

CEO Aubrey McClendon relied on financial engineering to build his company; now he needs more and more deals just to tread water.

# Chesapeake's deepest well: Wall Street

BY CARRICK MOLLENKAMP  
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**F**ar from the drilling rigs of Oklahoma, America's second-largest natural gas producer is having to dig ever deeper into the well that really fueled its growth: Wall Street.

In a Times Square office building, a team tapped by Chesapeake Energy Corp deployed more than 40 bankers, lawyers and other experts to plot another chapter in that strategy.

Dubbed Glenn Pool, it was more financial engineering than petroleum engineering. In essence, Chesapeake sold future rights to the gas in its wells. The deal took in approximately \$850 million last year.

Glenn Pool proved so innovative that a trade magazine honored it in March. In an especially creative twist, the borrowings were chopped into two slices and sold



to investors – akin to the way subprime housing loans were turned into securities and sold last decade.

Deals like Glenn Pool are known as volumetric production payments, or VPPs. These and other sophisticated financings are central to the business model of a company that in some ways resembles a hedge fund, using borrowed money to make big financial bets.

The financial-engineering strategy began as a way for CEO Aubrey McClendon to expand the company. Now, Chesapeake has become so reliant on deals like Glenn Pool that more such transactions may be necessary just to tread water.

Today, the Oklahoma City company is taking in more money from bankers, other investors and its own financial bets than it is from its oil and gas. Most big energy companies, such as Exxon Mobil Corp, typi-

cally earn more selling oil and gas than they spend on investments, financing and other costs, making them cash rich. Chesapeake is expanding so fast that it takes in much less revenue from its oil and gas than it spends, leaving it stretched.

Hence its business depends on deal-making: raise money from investors to acquire land and drill wells; sell the rights to the gas and oil in those wells; plow that money into new land and wells; repeat the cycle all over again.

### FUNDING SHORTFALLS

Now, some analysts question whether Chesapeake can keep striking enough deals to sate its cash needs, which are growing acute as natural gas prices languish. The gap between cash coming in and cash going out shows “massive internal funding shortfalls,” according to an April report by Standard & Poor’s.

On Wednesday, Moody’s Investors Service changed its outlook for Chesapeake’s debt to negative from stable, citing “an even-larger capital spending funding gap for 2012,” due both to lower energy prices and higher spending.

Between now and the end of 2013, Chesapeake expects as much as \$23.1 billion in costs for outlays such as wells and property, according to the company and analysts. Yet funds from operations over the same period are expected to total as much as \$8.3 billion. To cover the gap, Chesapeake plans to raise as much as \$20.5 billion from new ventures, including selling future production rights.

“There seems to be little acknowledgment by management or the board that the company faces a major financial crisis,” analysts at International Strategy & Investment Group in New York said in a report May 1.

Chesapeake says it has no trouble keeping itself well-financed.

“Chesapeake has superb assets and a track record of successfully completing large transactions to monetize assets in

“Chesapeake has a superb track record for completing large transactions. We’ll let our record speak for itself.”

**Michael Kehs**

Chesapeake spokesman



UNDER FIRE: McClendon was stripped of the chairmanship over his personal financial dealings but remains CEO. REUTERS/SEAN GARDNER

varying market conditions,” said spokesman Michael Kehs. “We’ll let our record speak for itself.”

A Reuters examination of Chesapeake’s books, VPP deals by the company and its CEO, and other novel transactions shows the financing is growing increasingly complex and costly – and in some cases is intertwined with the personal finances of the chief executive.

Last week, Reuters reported that McClendon had co-owned and actively traded in a \$200 million hedge fund that bought and sold the same commodities produced by Chesapeake.

On Tuesday, Reuters reported that one of Chesapeake’s chief financiers, EIG Global Energy Partners, arranged \$450 million in personal financing for McClendon in March. That brought to \$1.55 billion the

total amount of financing McClendon has taken out against his stakes in wells drilled by Chesapeake. Of that amount, \$1.33 billion came from EIG – which has also helped line up \$2.5 billion for Chesapeake itself since November.

The disclosures have embroiled the company in a corporate-governance crisis, prompting the board to strip McClendon of his chairmanship and U.S. regulators to open informal inquiries.

EIG is drawing attention for its central role in financing McClendon’s personal borrowings, which he took on to fund a lucrative perk giving him the right to receive stakes in company wells so long as he shoulders his share of the costs.

The coterie of financial engineers is much wider. It includes executives at Jefferies & Co, chiefly Ralph Eads III, a Houston oil banker and McClendon’s fraternity brother at Duke University.

The deals are so big that they require major trading partners and financiers, like Barclays PLC, which handled Glenn Pool. Wall Street’s biggest banks, including Deutsche Bank AG, Morgan Stanley, and Wells Fargo & Co, stepped in as both trading partners and lenders, according to court documents and company statements.

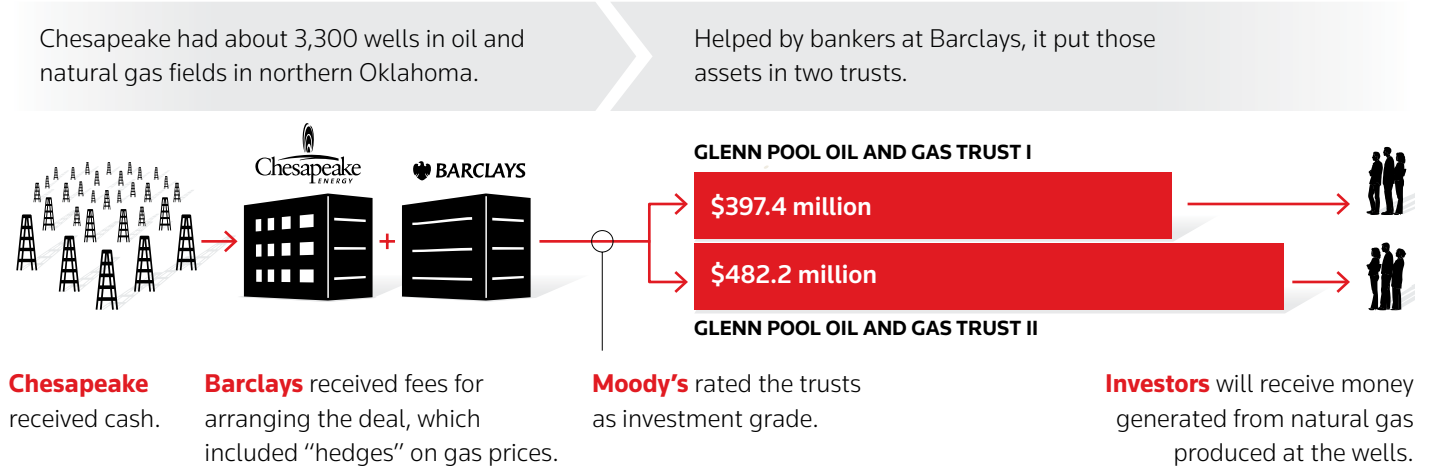
All told, the financiers have helped Chesapeake raise approximately \$40 billion in financing since 2000. They’ve used their trading desks to hedge bets on gas prices and interest rates, and advised on a host of deals, records show.

Some of the same financiers that have bankrolled Chesapeake’s deals also have made personal loans to McClendon, including Goldman Sachs Group Inc. and Wells Fargo, according to filings in Oklahoma. For collateral with Goldman, McClendon put up part of his wine collection. Wells Fargo and Goldman declined to comment.

Chesapeake has strengths that could enable it to ride out the storm. Low interest rates have made its junk bonds popular with investors. What’s more, Chesapeake is “asset

## An innovative deal

The Glenn Pool transaction was a breakthrough, generating approximately \$850 million for Chesapeake. Here's how it worked:



Source: Moody's Investor Service

Note: The \$850 million figure is net of reserve and transaction costs

rich,” S&P said, noting how the company “has been adept at structuring varied and innovative transactions to generate funds.”

With its aggressive financial management, some analysts say, Chesapeake could be making a correct bet that it can reinvest the cash it's raising in higher-yielding assets, such as new wells.

“They know what they are doing,” said John Rittenhouse, chief executive of EDF Trading, a London firm that is one of Chesapeake's largest trading partners. “It is a question of redeploying capital.”

### 15 MILLION ACRES

Chesapeake's remarkable rise dates to 1989, when McClendon co-founded the company. He dispatched “land men” across America to scout out energy plays, eventually building an empire on 15 million acres of land in 16 states. It's one of the biggest property-buying sprees ever by a public company in the United States, a combined area nearly the size of West Virginia.

As Chesapeake sped its expansion, it needed to raise ever-larger sums to lease land and drill on it. An important tool is the volumetric production payment, or VPP, which it first used in 2007.

The deals allow Chesapeake to sell to trading partners future natural gas and oil production in exchange for upfront cash. Rivals have used VPPs, but Chesapeake has tapped them much more frequently.

Reuters tallied 10 VPP deals by Chesapeake and two by McClendon. Chesapeake's use of VPPs has grown as rivals have moved away from them. The problem, analysts say, is that a company gives up future cash from a well. They also are a relatively expensive source of capital.

“It is rare for (exploration and production companies) to use VPPs as financing vehicles, especially in recent years,” said Joseph Allman, a J.P. Morgan Chase & Co analyst who follows Chesapeake.

Technically, VPP deals don't increase a company's debt, because they are deemed to be asset sales. But some analysts say VPPs are controversial because they effectively move future obligations to opaque off-balance sheet structures. Once a well is moved off the books, it can be difficult for investors to track production.

Broadly, investors frown on off-balance-sheet activity because it is much more difficult to monitor the use of money. Murky vehicles were a major factor in the account-

ing scandals involving Enron and others a decade ago.

Among McClendon's advisers on these deals are Jefferies & Co. and its vice chairman, Ralph Eads III. Both were members of the Sigma Alpha Epsilon fraternity at Duke, are big donors to the North Carolina university, and share a love of expensive French wine. Jefferies' connections extend into Chesapeake's corporate suite. McClendon has credited his CFO, Domenic Dell'Oso, a former Jefferies banker, for forming the “industry-leading VPP program.”

A Jefferies spokesman declined comment. Dell'Oso didn't reply to a request for comment.

Chesapeake has disclosed some but not all of the details of its VPP structures in company statements. In 2008, for example, Chesapeake told investors that it had raised \$1.1 billion in a VPP deal with affiliates of Deutsche Bank and UBS.

### GOLDMAN HELPS

Details on some VPP deals emerged in a lawsuit wending its way through federal court in New York. Mary Linda McCall of Harris County, Texas, claims she has stakes

in four wells that improperly were used to back unspecified Chesapeake VPP deals.

The lawsuit alleges Chesapeake didn't disclose that in 2008, two VPPs paid \$132 million to an entity called Chesapeake Investments. Reuters reported last month that McClendon used Chesapeake Investments to hold personal stakes in company-drilled wells, and pledged those wells as collateral to his lenders.

In this case, the VPPs, called Blue Devil and TW Investors, were constructed by Wells Fargo, the lawsuit says.

Chesapeake won a court order to dismiss the case last September. A federal judge ruled that Chesapeake in fact had only sold future oil and gas carved out of the company's "working interest" in the wells. McCall's attorneys filed an appeal at the U.S. Court of Appeals for the Second Circuit in New York.

Records unearthed by McCall's lawyers also show that a bank owned by George Kaiser, a billionaire Oklahoma investor, is a lender to McClendon. In 2008, a \$21 million investment from a Kaiser foundation, and financing from an affiliate of Goldman Sachs, enabled an enterprise called Argonaut VPP LLC to provide Chesapeake \$412 million. In exchange, Argonaut received well production in Oklahoma and Arkansas.

A year later, McClendon turned to Kaiser for a personal loan. Documents filed in Oklahoma show that McClendon pledged distributions from two of his personal companies as collateral to Kaiser. The size of the loans is not known.

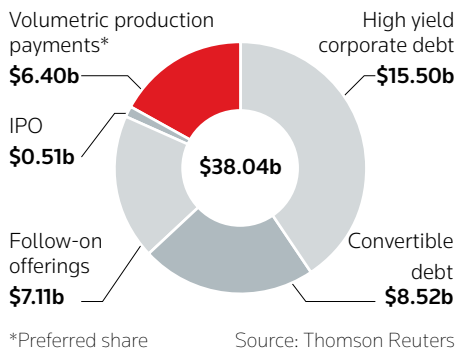
A spokesman for Kaiser declined comment.

In the past 12 months, Chesapeake's VPPs and other deals have gotten more complex. One example is Glenn Pool Oil & Gas Trust I and II, which was executed by the Barclays Capital unit of Barclays PLC.

This one stood out as cutting edge, earning the British bank a "deals of the year" honor from a commodities and risk trade publication called Energy Risk.

## Striking it rich

Chesapeake has raised about \$38 billion since 2000



This time, dozens of people worked on Glenn Pool, including employees from Barclays Capital's structuring, syndication, and ratings teams, according to the award description.

### CREATIVE TOUCH

In a typical VPP, an energy producer gets cash by exchanging future production rights with a trading partner, such as a bank. In the Glenn Pool deal, the trading partners—the two trusts—raised money by selling debt to investors. The investors then would recoup their investment from the revenue raised by the sale of natural gas from wells in seven counties in northern Oklahoma.

The sale of debt to investors meant the buyers needed to be assured of a return. That meant the deal needed a credit rating.

By spring 2011, the Glenn Pool deal was almost ready to be graded by the ratings firms. To verify that natural gas was in the ground, engineers from a Houston firm conducted a review, confirming there was plenty.

There was another risk for the debt investors: the fluctuation of gas prices and cash flows. To comfort investors, Barclays served as a middleman, providing hedges – financial contracts that effectively provide more stable prices or cash flow. The bank then reduced its risk exposure by taking

hedges against its own positions in the deal.

Next, it was time for Barclays to get the blessing of a ratings agency. In May 2011, Moody's Rating Service gave it a thumbs-up, granting the deal – two layers of debt, one maturing in 5 years and the other in 10 years – investment-grade ratings of Baa2 and Baa3.

Glenn Pool was innovative because prior VPP deals had remained on bank balance sheets. "Barclays Capital has pioneered a new approach in its recent transactions with Chesapeake," Energy Risk magazine wrote in bestowing an honor on the deal, "allowing a broad array of investors to take part in the investment while giving the gas producer a lower cost of capital."

The debt then was sold in two buckets. The first – five-year debt sold to investors such as hedge funds – fetched \$397.4 million. The second – 10-year debt sold to longer-term investors such as insurance companies – raised \$482.2 million.

The return paid by Chesapeake on the Glenn Pool deal wasn't disclosed. Chesapeake's borrowing costs on other recent deals have been divulged, however. Some analysts say those borrowings are coming at a high price as the company's financing gap widens and it makes a dash for cash.

### MORE IN THE PIPELINE

In the first quarter, Chesapeake spent more than \$2.5 billion drilling and completing wells, resulting in a cash shortfall. To cover it, Chesapeake relied on a series of conventional loans and creative deals to raise cash totaling \$3.4 billion.

Between Dec. 31 and Feb. 9, for example, Chesapeake tapped three loan commitments from banks to raise \$2.35 billion, according to a regulatory filing and analysis by J.P. Morgan Chase's Allman.

Chesapeake is going beyond VPP deals to other novel structures. Consider the two-stage deal it pulled off in November and December, when it traded 700,000 acres in eastern Ohio for \$1.25 billion.

## DRILLING FOR CASH CHESAPEAKE'S DEEPEST WELL: WALL STREET

A Chesapeake subsidiary, CHK Utica LLC, owns the leaseholds on the land. It issued \$750 million in perpetual preferred shares to an investment consortium led by EIG, the Washington, D.C., investment-management firm that also has loaned heavily to McClendon.

The consortium also includes an affiliate of private-equity firm Blackstone Group and Magnetar Capital – an Illinois hedge fund that profited handsomely with bets on subprime housing.

The consortium not only will receive a juicy dividend of 7 percent. It also will get royalty interests from gas produced from wells on the land.

The deal spree continues: In April, Chesapeake raised a total of \$2.6 billion.

A Chesapeake unit issued preferred shares to EIG and Magnetar in return for gas production in Oklahoma, this time netting \$1.25 billion.

Chesapeake also raised \$745 million in a VPP with Morgan Stanley. And the company agreed to sell a leasehold on 58,400 acres to raise \$590 million in a deal with an Exxon Mobil subsidiary.

This month, McClendon told investors in a conference call that more deals are afoot.

“We’ll have to work a bit harder on the asset monetization front to counteract currently soft U.S. natural gas prices to hit our year-end target,” McClendon said. “The good news is, the positives for our company are enduring, and the negatives we believe, are short-term.”

*Additional reporting by Anna Driver  
in Houston*

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**BIG BETS:** Chesapeake has spent heavily for acreage in plays such as the Eagle Ford shale formation in Texas.

**REUTERS/ANNA DRIVER**