013	May 31, 2013	$0.6900	$0.3010
September 2012 - November 2012	March 1, 2013	$0.6700	$0.3772

We have determined that the Trust is a variable interest entity (VIE) and that Chesapeake is the primary beneficiary. As a result, the Trust is included in our condensed consolidated financial statements. As of June 30, 2014 and December 31, 2013, $293 million and $314 million, respectively, of noncontrolling interests on our condensed consolidated balance sheets were attributable to the Trust. In the Current Quarter, the Prior Quarter, the Current Period and the Prior Period, income of approximately $2 million, $7 million, $7 million and $12 million, respectively, was attributable to the Trust's noncontrolling interests in our condensed consolidated statements of operations. See Note 12 for further discussion of VIEs.

Wireless Seismic, Inc. We have a controlling 52% equity interest in Wireless Seismic, Inc. (Wireless), a privately owned company engaged in research, development and production of wireless seismic systems and related technology that deliver seismic information obtained from standard geophones in real time to laptop and desktop computers. As of June 30, 2014 and December 31, 2013, $7 million and $9 million, respectively, of noncontrolling interests on our condensed consolidated balance sheets were attributable to Wireless. In the Current Quarter, the Prior Quarter, the Current Period and the Prior Period, losses of $1 million, $1 million, $2 million and $2 million, respectively, were attributable to noncontrolling interests of Wireless in our condensed consolidated statements of operations.

8. Share-Based Compensation

Chesapeake's share-based compensation program consists of restricted stock, stock options and performance share units (PSUs) granted to employees and restricted stock granted to non-employee directors under our long term incentive plans. The restricted stock and stock options are equity-classified awards and the PSUs and performance bonuses are liability-classified awards.

Equity-Classified Awards

Restricted Stock. We grant restricted stock to employees and non-employee directors. Restricted stock vests over a minimum of three years and the holder receives dividends on unvested shares. A summary of the changes in unvested shares of restricted stock during the Current Period is presented below.

	Number of Unvested Restricted Shares (in thousands)	Weighted Average Grant Date Fair Value
Unvested shares as of January 1, 2014	13,400	$23.38
Granted	4,754	$26.11
Vested	(2,623)	$23.00
Forfeited	(2,706)	$29.27
Unvested shares as of June 30, 2014	12,825	$23.23

The aggregate intrinsic value of restricted stock that vested during the Current Period was approximately $70 million based on the stock price at the time of vesting.

As of June 30, 2014, there was $191 million of total unrecognized compensation expense related to unvested restricted stock. The expense is expected to be recognized over a weighted average period of approximately 2.4 years.

The vesting of certain restricted stock grants may result 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 the Current Quarter and the Current Period, we recognized excess tax benefits related to restricted stock of a nominal amount and $3 million, respectively, and during the Prior Quarter and the Prior Period we recognized reductions in tax benefits related to restricted stock of $2 million and $12 million, respectively. Each adjustment was recorded to additional paid-in capital and deferred income taxes.

Stock Options. In the Current Period and the Prior Period, we granted members of senior management stock options that vest ratably over a three-year period. In January 2013, we also granted retention awards to certain officers of

stock options that vest one-third on each of the third, fourth and fifth anniversaries of the grant date. Each stock option award has an exercise price equal to the closing price of the Company's common stock on the grant date. Outstanding options generally expire ten years from the date of grant.

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We utilize the Black-Scholes option pricing model to measure the fair value of stock options. The expected life of an option is determined using the "simplified method", as there is no adequate historical exercise behavior available. Volatility assumptions are estimated based on an average of historical volatility of Chesapeake stock over the expected life of an option. The risk-free interest rate is based on the U.S. Treasury rate in effect at the time of the grant over the expected life of the option. The dividend yield is based on an annual dividend yield, taking into account the Company's current dividend policy, over the expected life of the option. The Company used the following weighted average assumptions to estimate the grant date fair value of the stock options granted in the Current Period:

Expected option life - years	5.9	
Volatility	48.63	%
Risk-free interest rate	1.93	%
Dividend yield	1.33	%

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

	Number of Shares Underlying Options	Weighted Average Exercise Price Per Share	Weighted Average Contract Life in Years	Aggregate Intrinsic Value[(a)]
	(in thousands)			($ in millions)
Outstanding at January 1, 2014	5,268	$19.28	6.66	$41
Granted	994	$24.43		
Exercised	(1,309)	$18.75		$11
Expired	(19)	$18.97		
Forfeited	(262)	$20.30		
Outstanding at June 30, 2014	4,672	$19.60	7.90	$54
Exercisable at June 30, 2014	1,106	$18.55	6.97	$14

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

As of June 30, 2014, there was $16 million of total unrecognized compensation expense related to stock options. The expense is expected to be recognized over a weighted average period of approximately 2.2 years.

The vesting of certain stock option grants may result 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 the Current Quarter, the Prior Quarter, the Current Period and the Prior Period, we recognized excess tax benefits related to stock options of a nominal amount, $0, a nominal amount and $0, respectively. Each adjustment was recorded to additional paid-in capital and deferred income taxes.

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Restricted Stock and Stock Option Compensation. We recognized the following compensation costs related to restricted stock and stock options during the Current Quarter, the Prior Quarter, the Current Period and the Prior Period:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
	($ in millions)			
General and administrative expenses	$11	$15	$24	$35
Natural gas and oil properties	9	12	16	32
Natural gas, oil and NGL production expenses	5	6	8	12
Marketing, gathering and compression expenses	1	1	3	4
Oilfield services expenses	3	2	5	5
Total	$29	$36	$56	$88

Liability-Classified Awards

Performance Share Units. In 2012, 2013 and 2014, we granted PSUs to senior management that settle in cash at the end of their respective performance periods and vest ratably over their respective terms. The 2012 awards were granted in one-, two- and three-year tranches and are settled in cash on the first, second and third anniversary dates of the awards, and the 2013 and 2014 awards are settled in cash on the third anniversary of the awards. The ultimate amount earned is based on achievement of performance metrics established by the Compensation Committee of the Board of Directors, which include relative and absolute total shareholder return (TSR) and, for certain of the awards, the achievement of operational performance goals such as production and proved reserve growth.

For PSUs granted in 2012, each of the TSR and operational payout components can range from 0% to 125% resulting in a maximum total payout of 250%. For PSUs granted in 2013, the TSR component can range from 0% to 125% and each of the two operational components can range from 0% to 62.5%; however, the maximum total payout is capped at 200%. For PSUs granted in 2014, the TSR component can range from 0% to 200%, with no operational components. For the 2013 and 2014 PSUs, the payout percentage is capped at 100% if the Company's absolute TSR is less than zero. The PSU grants are recognized quarterly and valued based on the 20-day average stock price multiplied by the current estimate of the performance units that will be allocated upon vesting. The number of units allocated is dependent upon the Company's estimates of the underlying performance measures. For the 2014 awards, the Company utilized the Monte Carlo simulation for the TSR performance measure, and used the following assumptions to determine the grant date fair value of the PSUs granted in the Current Period:

Volatility	41.37	%
Risk-free interest rate	0.76	%
Dividend yield for value of awards	1.36	%

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The following table presents a summary of our PSU awards as of June 30, 2014:

	Units	Fair Value as of Grant Date	Fair Value	Liability for Vested Amount
		($ in millions)		
2012 Awards [a]				
Payable 2015	884,507	$23	$31	$31
2013 Awards				
Payable 2016	1,701,941	$35	$66	$59
2014 Awards				
Payable 2017	658,059	$17	$20	$9

(a) In the Current Period and the Prior Period, we paid $11 million and $2 million, respectively, related to 2012 PSU awards.

PSU Compensation. We recognized the following compensation costs related to PSUs during the Current Quarter, the Prior Quarter, the Current Period and the Prior Period:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
	($ in millions)			
Natural gas and oil properties	$2	$1	$3	$4
General and administrative expenses	11	4	10	9
Marketing, gathering and compression expenses	1	—	1	2
Total	$14	$5	$14	$15

Effects of the Spin-off on Share Based-Compensation

The employee matters agreement (see Note 2) addresses the treatment of holders of Chesapeake stock options, restricted stock and performance share units. Unvested equity-based compensation awards held by COO employees were canceled and replaced with new awards of SSE, and unvested equity-based compensation awards held by Chesapeake employees were adjusted to account for the spin-off, each as of the spin-off date. The employee matters agreement provides that employees of SSE will no longer participate in benefit plans sponsored or maintained by Chesapeake. In addition, the employee matters agreement provides that each party will be responsible for the compensation of its current employees and for all liabilities relating to its former employees.

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9. Derivative and Hedging Activities

Chesapeake uses commodity derivative instruments to secure attractive pricing and margins on expected production, to reduce its exposure to fluctuations in future commodity prices and to protect its expected operating cash flow against significant market movements or volatility. Chesapeake also uses derivative instruments to mitigate a portion of its exposure to interest rate and foreign currency exchange rate fluctuations. All of our derivative instruments are net settled based on the difference between the fixed-price payment and the floating-price payment, resulting in a net amount due to or from the counterparty.

Natural Gas and Oil Derivatives

As of June 30, 2014 and December 31, 2013, our natural gas and oil derivative instruments consisted of the following types of instruments:

- Swaps: Chesapeake receives a fixed price and pays a floating market price to the counterparty for the hedged commodity.
- Collars: These instruments 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 put and the call strike prices, no payments are due from either party. Three-way collars include an additional put option in exchange for a more favorable strike price on the call option. This eliminates the counterparty's downside exposure below the second put option strike price.
- Options: Chesapeake sells, and occasionally buys, call options in exchange for a premium. At the time of settlement, if the market price exceeds the fixed price of the call option, Chesapeake pays the counterparty such excess on sold call options, and Chesapeake receives such excess on bought call options. If the market price settles below the fixed price of the call option, no payment is due from either party.
- Swaptions: Chesapeake sells call swaptions in exchange for a premium that allows a counterparty, on a specific date, to enter into a fixed-price swap for a certain period of time.
- Basis Protection Swaps: These instruments are arrangements that guarantee a fixed price differential to NYMEX from a specified delivery point. Chesapeake receives the fixed price differential and pays the floating market price differential to the counterparty for the hedged commodity.

The estimated fair values of our natural gas and oil derivative instrument assets (liabilities) as of June 30, 2014 and December 31, 2013 are provided below.

	June 30, 2014		December 31, 2013	
	Volume	Fair Value ($ in millions)	Volume	Fair Value ($ in millions)
Natural gas (tbtu):				
Fixed-price swaps	293	$(75)	448	$(23)
Three-way collars	335	(27)	288	(7)
Collars	22	4	—	—
Call options	193	(195)	193	(210)
Call swaptions	—	—	12	—
Basis protection swaps	106	15	68	3
Total natural gas	949	(278)	1,009	(237)
Oil (mmbbl):				
Fixed-price swaps	18.3	(146)	25.3	(50)
Three-way collars	4.4	(12)	—	—
Call options	38.9	(320)	42.5	(265)
Basis protection swaps	0.2	1	0.4	1

Total oil	61.8	(477)	68.2	(314)
Total estimated fair value		$(755)		$(551)

We have terminated certain commodity derivative contracts that were previously designated as cash flow hedges for which the hedged production is still expected to occur. See further discussion below under Effect of Derivative Instruments - Accumulated Other Comprehensive Income (Loss).

Interest Rate Derivatives

As of June 30, 2014 and December 31, 2013, our interest rate derivative instruments consisted of swaps. We enter into fixed-to-floating interest rate swaps (we receive a fixed interest rate and pay a floating market rate) to mitigate our exposure to changes in the fair value of our senior notes. We enter into floating-to-fixed interest rate swaps (we receive a floating market rate and pay a fixed interest rate) to manage our interest rate exposure related to our bank credit facility borrowings.

The notional amount of our interest rate derivative liabilities as of June 30, 2014 and December 31, 2013 was $1.950 billion and $2.250 billion, respectively. The estimated fair value of our interest rate derivative liabilities as of June 30, 2014 and December 31, 2013 was $48 million and $98 million, respectively.

We have terminated certain fair value hedges related to senior notes. Gains and losses related to these terminated hedges will be amortized as an adjustment to interest expense over the remaining term of the related senior notes. Over the next six years, we will recognize $10 million in net gains related to such transactions.

Foreign Currency Derivatives

We are party to cross currency swaps to mitigate our exposure to foreign currency exchange rate fluctuations that may result from the €344 million principal amount of our euro-denominated senior notes. The terms of the cross currency swaps were based on the dollar/euro exchange rate on the issuance date of $1.3325 to €1.00. Under the terms of the cross currency swaps we currently hold, on each semi-annual interest payment date, the counterparties pay us €11 million and we pay the counterparties $17 million, which yields an annual dollar-equivalent interest rate of 7.491%. Upon maturity of the notes, the counterparties will pay us €344 million and we will pay the counterparties $459 million. The swaps are designated as cash flow hedges and, because they are entirely effective in having eliminated any potential variability in our expected cash flows related to changes in foreign exchange rates, changes in their fair value do not impact earnings. The fair values of the cross currency swaps are recorded on the condensed consolidated balance sheet as an asset of $6 million as of June 30, 2014. The euro-denominated debt in long-term debt has been adjusted to $471 million as of June 30, 2014 using an exchange rate of $1.3692 to €1.00.

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Effect of Derivative Instruments – Condensed Consolidated Balance Sheets

The following table presents the fair value and location of each classification of derivative instrument included in the condensed consolidated balance sheets as of June 30, 2014 and December 31, 2013 on a gross basis and after same-counterparty netting:

	June 30, 2014		
Balance Sheet Classification	Gross Fair Value	Amounts Netted in Condensed Consolidated Balance Sheet	Net Fair Value Presented in Condensed Consolidated Balance Sheet
	($ in millions)		
Commodity Contracts			
Short-term derivative asset	$56	$(55)	$1
Long-term derivative asset	3	(3)	—
Short-term derivative liability	(469)	55	(414)
Long-term derivative liability	(345)	3	(342)
Total commodity contracts	(755)	—	(755