

**TESTIMONY OF  
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BEFORE THE  
COMMODITY FUTURES TRADING COMMISSION'S  
"HEARING ON ENERGY POSITION LIMITS AND HEDGE EXEMPTIONS"**

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Mr. Chairman and fellow commissioners, thank you for the opportunity to testify today regarding discussions on energy futures position limits and hedge exemptions. I am Elliot Chambers, Corporate Finance Manager for Chesapeake Energy Corporation. In that capacity, I am responsible for Chesapeake's risk-management activities, including our use of over-the-counter, or OTC, derivatives.

I would like to begin by saying that Chesapeake Energy Corporation appreciates and encourages regulatory efforts to prevent excessive market speculation. As an end user that extensively utilizes OTC commodity derivatives as a vital risk-management tool, we strongly support increased transparency, accountability, and market integrity.

*Chesapeake Energy Corporation*

Chesapeake Energy Corporation is the most active explorer for and the largest producer of U.S. natural gas. As such, we play a significant role in helping enhance America's energy independence; notably, we reinvest 100 percent of our free cash flow directly into finding and producing clean-burning natural gas right here in the United States, which represented an investment in excess of \$5 billion in 2008 alone.

In the second quarter of 2009, Chesapeake's average daily natural gas production was approximately 2.245 billion cubic feet (bcf) per day, or about 3.5 percent of total U.S. production. As you might know, it is essential that an energy company replace its production with new reserves. I am proud to say that, as the most active operator, Chesapeake currently has about 95 operated rigs drilling in the United States, and is responsible for one of every eight natural gas wells being drilled. To give you a better sense of the scale of our current operations, Chesapeake is responsible for more exploration activity in the United States than the five "super majors" – BP, Chevron, ConocoPhillips, ExxonMobil and Shell – combined.

These industry-leading efforts have helped us achieve extraordinary growth in natural gas production and reserves. Our active and significant exploration and production activities have resulted in approximately 12.5 trillion cubic feet equivalent of proved reserves, and a current inventory of over 36,000 net drilling locations. In short, we have a lot of natural gas to produce.

#### *Chesapeake Energy Corporation's Risk-Management Philosophy*

However, our superior success and growth would not be possible without the benefit of our risk-management activities. One of the reasons we are here today is because commodity prices can be extremely volatile, with natural gas being no exception. For example, on June 30, 2008 the Nymex natural gas spot price was \$13.18 per MMBtu. As of Friday, July 31, 2009, that price was approximately \$3.60, representing a 72 percent drop. Regional differences and distances to market further complicate and compound market price volatility for producers of natural gas. Additionally, please keep in mind that natural gas demand trends fluctuate

throughout the year with most volatility caused by weather changes, both normal seasonal changes and extreme weather events, including hurricanes, severe cold spells and heat events spurred by droughts.

Given such market volatility, and our highly active exploration and production program, we utilize responsible risk-management tools, such as OTC derivatives, to provide cash-flow certainty. Cash certainty is vital for planning and implementing our aggressive exploration and drilling program. Without the benefit of stability in cash flow, whether we drill one additional well or continue to develop an entire new potential gas field becomes a very problematic decision. Prudent risk management also allows us to invest in cutting-edge drilling and production technologies that help make our wells more economical and better for the environment. All of this is ultimately beneficial to American consumers and the U.S. economy as a whole.

A prime example of our risk-management strategy helping us enhance U.S. energy independence can be seen with our discovery and announcement of the Haynesville Shale natural gas play in March of 2008. The Haynesville Shale is possibly the largest natural gas field discovered in North America and is estimated to hold 245 tcf of natural gas. To put this in perspective, U.S. annual consumption of natural gas is approximately 23 tcf, so this one field alone could supply 10 or 11 years worth of natural gas for U.S. consumption at current rates.

In the end, given our responsible risk-management philosophy, our enormous investment of \$3.75 billion in the Haynesville Shale would not have been possible without these cash-

certainty benefits. We believe that to risk investing dollars into finding and developing significant new fields like the Haynesville Shale without the ability to count on cash flow would, ultimately, be irresponsible.

However, our risk-management strategy is not very complicated. First, we estimate how much natural gas we expect to produce on a monthly basis over the next several years. This first step is critical to understand because we are not in the business of adding commodity exposure. To that end, we will never hedge more than our estimated production, meaning *we never speculate*. In addition to this core principle, we also determine our average cost to find, develop, and produce our reserves and use that as a bench-mark break-even price. When natural gas prices rise above that break-even price, we look to “lock in” that margin over and above our costs. That margin is what we can count on to run our business and achieve our goals of finding new reserves.

While our risk-management strategy is not overly complex, much effort goes into ensuring we get it right. Specifically, to date, our portfolio of OTC derivatives has allowed us to receive, in many cases, double the current market price for our production. In the second quarter ended June 30, 2009 for example, we received \$5.56 per mcf of natural gas sold, of which \$2.88 – or 52 percent – came from our hedging contracts. In other words, without our risk-management strategy, we would have received \$2.68 per mcf and lost money on the gas we sold during the quarter.

In a time when natural gas prices have suffered, our risk-management program has provided us with cash flow that helps us continue our capital-intensive drilling activity. Our risk-management strategy is a core part of our strategy, and it has helped us weather the volatile storm in commodity prices. As a result, we have been able to continue our efforts to help make America less dependent on foreign sources of energy by finding major new gas plays.

*Energy Futures Position Limits and Hedge Exemptions – Chesapeake’s Concerns*

Chesapeake appreciates and supports the efforts of the CFTC to help make U.S. markets transparent, effective and efficient. We also believe the Commission’s concerns about excessive speculation in the commodity markets are certainly worthy of analysis and discussion. Chesapeake also shares these concerns because if the markets are impacted by excessive speculation, our risk-management program would be very difficult to implement.

However, our concerns around excessive speculation differ in many cases to what has been discussed in the media and by consumers of commodities. We do not agree that commodity prices increased last year solely because of speculative positions. Instead, we believe basic economic principles of supply and demand served as the main cause of prices increasing – and subsequently decreasing.

To suggest that speculators – or to categorize them differently and more accurately in our opinion, commodity investors – predominantly drove up prices is difficult to believe because, as prices rose, commodity investors were actively selling in the market – just like producers such as Chesapeake, thus, acting as a much-needed cap on prices. Keep in mind that any large

commodity investors buying commodities would have been financially ruined once the supply-and-demand pressures of the economic recession caught up to them.

Furthermore, commodity investors do not just *buy* commodities. They buy and sell based on supply-and-demand statistics. If commodity investors were responsible for prices running up, it is difficult to understand how they could also not be responsible for prices running down as well. While Chesapeake could arguably have an interest in making the claim that commodity investors are responsible for prices remaining as low as they currently are, we do not support that theory. Instead, we believe prices are where they are today because demand has plummeted and supply has increased. And watching commodity prices increase over the past few months does not change our view. Markets routinely over-shoot when correcting for significant economic events such as we have seen since the second half of 2008.

We believe all of this puts the CFTC and other regulators in a very difficult position, and we can appreciate the need to analyze and understand what occurred and whether changes to the current regulatory framework are necessary.

To that end, and with respect to the focus of this hearing today on energy futures position limits and hedge exemptions, Chesapeake has serious concerns regarding how position limits on energy futures and a more restrictive application of hedge exemptions would impact how we deploy our risk-management strategy. These concerns are primarily focused on market liquidity and related price stability.

Chesapeake is not specifically opposed to position limits, but we do have concerns that if these limits are too low it will remove vital liquidity from the marketplace. To illustrate our concerns, consider if Chesapeake was to be fully hedged, we would have in place approximately 7,000 natural gas contracts each month of the curve. As previously stated, Chesapeake's daily production represents approximately 3.5 percent of total daily U.S. natural gas output. This means if all producers of natural gas were to hedge themselves in a given month, the total amount of contracts would approach 200,000 contracts. For the same reasons that Chesapeake is not actively selling our production forward at currently depressed prices, we cannot count on purchasers of natural gas to be in the market in a size sufficient to make a market for us when prices increase and we want to hedge. Thus, if too low of a contract position limit is implemented for each individual month of the curve, we believe it would significantly dry up vital liquidity needed for producers to protect themselves.

Additionally, Chesapeake has concerns regarding removing hedge exemptions for swap dealers. It should be recognized that without swap dealers Chesapeake's risk-management program would not be possible. Typically, when we place a hedge with a swap dealer, they quickly off-load it, thus running a balanced derivative book. If there is any excess position left, swap dealers quickly utilize the futures market to remove that residual risk. These are valid risk-management activities. In short, we believe that both sides of this equation should be exempt from position limits since our activities are inherently risk reducing.

To the extent that modifications are made to existing position limits and hedge exemption criteria, we ask that the Commission take extreme care to not impact market liquidity and price

stability. Without liquidity, markets simply do not function. Price discovery becomes very problematic and could lead to significant and damaging pressures for all parties exposed to the underlying commodity.

In the end, for Chesapeake, a lack of market liquidity and price stability would mean we would not be able to fully utilize the market to protect our exposure to commodity prices. Less protection means less cash stability and, thus, less exploration and production activity. And Chesapeake would not likely be the only energy producer that would curtail risk-management activities. A sizable reduction in such activities could, in turn, cause the United States to become even more dependent on foreign sources of energy, such as liquefied natural gas (LNG). Additionally, end users who are producers of natural gas like Chesapeake will be much less active in “selling” the market down in the event prices run-up as they did in 2008. This could lead to less stability in energy prices. None of this is beneficial for the economy or desirable for long-term energy policy.

#### *Our Concerns about OTC Proposals*

I would also like to address Chesapeake’s concerns with some related proposals that have been introduced that would, in some cases, require OTC derivatives to be cleared through a clearinghouse or transacted on an exchange. First, it must be understood that the cash requirements of clearing OTC derivatives on an exchange would prove to be a significant liquidity drain on American companies, who like Chesapeake are using these contracts for prudent risk-management purposes. At a time when the U.S. economy needs more free-floating capital, posting cash margin on an exchange would prove to have the opposite effect; in fact, we



believe it would risk a more serious liquidity crisis and a sustained lack of economic growth. As stated previously, Chesapeake Energy invests 100 percent of its free cash flow into finding and producing clean-burning, American natural gas. A requirement to post cash would inject cash uncertainty into our business model and, thus, reduce our ability to explore for and produce natural gas.

For example, on June 30, 2008, Chesapeake's negative "mark-to-market," or what we owed our counterparties for natural gas hedging transactions, which were outstanding but not yet matured, was approximately \$6.3 billion. First, funding such an enormous amount of cash would have been nearly impossible and would have had significant negative effects on financial covenants included in our borrowing arrangements. However, assuming our company was able to fund such a cash requirement, we certainly would not have had the cash to invest in the previously mentioned Haynesville Shale. Additionally, by December 31, 2008, the natural gas market had reversed and our \$6.3 billion negative mark-to-market became a positive \$1.3 billion mark-to-market. In short, requiring cash margin to be posted would defeat the purpose of using OTC derivatives, which is to provide cash certainty for planning for and investing in the future.

Furthermore, we understand another significant concern about the OTC derivative market is that this market is unsecured. This is not the case for most end users of these contracts. For example, on June 30, 2008, when Chesapeake owed approximately \$6.3 billion under our OTC derivative contracts, we had pledged collateral valued at more than \$11 billion to our derivative counterparties. The collateral we pledged included both mortgages on our oil and gas properties – our underlying business assets – and letters of credit. While the security is not in cash, our

counterparties were and continue to be well-secured. This is how most end-users utilize this market and, as a result, help alleviate systemic risk.

Finally, there is a misconception that most OTC contracts are “standard” and can be easily housed on an exchange. However, an important feature of most OTC contracts is their ability to be “customized.” Exchange-traded derivatives would not be able to be customized to offset our risks, therefore, the derivative would not precisely match the economics of the underlying risk being hedged. While OTC derivatives are not inherently complex products, their exact terms and conditions must be specifically customized to meet our needs, most importantly from an accounting perspective. Clearing requires standardization, and mandated clearing eliminates this essential ability to customize. Outside of the lack of economic offset, a standardized OTC contract would not meet stringent accounting rules, thus increasing near-term income statement volatility because of prudent longer-term risk-management policies. This “mis-match” could cause investors to be confused about financial results.

In short, as evidenced above, a company like Chesapeake Energy is merely an end-user of OTC derivatives. Companies like ours do not make the market, and we believe that forced clearing ultimately will result in less end-user risk management and more volatility passed on to the consumer.

### *Conclusion*

In the end, I appreciate the opportunity to speak here today, and want to reiterate that Chesapeake supports regulatory efforts to prevent excessive market speculation, and increase

transparency, accountability, and market integrity. At the same time, as a company that uses risk-management tools to responsibly manage our core business of finding and producing natural gas, if overly stringent position limits are imposed or a more restrictive application of hedge exemptions is put in place, we believe our ability to continue to protect our exposures would be severely and negatively impacted. Equally concerning to our ability to implement our risk management strategy are legislative proposals that could require clearing and standardization of OTC derivatives.

In summary, if producers like Chesapeake cannot mitigate commodity price risk, then we will be forced to reduce drilling, which will reduce our nation's supply of clean, affordable, American natural gas. And ultimately, a reduction in the supply of natural gas will put upward pressure on prices paid by American consumers and weaken our nation's energy independence efforts.

We look forward to continuing to work together to continue to address these important issues. Again, thank you, Mr. Chairman and fellow Commissioners.