EBAY INC
Form 10-Q
October 19, 2012

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q

[x] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2012

OR

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _______ to _______

Commission file number 000-24821

eBay Inc.
(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	77-0430924 (I.R.S. Employer Identification Number)
2145 Hamilton Avenue San Jose, California (Address of principal executive offices)	95125 (Zip Code)

(408) 376-7400
(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	[ ]	(Do not check if a smaller reporting company)	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 October 15, 2012, there were 1,293,985,406 shares of the registrant's common stock, $0.001 par value, outstanding, which is the only class of common or voting stock of the registrant issued.

PART I: FINANCIAL INFORMATION
Item 1: Financial Statements
eBay Inc.
CONDENSED CONSOLIDATED BALANCE SHEET

	September 30, 2012	December 31, 2011
	(In millions, except par value amounts)	
	(Unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 7,331	$ 4,691
Short-term investments	1,804	1,238
Accounts receivable, net	694	682
Loans and interest receivable, net	1,792	1,501
Funds receivable and customer accounts	4,807	3,968
Other current assets	982	581
Total current assets	17,410	12,661
Long-term investments	2,500	2,453
Property and equipment, net	2,393	1,986
Goodwill	8,492	8,365
Intangible assets, net	1,234	1,406
Other assets	473	449
Total assets	$ 32,502	$ 27,320
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Short-term debt	$ 12	$ 565
Accounts payable	271	282
Funds payable and amounts due to customers	4,807	3,968
Accrued expenses and other current liabilities	1,776	1,511
Deferred revenue	132	110
Income taxes payable	63	298
Total current liabilities	7,061	6,734
Deferred and other tax liabilities, net	945	1,073
Long-term debt	4,506	1,525
Other liabilities	77	58
Total liabilities	12,589	9,390
Commitments and contingencies (Note 9)		
Stockholders' equity:		
Common stock, $0.001 par value; 3,580 shares authorized; 1,294 and 1,286 shares outstanding	2	2
Additional paid-in capital	11,811	11,145
Treasury stock at cost, 266 and 249 shares	(7,797)	(7,155)
Retained earnings	15,248	13,389
Accumulated other comprehensive income	649	549
Total stockholders' equity	19,913	17,930
Total liabilities and stockholders' equity	$ 32,502	$ 27,320

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

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eBay Inc.
CONDENSED CONSOLIDATED STATEMENT OF INCOME

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(In millions, except per share amounts) (Unaudited)			
Net revenues	$3,404	$2,966	$10,079	$8,272
Cost of net revenues	1,022	920	2,992	2,426
Gross profit	2,382	2,046	7,087	5,846
Operating expenses:				
Sales and marketing	726	623	2,120	1,763
Product development	389	319	1,157	891
General and administrative	369	336	1,131	1,018
Provision for transaction and loan losses	148	146	413	372
Amortization of acquired intangible assets	83	85	251	182
Total operating expenses	1,715	1,509	5,072	4,226
Income from operations	667	537	2,015	1,620
Interest and other, net	5	79	74	111
Gain (loss) on divested businesses	—	—	118	(256)
Income before income taxes	672	616	2,207	1,475
Provision for income taxes	(75)	(125)	(348)	(225)
Net income	$597	$491	$1,859	$1,250
Net income per share:				
Basic	$0.46	$0.38	$1.44	$0.97
Diluted	$0.45	$0.37	$1.42	$0.95
Weighted average shares:				
Basic	1,292	1,290	1,291	1,291
Diluted	1,314	1,309	1,311	1,311

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

eBay Inc.
CONDENSED CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME (LOSS)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(In millions) (Unaudited)			
Net income	$597	$491	$1,859	$1,250
Other comprehensive income (loss), before tax and net of reclassification adjustments:				
Foreign currency translation	191	(513)	80	5
Unrealized gains (losses) on investments, net	89	(253)	126	(150)
Unrealized (losses) gains on hedging activities, net	(73)	65	(90)	23
Other comprehensive income (loss), before tax	207	(701)	116	(122)
Tax (provision) benefit related to items of other comprehensive income	(22)	83	(16)	44
Other comprehensive income (loss), net tax	185	(618)	100	(78)
Comprehensive income (loss)	$782	$(127)	$1,959	$1,172

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

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eBay Inc.
CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS

	Nine Months Ended September 30,	
	2012	2011
	(In millions) (Unaudited)	
Cash flows from operating activities:		
Net income	$1,859	$1,250
Adjustments:		
Provision for transaction and loan losses	413	372
Depreciation and amortization	882	667
Stock-based compensation	360	346
(Gain) loss on divested businesses	(118)	256
Gain on acquisition of a business	—	(73)
Changes in assets and liabilities, net of acquisition effects	(943)	(527)
Net cash provided by operating activities	2,453	2,291
Cash flows from investing activities:		
Purchases of property and equipment, net	(961)	(672)
Changes in principal loans receivable, net	(335)	(254)
Purchases of investments	(1,470)	(1,884)
Maturities and sales of investments	938	1,298
Acquisitions, net of cash acquired	(143)	(3,155)
Proceeds from divested business, net of cash disposed	144	—
Other	(77)	(102)
Net cash used in investing activities	(1,904)	(4,769)
Cash flows from financing activities:		
Proceeds from issuance of common stock	359	188
Repurchases of common stock	(642)	(814)
Excess tax benefits from stock-based compensation	95	65
Tax withholdings related to net share settlements of restricted stock awards and units	(152)	(130)
Net (repayments) and borrowings under commercial paper program	(550)	700
Proceeds from the issuance of debt, net of issuance costs	2,976	—
Repayment of acquired debt	—	(199)
Funds receivable and customer accounts	(839)	(696)
Funds payable and amounts due to customers	839	696
Other	(4)	—
Net cash provided by (used in) financing activities	2,082	(190)
Effect of exchange rate changes on cash and cash equivalents	9	90
Net increase (decrease) in cash and cash equivalents	2,640	(2,578)
Cash and cash equivalents at beginning of period	4,691	5,577
Cash and cash equivalents at end of period	$7,331	$2,999
Supplemental cash flow disclosures:		
Cash paid for interest	$15	$14
Cash paid for income taxes	$757	$282
Non-cash investing and financing activities:		
Common stock options assumed pursuant to acquisition	$—	$25
Note receivable from divested business	$—	$287

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

eBay Inc.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 1 — The Company and Summary of Significant Accounting Policies

The Company

eBay Inc. (“eBay”) was incorporated in California in May 1996, and reincorporated in Delaware in April 1998. eBay is a global commerce platform and payments leader. We enable commerce through eBay, the world's largest online marketplace, which allows users to buy and sell in nearly every country on earth; through PayPal, which enables individuals and businesses to securely, easily and quickly send and receive online payments; and through GSI, which facilitates ecommerce, multichannel retailing and interactive marketing for global enterprises. X.commerce harnesses the developer community of Magento, an ecommerce platform, by providing technology solutions and eBay Inc. capabilities to merchants of all sizes, supporting eBay Inc.'s mission of enabling commerce. We also reach millions of people through specialized marketplaces such as StubHub, the world's largest ticket marketplace, and eBay classifieds sites, which together have a presence in more than 1,000 cities around the world.

We have three reportable business segments: Marketplaces, Payments and GSI. Our Marketplaces segment includes our eBay.com platform and its localized counterparts and our other online trading platforms, such as our online classifieds sites and StubHub. Our Payments segment is comprised of PayPal, Bill Me Later and Zong. Our GSI segment consists of GSI Commerce, Inc. ("GSI"), and was added upon the completion of our acquisition of GSI on June 17, 2011. The results of our GSI segment have been included in our consolidated results of operations from the acquisition date.
We are required to comply with various regulations worldwide in order to operate our businesses, particularly our Payments business. We also partner with banks and other financial institutions in order to offer our Payments services globally. Changes in regulations or how regulations are interpreted or enforced by governmental authorities and courts, non-compliance with regulations or loss of key bank or financial institution partners could have a significant adverse impact on our ability to operate our business; therefore, we monitor these areas closely to mitigate potential adverse impacts.
When we refer to “we,” “our,” “us” or “eBay” in this document, we mean the current Delaware corporation (eBay Inc.) and its California predecessor, as well as all of our consolidated subsidiaries.

Use of estimates

The preparation of condensed consolidated financial statements in conformity with U.S. generally accepted accounting principles (GAAP) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. On an ongoing basis, we evaluate our estimates, including those related to provisions for transaction and loan losses, legal contingencies, income taxes, revenue recognition, stock-based compensation, goodwill and the recoverability intangible assets. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. Actual results could differ from those estimates.
Principles of consolidation and basis of presentation

The accompanying condensed financial statements are consolidated and include the financial statements of eBay Inc., our wholly and majority-owned subsidiaries and variable interest entities ("VIE") if we were the primary beneficiary. Ownership interests of minority interests are recorded as a noncontrolling interest. All significant intercompany balances and transactions have been eliminated in consolidation. A qualitative approach is applied to assess the consolidation requirement for VIEs. Investments in entities where we hold at least a 20% ownership interest and have the ability to exercise significant influence, but not control, over the investee are accounted for using the equity method of accounting. For such investments, our share of the investees' results of operations is included in interest and other, net and our investment balance is included in long-term investments. Investments in entities where we hold less than a 20% ownership interest are generally accounted for using the cost method of accounting, and our share of the investees' results of operations is included in our consolidated statement of income to the extent dividends are received.

These condensed consolidated financial statements and accompanying notes should be read in conjunction with the audited consolidated financial statements and accompanying notes included in our Annual Report on Form 10-K for the year ended December 31, 2011. We have evaluated all subsequent events through the date the financial statements were issued.

eBay Inc.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

Recent Accounting Pronouncements

In 2012, the FASB issued a new accounting standard that simplifies the impairment test for indefinite-lived intangible assets other than goodwill. The new guidance gives the option to first assess qualitative factors to determine if it is more likely than not that the fair value of an indefinite-lived intangible asset is less than its carrying amount as a basis for determining whether it is necessary to perform a quantitative valuation test. The new standard is effective for fiscal years, and interim periods within those fiscal years, beginning on or after September 15, 2012. We will adopt this accounting standard in the fourth quarter of 2012 and we do not anticipate that this adoption will have a significant impact on our financial position, results of operations or cash flows.

Note 2 — Net Income Per Share

Basic net income per share is computed by dividing net income for the period by the weighted average number of common shares outstanding during the period. Diluted net income per share is computed by dividing net income for the period by the weighted average number of shares of common stock and potentially dilutive common stock outstanding during the period. The dilutive effect of outstanding options and restricted stock is reflected in diluted net income per share by application of the treasury stock method. The calculation of diluted net income per share excludes all anti-dilutive shares. The following table sets forth the computation of basic and diluted net income per share for the periods indicated:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(In millions, except per share amounts)			
Numerator:				
Net income	$597	$491	$1,859	$1,250
Denominator:				
Weighted average common shares - basic	1,292	1,290	1,291	1,291
Dilutive effect of equity incentive plans	22	19	20	20
Weighted average common shares - diluted	1,314	1,309	1,311	1,311
Net income per share:				
Basic	$0.46	$0.38	$1.44	$0.97
Diluted	$0.45	$0.37	$1.42	$0.95
Common stock equivalents excluded from income per diluted share because their effect would have been anti-dilutive	3	18	6	17

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Note 3 - Business Combinations and Divestitures

During the nine months ended September 30, 2012, we completed three acquisitions, two of which are included in our Marketplaces segment and one in our Payments segment, for aggregate purchase consideration of approximately $149 million, consisting primarily of cash. The allocation of the purchase consideration resulted in net liabilities of approximately $21 million, purchased intangible assets of $70 million and goodwill of $100 million. The allocations of the purchase price for these acquisitions have been prepared on a preliminary basis and changes to those allocations may occur as additional information becomes available. The consolidated financial statements include the operating results of the acquired businesses since the respective dates of the acquisitions. Pro forma results of operations have not been presented because the effect of the acquisitions were not material to our financial results.

In May 2012, we completed the sale of Rent.com for proceeds of approximately $145 million, resulting in a gain of approximately $118 million. The results of operations from Rent.com are not material to any period presented.

GSI

We acquired GSI on June 17, 2011. In conjunction with the acquisition of GSI, we immediately divested 100 percent of GSI's licensed sports merchandise business and 70 percent of GSI's ShopRunner and RueLaLa businesses (together, the "divested businesses").

Pro forma financial information

The unaudited pro forma financial information in the table below summarizes the combined results of our operations and those of GSI for the period shown as though the acquisition of GSI and the sale of the divested businesses had occurred as of the beginning of fiscal year 2011. The unaudited pro forma financial information for the period presented includes the business combination accounting effects of the acquisition, including amortization charges from acquired intangible assets. The unaudited pro forma financial information presented below is for informational purposes only, is subject to a number of estimates, assumptions and other uncertainties, and is not indicative of the results of operations that would have been achieved if the acquisition and divestiture had taken place at January 1, 2011. The unaudited pro forma financial information is as follows (in millions, except per share amounts):

	Nine Months Ended September 30, 2011
Total revenues	$8,658
Net income	1,190
Basic earnings per share	$0.92
Diluted earnings per share	$0.91

eBay Inc.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

Note 4 — Goodwill and Intangible Assets

Goodwill

The following table presents goodwill balances and adjustments to those balances for each of our reportable segments during the nine months ended September 30, 2012:

	December 31, 2011 (In millions)	Goodwill Acquired	Disposals	Adjustments	September 30, 2012
Reportable segments:					
Marketplaces	$4,537	$100	$(21)	$63	$4,679
Payments	2,515	—	—	3	2,518
GSI	1,293	—	—	(18)	1,275
Corporate and other	47	—	—	—	47
	$8,392	$100	$(21)	$48	$8,519

Investments accounted for under the equity method of accounting are classified on our balance sheet as long-term investments. Such investment balances include any related goodwill. As of September 30, 2012 and December 31, 2011, the goodwill related to our equity method investments was approximately $27 million.

The adjustments to goodwill during the nine months ended September 30, 2012 were due primarily to changes in tax items and foreign currency translation.

Intangible Assets

The components of identifiable intangible assets are as follows:

	September 30, 2012				December 31, 2011			
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Weighted Average Useful Life (Years)	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Weighted Average Useful Life (Years)
	(In millions, except years)							
Intangible assets:								
Customer lists and user base	$1,635	$ (928)	$707	5	$1,633	$(787)	$846	5
Trademarks and trade names	727	(532)	195	5	730	(469)	261	5
Developed technologies	523	(302)	221	4	498	(249)	249	3
All other	261	(150)	111	4	182	(132)	50	4
	$3,146	$ (1,912)	$1,234		$3,043	$(1,637)	$1,406	

Amortization expense for intangible assets was $110 million and $105 million for the three months ended September 30, 2012 and 2011, respectively. Amortization expense for intangible assets was $329 million and $228 million for the nine months ended September 30, 2012 and 2011, respectively.

eBay Inc.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

Note 5 — Segments

We have three reporting segments: Marketplaces, Payments and GSI. We allocate resources to and assess the performance of each reporting segment using information about its revenue and operating income (loss). We do not evaluate operating segments using discrete asset information. We do not allocate gains and losses from equity investments, interest and other income, or taxes to operating segments.

The corporate and other category includes income, expenses and charges such as:

- results of operations of our X.commerce initiative, which supports our businesses;
- corporate management costs, such as human resources, finance and legal, not allocated to our segments;
- amortization of intangible assets;
- restructuring charges; and
- stock based compensation expense.

The following tables summarize the financial performance of our reporting segments and reconciliation to our consolidated operating results for the periods reflected below (data for the nine months ended September 30, 2011 include GSI since the date of acquisition) (1):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(In millions)			
Net Revenue				
Marketplaces				
Net transaction revenues	$1,490	$1,354	$4,406	$3,988
Marketing services and other revenues	316	299	942	882
	1,806	1,653	5,348	4,870
Payments				
Net transaction revenues	1,264	1,032	3,715	2,966
Marketing services and other revenues	102	74	318	206
	1,367	1,107	4,033	3,173
GSI				
Net transaction revenues	170	148	516	165
Marketing services and other revenues	57	54	168	62
	226	202	684	227
Corporate and other				
Marketing services and other revenues	11	3	27	3
Elimination of inter-segment net revenue (2)	(6)	—	(13)	—
Total consolidated net revenue	$3,404	$2,966	$10,079	$8,272
Operating income (loss)				
Marketplaces	$705	$637	$2,093	$1,911
Payments	309	216	1,004	672
GSI	14	6	47	5
Corporate and other	(361)	(322)	(1,129)	(968)
Total operating income (loss)	$667	$537	$2,015	$1,620

(1) Certain amounts may not sum due to rounding.
(2) Represents revenue generated between our reportable segments.

eBay Inc.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

Note 6 — Fair Value Measurement of Assets and Liabilities

The following tables summarize our financial assets and liabilities measured at fair value on a recurring basis as of September 30, 2012 and December 31, 2011:

Description	Balance as of September 30, 2012	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
	(In millions)		
Assets:			
Cash and cash equivalents	$7,331	$7,331	$—
Short-term investments:			
Restricted cash	16	16	—
Corporate debt securities	1,093	—	1,093
Government and agency securities	14	—	14
Time deposits	10	—	10
Equity instruments	671	671	—
Total short-term investments	1,804	687	1,117
Derivatives	69	—	69
Long-term investments:			
Corporate debt securities	2,268	—	2,268
Government and agency securities	47	—	47
Total long-term investments	2,315	—	2,315
Total financial assets	$11,519	$8,018	$3,501
Liabilities:			
Derivatives	$75	$—	$75

eBay Inc.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

Description	Balance as of December 31, 2011	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
	(In millions)		
Assets:			
Cash and cash equivalents	$4,691	$4,691	$—
Short-term investments:			
Restricted cash	20	20	—
Corporate debt securities	448	—	448
Government and agency securities	42	—	42
Time deposits	82	—	82
Equity instruments	646	646	—
Total short-term investments	1,238	666	572
Derivatives	112	—	112
Long-term investments:			
Restricted cash	1	1	—
Corporate debt securities	2,186	—	2,186
Government and agency securities	71	—	71
Total long-term investments	2,258	1	2,257
Total financial assets	$8,299	$5,358	$2,941
Liabilities:			
Derivatives	$60	$—	$60

Our financial assets and liabilities are valued using market prices on both active markets (level 1) and less active markets (level 2). Level 1 instrument valuations are obtained from real-time quotes for transactions in active exchange markets involving identical assets. Level 2 instrument valuations are obtained from readily available pricing sources for comparable instruments or identical instruments in less active markets. The majority of our derivative instruments are valued using pricing models that take into account the contract terms as well as multiple inputs where applicable, such as equity prices, interest rate yield curves, option volatility and currency rates. Our derivative instruments are primarily short-term in nature, generally one month to one year in duration. Cash and cash equivalents are short-term, highly liquid investments with original or remaining maturities of three months or less when purchased and are comprised primarily of bank deposits and money market funds.

In addition to the long-term investments noted above, we had cost and equity method investments of approximately $180 million and $190 million included in long-term investments on our condensed consolidated balance sheet at September 30, 2012 and our consolidated balance sheet at December 31, 2011, respectively. At September 30, 2012 and December 31, 2011, we also held $5 million of time deposits classified as held to maturity, which are recorded at amortized cost.

Other financial instruments, including accounts receivable, loans and interest receivable, funds receivable, customer accounts, commercial paper, accounts payable, funds payable and amounts due to customers, are carried at cost, which generally approximates their fair value because of the short-term nature of these instruments.

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eBay Inc.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

Note 7 — Derivative Instruments

Fair Value of Derivative Contracts

The fair value of our outstanding derivative instruments as of September 30, 2012 and December 31, 2011 was as follows:

	Derivative Assets Reported in Other Current Assets		Derivative Liabilities Reported in Other Current Liabilities	
	September 30, 2012	December 31, 2011	September 30, 2012	December 31, 2011
	(In millions)			
Foreign exchange contracts designated as cash flow hedges	$20	$75	$38	$3
Foreign exchange contracts not designated as hedging instruments	37	29	37	57
Other contracts not designated as hedging instruments	12	8	—	—
Total fair value of derivative instruments	$69	$112	$75	$60

Effect of Derivative Contracts on Accumulated Other Comprehensive Income

The following table summarizes the activity of derivative contracts that qualify for hedge accounting as of September 30, 2012 and December 31, 2011, and the impact of designated derivative contracts on accumulated other comprehensive income for the nine months ended September 30, 2012:

	December 31, 2011	Amount of gain (loss) recognized in other comprehensive income (effective portion)	Amount of gain (loss) reclassified from accumulated other comprehensive income to net revenue and operating expense (effective portion)	September 30, 2012
	(In millions)			
Foreign exchange contracts designated as cash flow hedges	$72	$(30)	$60	$(18)

The following table summarizes the activity of derivative contracts that qualify for hedge accounting as of September 30, 2011 and December 31, 2010, and the impact of designated derivative contracts on accumulated other comprehensive income for the nine months ended September 30, 2011:

	December 31, 2010	Amount of gain (loss) recognized in other comprehensive income	Amount of gain (loss) reclassified from accumulated other	September 30, 2011

		(effective portion)	comprehensive income to net revenue and operating expense (effective portion)	
	(In millions)			
Foreign exchange contracts designated as cash flow hedges	$14	$29	$7	$36

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eBay Inc.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

Effect of Derivative Contracts on Condensed Consolidated Statement of Income

The following table provides the location in our financial statements of the recognized gains or losses related to our derivative instruments:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(In millions)			
Foreign exchange contracts designated as cash flow hedges recognized in net revenues	$16	$(6)	$42	$(23)
Foreign exchange contracts designated as cash flow hedges recognized in operating expenses	6	(3)	15	(8)
Foreign exchange contracts not designated as hedging instruments recognized in interest and other, net	(2)	15	(10)	8
Other contracts not designated as hedging instruments recognized in interest and other, net	—	—	4	—
Total gain (loss) recognized from derivative contracts in the condensed consolidated statement of income	$20	$6	$51	$(23)

Note 8 - Debt
The following table summarizes the carrying value of our outstanding debt:

	Coupon Rate	Carrying Value as of September 30, 2012	Effective Interest Rate	Carrying Value as of December 31, 2011	Effective Interest Rate
	(In millions, except percentages)				
Long-Term Debt					
Senior notes due 2013	0.875%	$400	1.078%	$400	1.078%
Senior notes due 2015	1.625%	598	1.805%	598	1.805%
Senior notes due 2015	0.700%	250	0.820%	—	N/A
Senior notes due 2017	1.350%	999	1.456%	—	N/A
Senior notes due 2020	3.250%	498	3.389%	497	3.389%
Senior notes due 2022	2.600%	999	2.678%	—	N/A
Senior notes due 2042	4.000%	743	4.114%	—	N/A
Total senior notes		4,487		1,495	
Notes payable		13		15	
Capital lease obligations		6		15	
Total long-term debt		$4,506		$1,525	
Short-Term Debt					
Commercial paper		$—		$550	
Notes payable		2		2	
Capital lease obligations		10		13	
Total short-term debt		12		565	
Total Debt		$4,518		$2,090	

Senior Notes
In July 2012, we issued senior unsecured notes, or senior notes, in an aggregate principal amount of $3 billion, of which $250 million will mature in July 2015, $1 billion will mature in July 2017, $1 billion will mature in July 2022

and $750 million will mature in July 2042. Interest on these senior notes is payable semiannually on January 15 and July 15. Additionally, we have other senior notes outstanding in an aggregate principal amount of $1.5 billion, of which $400 million will mature in October 2013, $600 million will mature in October 2015 and $500 million will mature in October 2020. Interest on these senior notes is payable semiannually on April 15 and October 15.

The effective interest rates for our fixed-rate debt include the interest payable, the amortization of debt issuance costs and the amortization of any original issue discount on these senior notes. Interest expense associated with these senior notes, including amortization of debt issuance costs, during the three and nine months ended September 30, 2012 was approximately $21 million and $37 million, respectively. Interest expense associated with these senior notes, including amortization of debt issuance costs, during the three and nine months ended September 30, 2011 was approximately $8 million and $24 million, respectively. At September 30, 2012, the estimated fair value of all these senior notes included in long-term debt was approximately $4.6 billion based on market prices on less active markets (Level 2).

The indenture pursuant to which the senior notes were issued includes customary covenants that, among other things, and subject to exceptions, limit our ability to incur, assume or guarantee debt secured by liens on specified assets or enter into sale and lease-back transactions with respect to specified properties, and also includes customary events of default.

Notes Payable

Notes payable consists primarily of a note that bears interest at 6.3% per annum and has a maturity date of December 2015.

Capital Lease Obligations

We acquired certain warehouse equipment and computer hardware and software under capital leases as part of our acquisition of GSI. The capital leases have maturity dates ranging from December 2012 to September 2014 and bear interest at rates ranging from 3% to 9% per annum. The present value of future minimum capital lease payments as of September 30, 2012 was as follows (in millions):

Gross capital lease obligations	$17	
Imputed interest	(1	)
Total present value of future minimum capital lease payments	$16	

Commercial Paper

We have a $2 billion commercial paper program pursuant to which we may issue commercial paper notes with maturities of up to 397 days from the date of issue. As of September 30, 2012, there were no commercial paper notes outstanding.

Credit Agreement

As of September 30, 2012, no borrowings or letters of credit were outstanding under our $3 billion credit agreement. As described above, we have a $2 billion commercial paper program and maintain $2 billion of available borrowing capacity under our credit agreement in order to repay commercial paper borrowings in the event we are unable to repay those borrowings from other sources when they become due. As a result, at September 30, 2012, $1 billion of borrowing capacity was available for other purposes permitted by the credit agreement.   The credit agreement includes customary covenants that, among other things and subject to exceptions, limit our ability to create, assume or permit to exist liens on our property, assets and revenue (other than certain permitted liens) and require that we maintain a minimum consolidated interest coverage ratio, and also includes customary events of default.

As of September 30, 2012, we were in compliance with all covenants in our outstanding debt instruments.

Note 9 — Commitments and Contingencies

Commitments

As of September 30, 2012, approximately $12 billion of unused credit was available to Bill Me Later accountholders. The individual lines of credit that make up this unused credit are subject to periodic review and termination by the chartered financial institution that is the issuer of Bill Me Later credit products based on, among other things, account usage and customer creditworthiness. Currently, when a consumer makes a purchase using a Bill Me Later credit product, the chartered financial institution extends credit to the consumer, funds the extension of credit at the point of sale and advances funds to the merchant. We subsequently purchase the receivables related to the consumer loans extended by the chartered financial institution and, as a result of the purchase, bear the risk of loss in the event of loan defaults. Although the chartered financial institution continues to own each customer account, we own the related receivable, and Bill Me Later is responsible for all servicing functions related to the account.

eBay Inc.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

Litigation and Other Legal Matters

Overview
We are involved in legal proceedings on an ongoing basis. If we believe that a loss arising from such matters is probable and can be reasonably estimated, we accrue the estimated liability in our financial statements. If only a range of estimated losses can be determined, we accrue an amount within the range that, in our judgment, reflects the most likely outcome; if none of the estimates within that range is a better estimate than any other amount, we accrue the low end of the range. Amounts accrued for legal proceedings for which we believe a loss is probable were not material for the nine months ended September 30, 2012. Except as otherwise noted, we have concluded that reasonably possible losses arising directly from the proceedings (i.e., monetary damages or amounts paid in judgment or settlement) in excess of our accruals are also not material. For those proceedings in which an unfavorable outcome is reasonably possible but not probable, we have disclosed an estimate of the reasonably possible loss or range of losses or we have concluded that an estimate of the reasonably possible loss or range of losses arising directly from the proceeding (i.e., monetary damages or amounts paid in judgment or settlement) are not material. If we cannot estimate the probable or reasonably possible loss or range of losses arising from a legal proceeding, we have disclosed that fact. In assessing the materiality of a legal proceeding, we evaluate, among other factors, the amount of monetary damages claimed, as well as the potential impact of non-monetary remedies sought by plaintiffs (e.g., injunctive relief) that may require us to change our business practices in a manner that could have a material adverse impact on our business. With respect to the matters disclosed in this Note 9, we are unable to estimate the possible loss or range of losses that could potentially result from the application of such non-monetary remedies.

Specific Matters

In August 2006, Louis Vuitton Malletier and Christian Dior Couture filed two lawsuits in the Paris Court of Commerce against eBay Inc. and eBay International AG. Among other things, the complaint alleged that we violated French tort law by negligently broadcasting listings posted by third parties offering counterfeit items bearing plaintiffs' trademarks and by purchasing certain advertising keywords. Around September 2006, Parfums Christian Dior, Kenzo Parfums, Parfums Givenchy, and Guerlain Société also filed a lawsuit in the Paris Court of Commerce against eBay Inc. and eBay International AG. The complaint alleged that we had interfered with the selective distribution network the plaintiffs established in France and the European Union by allowing third parties to post listings offering genuine perfumes and cosmetics for sale on our websites. In June 2008, the Paris Court of Commerce ruled that eBay and eBay International AG were liable for failing to prevent the sale of counterfeit items on its websites that traded on plaintiffs' brand names and for interfering with the plaintiffs' selective distribution network. The court awarded plaintiffs approximately EUR 38.6 million in damages and issued an injunction (enforceable by daily fines of up to EUR 100,000) prohibiting all sales of perfumes and cosmetics bearing the Dior, Guerlain, Givenchy and Kenzo brands over all worldwide eBay sites to the extent that they are accessible from France. We appealed this decision, and in September 2010, the Paris Court of Appeal reduced the damages award to EUR 5.7 million and modified the injunction. We further appealed this decision to the French Supreme Court, and in May 2012, the French Supreme Court ruled that the appeal court should not have assumed jurisdiction upon activity that took place on the eBay.com site and that the injunction was too broad insofar as it did not exclude private sales. The court also noted that the appeal court had not sufficiently dealt with assertions that the plaintiffs' distribution contracts were not valid. Those matters will now be remanded to the Paris Court of Appeal. In 2009, plaintiffs filed an action regarding our compliance with the original injunction, and in November 2009, the court awarded the plaintiffs EUR 1.7 million (the equivalent of EUR 2,500 per day) and indicated that as a large Internet company we should do a better job of enforcing the injunction. Parfums Christian Dior has filed another motion relating to our compliance with the injunction. We have taken measures to comply with the injunction and have appealed these rulings, noting, among other things, the modification of the initial injunction. In light of the French Supreme Court ruling mentioned above, we asked the court to stay proceedings with respect to enforcement of the injunction pending the retrial of the matters on appeal, and this request has been granted. However, these and similar suits may force us to modify our business practices, which could lower our revenue, increase our costs, or make our websites less convenient to our customers. Any such results could materially harm our business. Other brand owners have also filed suit against us or have threatened to do so in numerous different jurisdictions, seeking to hold us liable for, among other things, alleged counterfeit items listed on our websites by third parties, "tester" and other not for resale consumer products listed on our websites by third parties, alleged misuse of trademarks in listings, alleged violations of selective distribution channel laws, alleged violations of parallel import laws, alleged non-compliance with consumer protection laws and in connection with paid search advertisements. We have prevailed in some of these suits, lost in others, and many are in various stages of appeal. We continue to believe that we have meritorious defenses to these suits and intend to defend ourselves vigorously.

eBay Inc.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(Unaudited)

In May 2009, the U.K. High Court of Justice ruled in the case filed by L'Oréal SA, Lancôme Parfums et Beauté & Cie, Laboratoire Garnier & Cie and L'Oréal (UK) Ltd against eBay International AG, other eBay companies, and several eBay sellers (No. HC07CO1978) that eBay was not jointly liable with the seller co-defendants as a joint tortfeasor, and indicated that it would certify to the European Court of Justice ("ECJ") questions of liability for the use of L'Oréal trademarks, hosting liability, and the scope of a possible injunction against intermediaries. On July 12, 2011 the ECJ ruled on the questions certified by the U.K. High Court of Justice. It held that (a) brand names could be used by marketplaces as keywords for paid search advertising without violating a trademark owner's rights if it were clear to consumers that the goods reached via the key word link were not being offered by the trademark owner or its designees but instead by third parties, (b) that marketplaces could invoke the limitation from liability provided by Article 14 of the ecommerce directive if they did not take such an active role with respect to the listings in question that the limitation would not be available, but that even where the limitation was available, the marketplace could be liable if it had awareness (through notice or its own investigation) of the illegality of the listings, (c) that a marketplace would be liable in a specific jurisdiction only if the offers on the site at issue were targeting that jurisdiction, a question of fact, (d) that injunctions may be issued to a marketplace in connection with infringing third party content, but that such injunctions must be proportionate and not block legitimate trade and (e) that trademark rights can only be evoked by a rights owner as a result of a seller's commercial activity as opposed to private activity. The matter will now return to the U.K. High Court of Justice for further action in light of the ECJ opinion. The case was originally filed in July 2007. L'Oréal's complaint alleged that we were jointly liable for trademark infringement for the actions of the sellers who allegedly sold counterfeit goods, parallel imports and testers (not for resale products). Additionally, L'Oréal claimed that eBay's use of L'Oréal brands on its website, in its search engine and in sponsored links, and purchase of L'Oréal trademarks as keywords, constitute trademark infringement. The suit sought an injunction preventing future infringement, full disclosure of the identity of all past and present sellers of infringing L'Oréal goods, and a declaration that our Verified Rights Owner (VeRO) program as then operated was insufficient to prevent such infringement. The scope of a possible injunction claimed is to be specified after the trial upon remand from the ECJ.

eBay's Korean subsidiary, IAC (which has merged into Gmarket and is now named eBay Korea), has notified its approximately 20 million users of a January 2008 data breach involving personally identifiable information including name, address, resident registration number and some transaction and refund data (but not including credit card information or real time banking information). Approximately 149,000 users sued IAC over this breach in several lawsuits in Korean courts and more may do so in the future (including after final determination of liability). Trial for a group of four representative suits began in August 2009 in the Seoul District Court, and trial for a group of 23 other suits began in September 2009 in the Seoul District Court. There is some precedent in Korea for a court to grant "consolation money" for data breaches without a specific finding of harm from the breach. Such precedents have involved payments of up to approximately $200 per user. In January 2010, the Seoul District Court ruled that IAC had met its obligations with respect to defending the site from intrusion and, accordingly, had no liability for the breach. This ruling has been appealed by approximately 34,000 plaintiffs to the Seoul High Court. In September 2012, a bench of the Seoul High Court announced its decision upholding the Seoul District Court's 2010 decision for three cases involving 55 plaintiffs. The remaining cases are currently being heard de novo, and a decision is expected in early 2013.

General Matters

Other third parties have from time to time claimed, and others may claim in the future, that we have infringed their intellectual property rights. We are subject to patent disputes, and expect that we will increasingly be subject to additional patent infringement claims involving various aspects of our Marketplaces, Payments and GSI businesses as our services continue to expand in scope and complexity. Such claims may be brought directly against our companies and/or against our customers (who may be entitled to contractual indemnification under their contracts with us), and we are subject to increased exposure to such claims as a result of our recent acquisitions, particularly in cases where we are entering into new businesses in connection with such acquisitions. We have in the past been forced to litigate such claims. We may also become more vulnerable to third-party claims as laws such as the Digital Millennium Copyright Act, the Lanham Act and the Communications Decency Act are interpreted by the courts, and as we expand the range and geographical scope of our services and become subject to laws in jurisdictions where the underlying laws with respect to the potential liability of online intermediaries like ourselves are either unclear or less favorable. We believe that additional lawsuits alleging that we have violated patent, copyright or trademark laws will be filed against us. Intellectual property claims, whether meritorious or not, are time consuming and costly to defend and resolve, could require expensive changes in our methods of doing business, or could require us to enter into costly royalty or licensing agreements on unfavorable terms.

From time to time, we are involved in other disputes or regulatory inquiries that arise in the ordinary course of business, including suits by our users (individually or as class actions) alleging, among other things, improper disclosure of our prices, rules or policies, that our prices, rules, policies or customer/user agreements violate applicable law, or that we have not acted in conformity with such prices, rules, policies or agreements. The number and significance of these disputes and inquiries are increasing as our company has grown larger, our businesses have expanded in scope and our products and services have increased in complexity. Any claims or regulatory actions against us, whether meritorious or not, could be time consuming, result in costly litigation, damage awards (including statutory damages for certain causes of action in certain jurisdictions), injunctive relief or increased costs of doing business through adverse judgment or settlement, require us to change our business practices in expensive ways, require significant amounts of management time, result in the diversion of significant operational resources or otherwise harm our business.

Indemnification Provisions

In the ordinary course of business, we have included limited indemnification provisions in certain of our agreements with parties with which we have commercial relations, including our standard marketing, promotions and application-programming-interface license agreements. Under these contracts, we generally indemnify, hold harmless and agree to reimburse the indemnified party for losses suffered or incurred by the indemnified party in connection with claims by a third party with respect to our domain names, trademarks, logos and other branding elements to the extent that such marks are applicable to our performance under the subject agreement. In certain cases, we have agreed to provide indemnification for intellectual property infringement. GSI has provided in many of its major online commerce agreements an indemnity for other types of third-party claims, which are indemnities mainly related to various intellectual property rights, and we have provided similar indemnities in a limited number of agreements for our other businesses. In our PayPal business, we have provided an indemnity to our payment processors in the event of certain third-party claims or card association fines against the processor arising out of conduct by PayPal or PayPal customers. It is not possible to determine the maximum potential loss under these indemnification provisions due to our limited history of prior indemnification claims and the unique facts and circumstances involved in each particular provision. To date, losses recorded in our statement of income in connection with our indemnification provisions have not been significant, either individually or collectively.

Off-Balance Sheet Arrangements

As of September 30, 2012, we had no off-balance sheet arrangements that have, or are reasonably likely to have, a current or future material effect on our consolidated financial condition, results of operations, liquidity, capital expenditures or capital resources.

In Europe, we have two cash pooling arrangements with a financial institution for cash management purposes. These arrangements allow for cash withdrawals from this financial institution based upon our aggregate operating cash balances held in Europe within the same financial institution (“Aggregate Cash Deposits”) for more efficient cash management and investment purposes. These arrangements also allow us to withdraw amounts exceeding the Aggregate Cash Deposits up to an agreed-upon limit. The net balance of the withdrawals and the Aggregate Cash Deposits are used by the financial institution as a basis for calculating our net interest expense or income. As of September 30, 2012, we had a total of $5 billion in cash withdrawals offsetting our $5 billion in Aggregate Cash Deposits held within the same financial institution under these cash pooling arrangements.

Based on differences in regulatory requirements and commercial law in the jurisdictions where PayPal operates, PayPal holds customer balances either as direct claims against PayPal or as an agent or custodian on behalf of PayPal's customers. Customer funds held by PayPal as an agent or custodian on behalf of our customers are not reflected in our consolidated balance sheet. These off-balance sheet funds totaled approximately $3 billion as of September 30, 2012 and December 31, 2011. These funds represent funds held on behalf of U.S. customers that are deposited in bank accounts insured by the Federal Deposit Insurance Corporation (subject to applicable limits).

PayPal's California regulator, the California Department of Financial Institutions, recently notified PayPal that PayPal's current practice of holding the funds underlying U.S. customer balances as an agent on behalf of its customers, rather than as owner of those funds, means that PayPal cannot treat those funds as liquid assets for purposes of the liquidity rules applicable to California money transmitter licensees. Based on changes to our U.S. PayPal user agreement effective November 1, 2012, PayPal will begin holding U.S. customer balances as direct claims against PayPal, rather than as an agent or custodian on behalf of such PayPal customers. As a result, effective as of November 1, 2012, all U.S. PayPal customer balances, which are currently reported as off-balance sheet, will be prospectively reflected as assets in our consolidated balance sheet with an associated liability.

Note 10 — Stock Repurchase Programs

In September 2010, our Board of Directors authorized a stock repurchase program that provides for the repurchase of up to $2 billion of our common stock, with no expiration from the date of authorization. In June 2012, our Board authorized an additional stock repurchase program that provides for the repurchase of up to an additional $2 billion of our common stock, with no expiration from the date of authorization. These stock repurchase programs are intended to offset the impact of dilution from our equity compensation programs. The stock repurchase activity under our stock repurchase programs during the first nine months of 2012 is summarized as follows:

	Shares Repurchased	Average Price per Share	Value of Shares Repurchased	Remaining Amount Authorized
	(In millions, except per share amounts)			
Balance at January 1, 2012	35	$31.55	$1,119	$881
Authorization of additional plan in June 2012				2,000
Repurchase of common stock	17	37.72	641	(641)
Balance at September 30, 2012	52	$33.55	$1,760	$2,240

These repurchased shares were recorded as treasury stock and were accounted for under the cost method. No repurchased shares have been retired.

Note 11 — Stock-Based Plans

Stock Option Activity

The following table summarizes stock option activity for the nine-month period ended September 30, 2012:

	Options
	(In millions)
Outstanding at January 1, 2012	40
Granted and assumed	2
Exercised	(13)
Forfeited/expired/canceled	(2)
Outstanding at September 30, 2012	27

The weighted average exercise price of stock options granted during the period was $36.52 per share and the related weighted average grant date fair value was $11.16 per share.

Restricted Stock Unit Activity

The following table summarizes restricted stock unit ("RSU") activity for the nine-month period ended September 30, 2012:

	Units
	(In millions)
Outstanding at January 1, 2012	40
Awarded and assumed	18
Vested	(13)
Forfeited	(4)
Outstanding at September 30, 2012	41

The weighted average grant date fair value for RSUs awarded during the period was $37.13 per share.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
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Stock-Based Compensation Expense

The impact on our results of operations of recording stock-based compensation expense for the three and nine months ended September 30, 2012 and 2011 was as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(In millions)			
Cost of net revenues	$13	$14	$41	$43
Sales and marketing	35	32	99	100
Product development	34	26	101	91
General and administrative	40	36	119	112
Total stock-based compensation expense	$122	$108	$360	$346
Capitalized in product development	$5	$6	$15	$14

Valuation Assumptions

We calculated the fair value of each stock option award on the date of grant using the Black-Scholes option pricing model. The following weighted average assumptions were used for the three and nine months ended September 30, 2012 and 2011:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Risk-free interest rate	0.48 %	1.00 %	0.71 %	1.22 %
Expected life (in years)	3.8	3.7	4.0	3.8
Dividend yield	— %	— %	— %	— %
Expected volatility	40 %	39 %	38 %	38 %

Our computation of expected volatility is based on a combination of historical and market-based implied volatility from traded options on our common stock. Our computation of expected life is based on historical experience of similar awards, giving consideration to the contractual terms of the stock-based awards, vesting schedules and expectations of future employee behavior. The interest rate for periods within the contractual life of the award is based on the U.S. Treasury yield curve in effect at the time of grant.

Note 12 — Income Taxes

The following table reflects changes in unrecognized tax benefits for the nine-month period ended September 30, 2012:

	(In millions)
Gross amounts of unrecognized tax benefits as of January 1, 2012	$286
Increases related to prior period tax positions	44
Decreases related to prior period tax positions	(8)
Increases related to current period tax positions	12

Settlements	(1)
Gross amounts of unrecognized tax benefits as of September 30, 2012	$333

As of September 30, 2012 and December 31, 2011, our liabilities for unrecognized tax benefits were included in deferred and other tax liabilities, net. The increase in liabilities for unrecognized tax benefits for the first nine months of 2012 relates primarily to the point at which certain foreign earnings became subject to U.S taxation.

We recognize interest and/or penalties related to uncertain tax positions in income tax expense. The amount of interest and penalties accrued as of September 30, 2012 and December 31, 2011 was approximately $113 million and $83 million, respectively.

We are subject to both direct and indirect taxation in the U.S. and various states and foreign jurisdictions. We are under examination by certain tax authorities for the 2003 to 2009 tax years. We believe that adequate amounts have been reserved for any adjustments that may ultimately result from these examinations. The material jurisdictions where we are subject to potential examination by tax authorities for tax years after 2002 include, among others, the U.S. (Federal and California), France, Germany, Italy, Korea, Israel, Switzerland, Singapore and Canada.

Although the timing of the resolution and/or closure of audits is highly uncertain, it is reasonably possible that the balance of gross unrecognized tax benefits could significantly change in the next 12 months. However, given the number of years remaining subject to examination and the number of matters being examined, we are unable to estimate the full range of possible adjustments to the balance of gross unrecognized tax benefits.

During the three and nine months ended September 30, 2012, we provided for U.S. income and foreign withholding taxes on approximately 15% of our non-U.S. subsidiaries' undistributed earnings. The remaining portion of our non-U.S. subsidiaries undistributed earnings is intended to be indefinitely reinvested in our international operations; upon distribution of those earnings in the form of dividends or otherwise, we would be subject to U.S. income taxes (subject to adjustments for foreign tax credits). It is not practicable to determine the income tax liability that might be incurred if the indefinitely reinvested earnings were to be distributed. On a regular basis, we develop cash forecasts to estimate our cash needs internationally and domestically. We consider projected cash needs for, among other things, investments in our existing businesses, potential acquisitions and capital transactions, including repurchases of our common stock and debt repayments. We estimate the amount of cash available or needed in the jurisdictions where these investments are expected, as well as our ability to generate cash in those jurisdictions and our access to capital markets. This analysis enables us to conclude whether or not we will indefinitely reinvest the current period's foreign earnings.

Our effective tax rate differs from the U.S. federal statutory rate due primarily to lower tax rates associated with certain earnings from our operations outside the U.S.

Note 13 - Loans and Interest Receivable, Net

Loans and interest receivable represent purchased consumer receivables arising from loans made by a partner chartered financial institution to individual consumers in the U.S. to purchase goods and services through our Bill Me Later merchant network. During the three months ended September 30, 2012 and 2011, we purchased approximately $775 million and $566 million, respectively, in consumer receivables. During the nine months ended September 30, 2012 and 2011, we purchased approximately $2.1 billion and $1.5 billion, respectively, in consumer receivables. Loans and interest receivable are reported at their outstanding principal balances, net of allowances, including unamortized deferred origination costs and estimated collectible interest and fees. We use a consumer's FICO score, among other measures, in evaluating the credit quality of our consumer receivables. A FICO score is a type of credit score that lenders use to assess an applicant's credit risk and whether to extend credit. Individual FICO scores generally are obtained each quarter the consumer has an outstanding loan receivable owned by Bill Me Later. The weighted average consumer FICO score related to our loans and interest receivable balance outstanding at September 30, 2012 was 691 as compared to 692 at December 31, 2011. As of September 30, 2012 and December 31, 2011, approximately 56.6% and 59.3%, respectively, of our loans and interest receivable balance was due from consumers with FICO scores greater than 680, which is generally considered "prime" by the consumer credit industry. As of September 30, 2012, approximately 89% of our loans and interest receivable portfolio was current.

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The following table summarizes the activity in the allowance for loans and interest receivable:

	Nine Months Ended September 30,	
	2012	2011
	(In millions)	
Balance as of January 1	$59	$42
Charge-offs	(94)	(55)
Recoveries	7	5
Provision	115	59
Balance as of September 30	$87	$51

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Item 2: Management's Discussion and Analysis of Financial Condition and Results of Operations

FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, including statements that involve expectations, plans or intentions (such as those relating to future business, future results of operations or financial condition, new or planned features or services, or management strategies). You can identify these forward-looking statements by words such as “may,” “will,” “would,” “should,” “could,” “expect,” “anticipate,” “believe,” “estimate,” “intend,” other similar expressions. These forward-looking statements involve risks and uncertainties that could cause our actual results to differ materially from those expressed or implied in our forward-looking statements. Such risks and uncertainties include, among others, those discussed in“Part II — Item 1A: Risk Factors” of this Quarterly Report on Form 10-Q as well as in our condensed consolidated financial statements, related notes, and the other information appearing elsewhere in this report and our other filings with the Securities and Exchange Commission, or the SEC. We do not intend, and undertake no obligation, to update any of our forward-looking statements after the date of this report to reflect actual results or future events or circumstances. Given these risks and uncertainties, readers are cautioned not to place undue reliance on such forward-looking statements.

You should read the following Management's Discussion and Analysis of Financial Condition and Results of Operations in conjunction with the unaudited condensed consolidated financial statements and the related notes that appear elsewhere in this report.
When we refer to “we,” “our,” “us” or “eBay” in this document, we mean eBay Inc., a Delaware corporation and its California predecessor, as well as all of our consolidated subsidiaries.

Overview

eBay is a global commerce platform and payments leader. We enable commerce through eBay, the world's largest online marketplace, which allows users to buy and sell in nearly every country on earth; through PayPal, which enables individuals and businesses to securely, easily and quickly send and receive online payments; and through GSI, which facilitates ecommerce, multichannel retailing and interactive marketing for global enterprises. X.commerce harnesses the developer community of Magento, an ecommerce platform, by providing technology solutions and eBay Inc. capabilities to merchants of all sizes, supporting eBay Inc.'s mission of enabling commerce. We also reach millions of people through specialized marketplaces such as StubHub, the world's largest ticket marketplace, and eBay classifieds sites, which together have a presence in more than 1,000 cities around the world.

We have three reportable business segments: Marketplaces, Payments and GSI. Our Marketplaces segment includes our eBay.com platform and its localized counterparts and our other online trading platforms, such as our online classifieds sites and StubHub. Our Payments segment is comprised of PayPal, Bill Me Later and Zong. Our GSI segment consists of GSI Commerce, Inc. ("GSI"), and was added upon the completion of our acquisition of GSI on June 17, 2011. The results of our GSI segment have been included in our consolidated results of operations from the acquisition date.

Net revenues for the three months ended September 30, 2012 increased 15% to $3.4 billion, compared to the same period of the prior year, driven primarily by increases in net revenues from each of our business segments. For the three months ended September 30, 2012, our operating margin increased to 20% from 18% in the same period of the prior year due primarily to an increase in operating margins in each of our business segments. For the three months ended September 30, 2012, our diluted earnings per share increased to $0.45, a $0.08 increase compared to the same period of the prior year, driven primarily by strong growth in net revenues, improvement in operating margin and a lower effective tax rate, partially offset by lower investment gains and higher interest expense. For the three months ended September 30, 2012, we generated cash flow from operations of approximately $1.2 billion, compared to $809 million for the same period of the prior year.

Our Marketplaces segment total net revenues increased $153 million, or 9%, for the three months ended September 30, 2012 compared to the same period of the prior year. The increase in total net revenues was driven primarily by a year-over-year increase in GMV (as defined below) excluding vehicles of 11%, which was attributable to strong growth across all regions, partially offset by the negative impact of foreign currency movements relative to the U.S. dollar. Marketplaces

segment operating margin increased 0.5 percentage points for the three months ended September 30, 2012 compared to the same period of the prior year due primarily to operating leverage, partially offset by investments in technology and marketing.
Our Payments segment total net revenues increased $260 million, or 23%, for the three months ended September 30, 2012 compared to the same period of the prior year. The increase in total net revenues was driven primarily by a year-over-year increase in net TPV (as defined below) of 20% and strong growth in Bill Me Later. Our Payments segment operating margin increased 3.1 percentage points for the three months ended September 30, 2012 compared to the same period of the prior year, due primarily to a higher take rate and lower transaction processing costs.
Our GSI segment total net revenues increased $24 million, or 12%, for the three months ended September 30, 2012 compared to the same period of the prior year. The increase in total net revenues was driven primarily by a year-over-year increase in GeC Merchandise Sales (as defined below) of 16%. For the three months ended September 30, 2012, GSI had a segment operating margin of 6.1%, a 3.3 percentage point increase compared to the same period of the prior year.
Some key operating metrics that members of our senior management regularly review to evaluate our financial results include net promoter score (NPS), market share, GMV, GMV excluding vehicles, number of sold items, net TPV, Merchant Services net TPV (as defined below), on eBay net TPV (as defined below), net number of payments, global ecommerce (GeC) Merchandise Sales, penetration rates, active registered accounts, same store sales, funding mix (the mix of payments vehicles, such as credit cards, debit cards, bank accounts and PayPal accounts, used by customers to make payments through our Payments networks), free cash flow (a non-GAAP measure, which we define as net cash provided by operating activities less purchases of property and equipment, net) and revenue excluding acquisitions and foreign currency impact (also a non-GAAP measure).

We define GMV as the total value of all successfully closed items between users on our eBay Marketplaces trading platforms (excluding eBay's classified websites and Shopping.com) during the applicable period, regardless of whether the buyer and seller actually consummated the transaction. We define net TPV as the total dollar volume of payments, net of payment reversals, successfully completed through our Payments networks, Bill Me Later accounts and Zong during the applicable period, excluding PayPal's payment gateway business. We define Merchant Services net TPV as the total dollar volume of payments, net of payment reversals, successfully completed through our Payments networks, Bill Me Later accounts and Zong during the applicable period, excluding PayPal's payment gateway business and payments for transactions on eBay Marketplaces and GSI platforms. We define on eBay net TPV as the total dollar volume of payments, net of payment reversals, successfully completed through our Payments networks during the applicable period for transactions on eBay Marketplaces or GSI platforms. We define GeC Merchandise Sales as the retail value of all sales transactions, inclusive of freight charges and net of allowance for returns and discounts, which flow through the GSI ecommerce services platform during the applicable period, whether we record the full amount of such transaction as a product sale or a percentage of such transaction as a service fee.

Results of Operations

Summary of Net Revenues

We generate two types of net revenues: net transaction revenues and marketing services and other revenues. Our net transaction revenues are derived principally from listing fees, final value fees (which are fees payable on transactions completed on our Marketplaces trading platforms), fees paid by merchants for payment processing services and ecommerce service fees. Our marketing services revenues are derived principally from the sale of advertisements, revenue sharing arrangements, classifieds fees, marketing service fees and lead referral fees. Other revenues are derived principally from interest and fees earned on the Bill Me Later portfolio of receivables from loans, interest earned on certain PayPal customer account balances and fees from contractual arrangements with third parties that provide services to our users.

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The following table sets forth the breakdown of net revenues by type and geography for the periods presented. (1)

	Three Months Ended September 30,		Percent		Nine Months Ended September 30,		Percent	
	2012	2011	Change		2012	2011(2)	Change	
	(In millions, except percentage changes)							
Net Revenues by Type:								
Net transaction revenues								
Marketplaces	$1,490	$1,354	10	%	$4,406	$3,988	10	%
Payments	1,264	1,032	22	%	3,715	2,966	25	%
GSI	170	148	14	%	516	165	N/A	
Total net transaction revenues	2,925	2,535	15	%	8,637	7,119	21	%
Marketing services and other revenues								
Marketplaces	316	299	5	%	942	882	7	%
Payments	102	74	37	%	318	206	54	%
GSI	57	54	4	%	168	62	N/A	
Corporate and other	11	3	267	%	27	3	800	%
Total marketing services and other revenues	485	431	13	%	1,455	1,152	26	%
Elimination of inter-segment net revenue (3)	(6)	—	N/A		(13)	—	N/A	
Total net revenues	$3,404	$2,966	15	%	$10,079	$8,272	22	%
Net Revenues by Geography:								
U.S.	$1,637	$1,428	15	%	$4,829	$3,818	26	%
International	1,767	1,538	15	%	5,250	4,454	18	%
Total net revenues	$3,404	$2,966	15	%	$10,079	$8,272	22	%

(1) Certain amounts may not sum due to rounding and may not recalculate using the rounded dollar amounts provided.

(2) Includes data for GSI since June 17, 2011 the date the acquisition of GSI was completed. Accordingly, the percent changes in GSI's revenues between the nine-month periods ended September 30, 2011 and 2012 are not meaningful.

(3) Represents revenue generated between our reportable segments.

Revenues are attributed to U.S. and international geographies based primarily upon the country in which the seller, payment recipient, customer, website that displays advertising, or other service provider, as the case may be, is located.

Because we generate substantial net revenues internationally, we are subject to the risks of doing business in foreign countries as discussed under "Part II - Item 1A - Risk Factors." In that regard, fluctuations in foreign currency exchange rates impact our results of operations. We have a foreign exchange risk management program that is designed to reduce our exposure to fluctuations in foreign currencies; however, the effectiveness of this program in mitigating the impact of foreign currency fluctuations on our results of operations varies from period to period, and in any given period, our operating results are usually affected, sometimes significantly, by changes in currency exchange rates. Fluctuations in exchange rates also directly affect our cross-border revenue. We calculate the year-over-year impact of foreign currency movements on our business using prior period foreign currency rates applied to current year transactional currency amounts.

For the three months ended September 30, 2012, foreign currency movements relative to the U.S. dollar negatively impacted net revenues by approximately $80 million (net of a $16 million positive impact from hedging activities included in PayPal's net revenue) compared to the same period of the prior year. On a business segment basis, for the three months ended September 30, 2012, foreign currency movements relative to the U.S. dollar negatively impacted Marketplaces, Payments and GSI net revenues by approximately $66 million, $14 million and less than $1 million, respectively, in each case compared to the same period of the prior year (net of the impact of hedging activities noted above).

For the nine months ended September 30, 2012, foreign currency movements relative to the U.S. dollar negatively impacted net revenues by approximately $202 million (net of a $42 million positive impact from hedging activities included in PayPal's net revenue) compared to the same period of the prior year. On a business segment basis, for the nine months ended September 30, 2012, foreign currency movements relative to the U.S. dollar negatively impacted Marketplaces, Payments and GSI net revenues by approximately $170 million, $31 million and $1 million, respectively, in each case compared to the same period of the prior year (net of the impact of hedging activities noted above).

The following table sets forth, for the periods presented, certain key operating metrics that we believe are significant factors affecting our net revenues. (1)

	Three Months Ended September 30,		Percent	Nine Months Ended September 30,		Percent
	2012	2011	Change	2012	2011	Change
	(In millions, except percentage changes)					
Supplemental Operating Data:						
Marketplaces Segment: (2)						
GMV excluding vehicles (3)	$16,281	$14,666	11%	$48,658	$43,842	11%
GMV vehicles only (4)	$1,994	$2,149	(7)%	$5,885	$6,437	(9)%
Total GMV (5)	$18,274	$16,815	9%	$54,543	$50,279	8%
Payments Segment:						
Merchant services net TPV (6)	$23,704	$19,314	23%	$69,251	$55,741	24%
On eBay net TPV (7)	$11,455	$9,968	15%	$34,216	$29,645	15%
Total net TPV (8)	$35,159	$29,282	20%	$103,467	$85,386	21%
GSI Segment:						
GeC Merchandise Sales (9)	$698	$601	16%	$2,087	$677	208%

(1) Certain amounts may not sum due to rounding and may not recalculate using the rounded dollar amounts provided.

(2) eBay's classifieds websites and Shopping.com are not included in these metrics.

(3) Total value of all successfully closed items between users on eBay Marketplaces trading platforms during the period, regardless of whether the buyer and seller actually consummated the transaction, excluding vehicles GMV.

(4) Total value of all successfully closed vehicle transactions between users on eBay Marketplaces trading platforms during the period, regardless of whether the buyer and seller actually consummated the transaction.

(5) Total value of all successfully closed items between users on eBay Marketplaces trading platforms during the period, regardless of whether the buyer and seller actually consummated the transaction.

(6) Total dollar volume of payments, net of payment reversals, successfully completed through our Payments networks, Bill Me Later accounts and Zong during the period, excluding PayPal's payment gateway business and payments for transactions on eBay Marketplaces and GSI platforms.

(7) Total dollar volume of payments, net of payment reversals, successfully completed through our Payments networks during the period for transactions on eBay Marketplaces and GSI platforms.

(8) Total dollar volume of payments, net of payment reversals, successfully completed through our Payments networks, Bill Me Later accounts and Zong during the period, excluding PayPal's payment gateway business.

(9) Represents the retail value of all sales transactions, inclusive of freight charges and net of allowance for returns and discounts, which flow through the GSI ecommerce services platform during the period, whether we record the full amount of such transaction as a product sale or a percentage of such transaction as a service fee.

Seasonality

The following table sets forth, for the periods presented, our total net revenues and the sequential quarterly movements of these net revenues:

	Quarter Ended March 31	June 30	September 30	December 31
	(In millions, except percentage changes)			
2010				
Net revenues	$2,196	$2,215	$2,249	$2,495
Percent change from prior quarter	(7)%	1%	2%	11%
2011[(1)]				
Net revenues	$2,546	$2,760	$2,966	$3,380
Percent change from prior quarter	2%	8%	7%	14%
2012				
Net revenues	$3,277	$3,398	$3,404	—
Percent change from prior quarter	(3)%	4%	—%	—

(1) Net revenues attributable to the GSI segment are reflected from June 17, 2011 (the date the acquisition of GSI was completed).

We expect transaction activity patterns on our websites to mirror general consumer buying patterns. Our GSI segment is highly seasonal. The fourth calendar quarter typically accounts for a disproportionate amount of GSI's total annual revenue because consumers increase their purchases and businesses increase their advertising to consumers during the fourth quarter holiday season.

Marketplaces Net Transaction Revenues

Marketplaces net transaction revenues increased $136 million, or 10%, while GMV excluding vehicles increased 11% during the third quarter of 2012 compared to the same period in the prior year. The increase in net transaction revenue and GMV excluding vehicles was due primarily to strong growth across all regions, partially offset by the negative impact of approximately $47 million in foreign currency movements relative to the U.S. dollar.

Marketplaces net transaction revenues increased $418 million, or 10%, while GMV excluding vehicles increased 11% during the first nine months of 2012 compared to the same period in the prior year. The increase in net transaction revenue and GMV excluding vehicles was due primarily to strong growth across all regions, partially offset by the negative impact of approximately $119 million in foreign currency movements relative to the U.S. dollar.

Marketplaces net transaction revenues earned internationally (i.e., outside the U.S.) totaled $814 million and $2.5 billion during the third quarter and first nine months of 2012, respectively, representing 55% and 56% of total Marketplaces net transaction revenues during those respective periods. Marketplaces net transaction revenues earned internationally totaled $760 million and $2.2 billion during the third quarter and first nine months of 2011, respectively, representing 56% of total Marketplaces net transaction revenues in each period.

Payments Net Transaction Revenues

Payments net transaction revenues increased $232 million, or 22%, during the third quarter of 2012 compared to the same period of the prior year, due primarily to net TPV growth of 20% and a higher take rate. The increase in net TPV was due primarily to growth in consumer and merchant adoption and use of PayPal both on and off eBay. Our Merchant Services net TPV increased 23% during the third quarter of 2012, compared to the same period of the prior year, and represented 67% of PayPal's net TPV in the third quarter of 2012, compared with 66% in the same period of the prior year. On eBay net TPV increased 15% during the third quarter of 2012, compared to the same period of the prior year and represented 33% of PayPal's net TPV in the third quarter of 2012, compared to 34% for the same period in the prior year. The increase in the take rate was driven primarily by foreign exchange income and gains from hedging activities.

Payments net transaction revenues increased $749 million, or 25%, during the first nine months of 2012 compared to the same period of the prior year, due primarily to net TPV growth of 21% and a higher take rate. The increases in net TPV and take rate were due to the same factors described above. Our Merchant Services net TPV increased 24% during the first nine months of 2012, compared to the same period of the prior year and represented 67% of PayPal's net TPV in the first nine months of 2012, compared with 65% for the same period of the prior year. On eBay net TPV increased 15% during the first nine months of 2012, compared to the same period of the prior year and represented 33% of PayPal's net TPV for the first nine months of 2012, compared to 35% for the same period of the prior year.

Payments net transaction revenues earned internationally totaled $697 million and $2.0 billion during the third quarter and first nine months of 2012, respectively, representing 55% of total Payments net transaction revenues in each period. Payments net transaction revenues earned internationally totaled $545 million and $1.5 billion during the third quarter and first nine months of 2011, respectively, representing 53% and 52% of total Payments net transaction revenues during those respective periods. The increase in international net transaction revenues was due primarily to the growth of our Merchant Services business and increased penetration on eBay Marketplaces platforms internationally.

GSI Net Transaction Revenues

GSI net transaction revenues increased $22 million, or 14%, during the third quarter of 2012 compared to the same period of the prior year, due primarily to the 16% increase in GeC Merchandise Sales in the third quarter of 2012 compared to the same period in the prior year.

GSI net transaction revenues were $516 million during the first nine months of 2012, compared to $165 million for the same period of the prior year. Net transaction revenues attributable to the GSI segment for the first nine months of 2011 are reflected from June 17, 2011 (the date the acquisition of GSI was completed). Accordingly, comparisons with GSI's net transaction revenues in the corresponding 2011 period are not meaningful.

Marketing Services and Other Revenues

Marketing services and other revenues increased $54 million, or 13%, during the third quarter of 2012, compared to the same period of the prior year, and represented 14% of total net revenues for the third quarter of 2012. The increase in marketing services and other revenues was due primarily to growth in our Bill Me Later portfolio of receivables from loans, as well as increased revenue from our advertising business.

Marketing services and other revenues increased $303 million, or 26%, during the first nine months of 2012, compared to the same period of the prior year, and represented 14% of total net revenues for the first nine months of 2012. The increase in marketing services and other revenues was due primarily to revenues attributable to GSI and growth in our Bill Me Later portfolio of receivables from loans, as well as increased revenue from our classifieds and advertising businesses.

Summary of Cost of Net Revenues

The following table summarizes changes in cost of net revenues for the periods presented:

	Three Months Ended September 30,		Change from 2011 to 2012		Nine Months Ended September 30,		Change from 2011 to 2012	
	2012	2011	in Dollars	in %	2012	2011(1)	in Dollars	in %
	(In millions, except percentages)							
Cost of net revenues:								
Marketplaces	$314	$298	$16	5 %	$923	$897	$26	3 %
As a percentage of total Marketplaces net revenues	17.4 %	18.0 %			17.3 %	18.4 %		
Payments	549	479	70	15 %	1,589	1,370	219	16 %
As a percentage of total Payments net revenues	40.2 %	43.3 %			39.4 %	43.2 %		
GSI	154	141	13	9 %	446	157	289	N/A
As a percentage of total GSI net revenues	68.1 %	69.7 %			65.2 %	69.4 %		
Corporate and other	5	2	3	150 %	34	2	32	N/A
Total cost of net revenues	$1,022	$920	$102	11 %	$2,992	$2,426	$566	23 %
As a percentage of net revenues	30.0 %	31.0 %			29.7 %	29.3 %		

(1) Cost of net revenues attributable to the GSI segment for the nine months ended September 30, 2011 are reflected from June 17, 2011 (the date the acquisition of GSI was completed). Accordingly, the percent changes in GSI's cost of revenues between the nine-month periods ended September 30, 2011 and 2012 are not meaningful.

Cost of Net Revenues

Cost of net revenues consists primarily of costs associated with payment processing, customer support, site operations, fulfillment and inventory. Significant components of these costs include bank transaction fees, credit card interchange and assessment fees, interest expense on indebtedness incurred to finance the purchase of consumer loans receivable by Bill Me Later, employee compensation, contractor costs, facilities costs, depreciation of equipment and amortization expense.

Marketplaces

Marketplaces cost of net revenues increased $16 million and $26 million, or 5% and 3%, during the third quarter and first nine months of 2012, respectively, compared to the same periods of the prior year. The increases were due primarily to increases in our customer support costs and site operations associated with our volume growth.

Marketplaces cost of net revenues as a percentage of Marketplaces net revenues decreased 0.6 and 1.1 percentage points during the third quarter and first nine months of 2012, respectively, compared to the same periods of the prior year, due primarily to improved operating leverage from our site operation infrastructure, partially offset by investment in customer support programs.

Payments

Payments cost of net revenues increased $70 million and $219 million, or 15% and 16%, during the third quarter and first nine months of 2012, respectively, compared to the same periods of the prior year. The increase in Payments cost of net revenues was due primarily to the impact of growth in net TPV.

Payments cost of net revenues as a percentage of Payments net revenues decreased 3.1 and 3.8 percentage points during the third quarter and first nine months of 2012, respectively, compared to the same periods of the prior year, due primarily to a lower transaction expense rate driven by the impact of certain regulatory changes, primarily the Durbin amendment of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

GSI

GSI cost of net revenues increased $13 million, or 9%, during the third quarter of 2012, compared to the same period of the prior year. The increase in GSI cost of net revenues was due primarily to growth in GSI revenues.

GSI cost of net revenues was $446 million during the first nine months of 2012. Cost of net revenues attributable to the GSI segment for the first nine months of 2011 are reflected from June 17, 2011 (the date the acquisition of GSI was completed). Accordingly, comparisons with GSI's cost of revenues in the corresponding 2011 period are not meaningful.

Summary of Operating Expenses, Non-Operating Items and Provision for Income Taxes

The following table summarizes changes in operating expenses, non-operating items and provision for income taxes for the periods presented:

	Three Months Ended September 30,		Change from 2011 to 2012		Nine Months Ended September 30,		Change from 2011 to 2012	
	2012	2011	in Dollars	in %	2012	2011	in Dollars	in %
	(In millions, except percentage changes)							
Sales and marketing	$726	$623	$103	17%	$2,120	$1,763	$357	20%
Product development	389	319	70	22%	1,157	891	266	30%
General and administrative	369	336	33	10%	1,131	1,018	113	11%
Provision for transaction and loan losses	148	146	2	1%	413	372	41	11%
Amortization of acquired intangible assets	83	85	(2)	(2)%	251	182	69	38%
Interest and other, net	5	79	(74)	(94)%	74	111	(37)	(33)%
Gain (loss) on divested business	—	—	—	N/A	118	(256)	374	(146)%
Provision for income taxes	(75)	(125)	50	(40)%	(348)	(225)	(123)	55%

Sales and Marketing

Sales and marketing expenses consist primarily of advertising costs and marketing programs (both online and offline), employee compensation, contractor costs, facilities costs and depreciation on equipment. Online marketing expenses represent traffic acquisition costs in various channels such as paid search, affiliates marketing and display advertising. Offline advertising includes brand campaigns, buyer/seller communications and general public relations expenses. A significant portion of our sales and marketing expense is attributable to our online marketing programs, primarily paid search, which include keyword advertising and third party lead generation costs, in order to drive traffic to our Marketplaces and Payments websites.

Sales and marketing expenses increased $103 million, or 17%, during the third quarter of 2012, compared to the same period of the prior year. The increase in sales and marketing expense was due primarily to higher employee-related expenses (including consultant costs, facility costs and equipment-related costs) and marketing program costs to drive consumer engagement.

Sales and marketing expenses increased $357 million, or 20%, during the first nine months of 2012, compared to the same period of the prior year. The increase in sales and marketing expense was due primarily to the factors noted above and the impact from acquisitions, primarily GSI.

Product Development

Product development expenses consist primarily of employee compensation, contractor costs, facilities costs and depreciation on equipment. Product development expenses are net of required capitalization of major site and other product development efforts, including the development of our next generation platform architecture, migration of certain platforms, seller tools and Payments services projects. Our top technology priorities include mobile, user experience, search, platform and new products such as PayPal Here. Capitalized site and product development costs were $60 million and $177 million in the third quarter and first nine months of 2012, respectively, compared to $48 million and $129 million in the third quarter and first nine months of 2011, respectively, and are primarily reflected as a cost of net revenues when amortized in future periods.

Product development expenses increased $70 million, or 22%, during the third quarter of 2012, compared to the same period of the prior year. The increase was due primarily to higher employee-related costs (including consultant costs, facility costs and equipment-related costs) driven by increased investment in platform, mobile and offline.

Product development expenses increased $266 million, or 30%, during the first nine months of 2012, compared to the same period of the prior year. The increase was due primarily to the factors described above and the impact from acquisitions, primarily GSI.

General and Administrative

General and administrative expenses consist primarily of employee compensation, contractor costs, facilities costs, depreciation of equipment, employer payroll taxes on stock-based compensation, legal expenses, insurance premiums and professional fees. Our legal expenses, including those related to various ongoing legal proceedings, may fluctuate substantially from period to period.

General and administrative expenses increased $33 million or 10% , during the third quarter of 2012, compared to the same period of the prior year. The increase was due primarily to an increase in payroll and related expenses.

General and administrative expenses increased $113 million, or 11%, during the first nine months of 2012, compared to the same period of the prior year. The increase was due primarily to the factors described above and the impact of acquisitions, primarily GSI, partially offset by GSI acquisition related costs incurred in 2011.

Provision for Transaction and Loan Losses

Provision for transaction and loan losses consists primarily of transaction loss expense associated with our consumer protection programs, fraud, chargebacks, and merchant credit losses; bad debt expense associated with our accounts receivable balance; and loan loss reserves associated with our principal loan receivable balance. We expect our provision for transaction and loan loss expense to fluctuate depending on many factors, including macroeconomic conditions, our consumer protection programs and the impact of regulatory changes.
Provision for transaction and loan losses increased $2 million and $41 million, or 1% and 11%, during the third quarter and first nine months of 2012, respectively, compared to the same periods of the prior year. This increase was due primarily to higher transaction volume and growth in our Bill Me Later portfolio of receivables from loans. The increase was partially offset by a reduction in our Marketplaces consumer protection program expense as a result of certain loss prevention programs and lower Marketplaces bad debt expense.

Amortization of Acquired Intangible Assets
From time to time we have purchased, and we expect to continue to purchase, assets and businesses. These purchase transactions generally result in the creation of acquired intangible assets with finite lives and lead to a corresponding increase in our amortization expense in periods subsequent to acquisition. We amortize intangible assets over the period of estimated benefit, using the straight-line method and estimated useful lives ranging from one to eight years. Amortization of acquired intangible assets is also impacted by our sales of assets and businesses and timing of acquired intangible assets becoming fully amortized.

Amortization of acquired intangible assets decreased by $2 million, or 2%, during the third quarter of 2012, compared to the same period of the prior year. Amortization of acquired intangible assets increased by $69 million, or 38%, during the first nine months of 2012, compared to the same period of the prior year due primarily to the impact of acquisitions, primarily GSI.

Interest and Other, Net

Interest and other, net, consists of interest earned on cash, cash equivalents and investments, as well as foreign exchange transaction gains and losses, our portion of operating results from investments accounted for under the equity method of accounting, investment gain/loss on acquisitions and interest expense consisting of interest charges on our outstanding commercial paper and debt securities and on the amounts, if any, drawn under our credit agreement. Interest and other income, net excludes interest expense on borrowings incurred to finance Bill Me Later's portfolio of loan receivables, which is included in cost of net revenues.

Interest and other, net decreased $74 million during the third quarter of 2012, compared to the same period of the prior year. The decrease in interest and other, net was due primarily to investment gains of approximately $56 million associated with the acquisition of Magento during the third quarter of 2011 and an increase in interest expense of approximately $14 million as a result of our issuance of $3 billion of senior notes in July 2012.

Interest and other, net decreased $37 million during the first nine months of 2012, compared to the same period of the prior year. The decrease in interest and other, net was due primarily to the factors described above as well as investment gains of approximately $17 million associated with the acquisition of GittiGidiyor during the second quarter of 2011, partially offset by a favorable impact from foreign currency activity, higher interest income from investments, and favorable resolution of an indirect tax dispute.

Gain (Loss) on Divested Business

We incurred a gain on the divestiture of Rent.com of $118 million during the first nine months of 2012. We realized a loss on the divestiture of certain GSI businesses of $256 million during the first nine months of 2011. We sold these businesses as they were not core to our long-term strategy.

Provision for Income Taxes

Our effective tax rate was 11.2% for the third quarter of 2012, compared to 20.3% for the same period in the prior year. The decrease in our effective tax rate during the third quarter of 2012 compared to the same period of the prior year was due primarily to increased earnings in low-tax jurisdictions and the net favorable impact of discrete items primarily related to stock-based compensation.

Our effective tax rate was 15.8% for the first nine months of 2012, compared to 15.3% for the same period in the prior year. The increase in our effective tax rate during the first nine months of 2012 compared to the same period of the prior year was due primarily to the 2011 tax benefit associated with the loss on the divestiture of certain GSI businesses in 2011.

From time to time, we engage in certain intercompany transactions and legal entity restructurings. We consider many factors when evaluating these transactions, including the alignment of our corporate structure with our organizational objectives and the operational and tax efficiency of our corporate structure, as well as the long-term cash flows and cash needs of our different businesses. These transactions may impact our overall tax rate and/or result in additional cash tax payments. The impact in any period may be significant. These transactions may be complex and the impact of such transactions on future periods may be difficult to estimate.

We are regularly under examination by tax authorities both domestically and internationally. We believe that adequate amounts have been reserved for any adjustments that may ultimately result from these examinations, although we can provide no assurances that this will be the case given the inherent uncertainties in these examinations. Due to the ongoing tax examinations, we believe it is impractical to determine the amount and timing of these adjustments.

Liquidity and Capital Resources

Cash Flows

	Nine Months Ended September 30,	
	2012	2011
	(In millions)	

Net cash provided by (used in):		
Operating activities	$2,453	$2,291
Investing activities	(1,904)	(4,769)
Financing activities	2,082	(190)
Effect of exchange rates on cash and cash equivalents	9	90
Net increase/(decrease) in cash and cash equivalents	$2,640	$(2,578)

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Operating Activities

We generated cash from operating activities of $2.5 billion and $2.3 billion in the nine months ended September 30, 2012 and September 30, 2011, respectively. Non-cash charges to earnings were $1.7 billion and $1.4 billion in the nine months ended September 30, 2012 and 2011, respectively. Non-cash charges to earnings include depreciation and amortization on our long-term assets, stock-based compensation and the provision for transaction and loan losses. The increase in cash provided by operating activities during the nine months ended September 30, 2012 compared to the same period of the prior year was due primarily to an increase in net income of $609 million, partially offset by an increase in cash paid for income taxes of $475 million, which resulted from the gain on the sale of our remaining equity interest in Skype in October 2011.

Investing Activities

The net cash used in investing activities of $1.9 billion in the nine months ended September 30, 2012 was due primarily to cash paid for the purchases of investments of $1.5 billion, purchases of property and equipment of $961 million and the purchase of a significant portfolio of patents, partially offset by proceeds of $938 million from the maturities and sale of investments and $144 million from the disposition of a business.

The net cash used in investing activities of $4.8 billion in the nine months ended September 30, 2011 was due primarily to cash paid for the acquisition of businesses of $3.2 billion, purchases of investments of $1.9 billion and purchases of property and equipment of $672 million, partially offset by proceeds of $1.3 billion from the maturities and sale of investments.

Financing Activities

The net cash provided by financing activities of $2.1 billion in the nine months ended September 30, 2012 was due primarily to cash inflows of approximately $3.0 billion from the issuance of senior notes, $359 million from the issuance of common stock in connection with the exercise of stock options and $95 million of excess tax benefits from stock-based compensation. These cash inflows were partially offset by outflows of $642 million to repurchase common stock and $550 million for the repayment of commercial paper, as well as cash paid for tax withholdings in the amount of $152 million related to net share settlements of restricted stock units and awards. We used a portion of the net proceeds from the issuance of our senior notes to repay the commercial paper referred to above.
The net cash used in financing activities of $190 million in the nine months ended September 30, 2011 was due primarily to cash outflows of $814 million to repurchase common stock and $199 million to repay acquired debt, as well as cash paid for tax withholdings in the amount of $130 million related to net share settlements of restricted stock awards and units. These cash outflows were partially offset by proceeds of $700 million from additional borrowings under our commercial paper program, $188 million from the issuance of common stock in connection with the exercise of stock options and $65 million of excess tax benefits from stock-based compensation
The positive effect of exchange rate movements on cash and cash equivalents during the nine months ended September 30, 2012 and September 30, 2011 was due to the weakening of the U.S. dollar against other currencies, primarily the British pound and Korean won.

Stock Repurchases

In September 2010, our Board of Directors authorized a stock repurchase program that provides for the repurchase of up to $2 billion of our common stock, with no expiration from the date of authorization. In June 2012, our Board authorized an additional stock repurchase program that provides for the repurchase of up to an additional $2 billion of our common stock, with no expiration from the date of authorization. These stock repurchase programs are intended to offset the impact of dilution from our equity compensation programs. During the nine months ended September 30, 2012, we repurchased approximately $641 million of our common stock under our stock repurchase programs. As of September 30, 2012, approximately $2.2 billion remained for further repurchases of our common stock under our stock repurchase programs.

Shelf Registration Statement and Long-Term Debt

At September 30, 2012, we had an effective shelf registration statement on file with the Securities and Exchange Commission that allows us to issue various types of debt securities, such as fixed or floating rate notes, U.S. dollar or foreign currency denominated notes, redeemable notes, global notes, and dual currency or other indexed notes. Issuances under the shelf registration will require the filing of a prospectus supplement identifying the amount and terms of the securities to be issued. The registration statement does not limit the amount of debt securities that may be issued thereunder. Our ability to issue debt securities is subject to market conditions and other factors impacting our borrowing capacity, including our credit ratings and compliance with the covenants in our credit agreement.

We issued $3 billion of senior notes in an underwritten public offering in July 2012. These senior notes remain outstanding and consist of $250 million aggregate principal amount of 0.70% notes due 2015, $1 billion aggregate principal amount of 1.35% notes due 2017, $1 billion aggregate principle amount of 2.60% notes due 2022 and $750 million aggregate principal amount of 4.00% notes due 2042. We issued $1.5 billion of senior notes under a prior shelf registration statement in an underwritten public offering in 2010. These senior notes remain outstanding and consist of $400 million aggregate principal amount of 0.875% notes due 2013, $600 million aggregate principal amount of 1.625% notes due 2015 and $500 million aggregate principal amount of 3.250% notes due 2020.

The indenture pursuant to which the senior notes were issued includes customary covenants that, among other things, and subject to exceptions, limit our ability to incur, assume or guarantee debt secured by liens on specified assets or enter into sale and lease-back transactions with respect to specified properties, and also includes customary events of default.

Commercial Paper

We have a $2 billion commercial paper program pursuant to which we may issue commercial paper notes with maturities of up to 397 days from the date of issue in an aggregate principal amount of up to $2 billion at any time outstanding. As of September 30, 2012, there were no commercial paper notes outstanding. We may elect, subject to market conditions, to issue additional commercial paper notes from time to time in the future.

Credit Agreement

As of September 30, 2012, no borrowings or letters of credit were outstanding under our $3 billion credit agreement. As described above, we have a $2 billion commercial paper program and maintain $2 billion of available borrowing capacity under our credit agreement in order to repay commercial paper borrowings in the event we are unable to repay those borrowings from other sources when they become due. As a result, at September 30, 2012, $1 billion of borrowing capacity was available for other purposes permitted by the credit agreement. The credit agreement includes customary covenants that, among other things and subject to exceptions, limit our ability to create, assume or permit to exist liens on our property, assets and revenue (other than certain permitted liens) and require that we maintain a minimum consolidated interest coverage ratio, and also includes customary events of default.

Notes Payable and Capital Lease Obligations

In addition to the debt described above, as of September 30, 2012, we had notes payable of $15 million and capital lease obligations of $16 million.

As of September 30, 2012, we were in compliance with all covenants in our outstanding debt instruments.

Commitments

As of September 30, 2012, approximately $12 billion of unused credit was available to Bill Me Later accountholders. The individual lines of credit that make up this unused credit are subject to periodic review and termination by the chartered financial institution that is the issuer of Bill Me Later credit products based on, among other things, account usage and customer creditworthiness. Currently, when a consumer makes a purchase using a Bill Me Later credit product, the chartered financial institution extends credit to the consumer, funds the extension of credit at the point of sale and advances funds to the merchant. We subsequently purchase the receivables related to the consumer loans extended by the chartered financial institution and, as a result of the purchase, bear the risk of loss in the event of loan defaults. Although the chartered financial institution continues to own each customer account, we own the related receivable, and Bill Me Later is responsible for all servicing functions related to the account.

Liquidity and Capital Resource Requirements

As of September 30, 2012 and December 31, 2011, we had assets classified as cash and cash equivalents, as well as time deposits and fixed income securities classified as short-term and long-term investments, in an aggregate amount of $11 billion. As of September 30, 2012, this amount included assets of these types held outside the U.S. in certain of our foreign operations totaling approximately $7 billion. If these assets were distributed to the U.S., we may be subject to additional U.S. taxes in certain circumstances. We actively monitor the third-party depository institutions and money market funds that hold these assets, primarily focusing on the safety of principal and secondarily on yield on these assets. We diversify our cash and cash equivalents and investments among various financial institutions and money market funds in order to reduce our exposure should any one of these financial institutions or money market funds fail or encounter difficulties. To date, we have not experienced any material loss or lack of access to our invested cash, cash equivalents or short-term investments; however, we can provide no assurances that access to our invested cash, cash equivalents or short-term investments will not be impacted by adverse conditions affecting those depository institutions or money market funds or the financial markets generally. At any point in time we have funds in our operating accounts and customer accounts that are deposited with third party financial institutions. These balances in the U.S. may exceed the Federal Deposit Insurance Corporation (FDIC) insurance limits. While we monitor the cash balances in our operating accounts, these cash balances could be adversely impacted if the underlying financial institutions fail and could be subject to other adverse conditions in the financial markets.

To the extent that our Bill Me Later products become more widely available through improved and more comprehensive product integrations with eBay, PayPal and other channels, and as we further promote Bill Me Later products, customer adoption and usage of Bill Me Later products may expand. Any resulting growth in the portfolio of Bill Me Later loan receivables would increase our liquidity needs and any failure to meet those liquidity needs could adversely affect the Bill Me Later business. We currently fund the expansion of the Bill Me Later portfolio of loan receivables with borrowings and domestic and international cash resources.

We believe that our existing cash, cash equivalents and investments, together with cash expected to be generated from operations, borrowings available under our credit agreement and commercial paper program, and our access to capital markets will be sufficient to fund our operating activities, anticipated capital expenditures, Bill Me Later portfolio of receivables from loans and stock repurchases for the foreseeable future.

Off-Balance Sheet Arrangements

As of September 30, 2012, we had no off-balance sheet arrangements that have, or are reasonably likely to have, a current or future material effect on our consolidated financial condition, results of operations, liquidity, capital expenditures or capital resources.

In Europe, we have two cash pooling arrangements with a financial institution for cash management purposes. These arrangements allow for cash withdrawals from this financial institution based upon our aggregate operating cash balances held in Europe within the same financial institution (“Aggregate Cash Deposits”) for more efficient cash management and investment purposes. These arrangements also allow us to withdraw amounts exceeding the Aggregate Cash Deposits up to an agreed-upon limit. The net balance of the withdrawals and the Aggregate Cash Deposits are used by the financial institution as a basis for calculating our net interest expense or income. As of September 30, 2012, we had a total of $5 billion in cash withdrawals offsetting our $5 billion in Aggregate Cash Deposits held within the same financial institution under these cash pooling arrangements.

Based on differences in regulatory requirements and commercial law in the jurisdictions where PayPal operates, PayPal holds customer balances either as direct claims against PayPal or as an agent or custodian on behalf of PayPal's customers. Customer funds held by PayPal as an agent or custodian on behalf of our customers are not reflected in our consolidated balance sheet. These off-balance sheet funds totaled approximately $3 billion as of September 30, 2012 and December 31, 2011. These funds represent funds held on behalf of U.S. customers that are deposited in bank accounts insured by the FDIC (subject to applicable limits).

PayPal's California regulator, the California Department of Financial Institutions, recently notified PayPal that PayPal's current practice of holding the funds underlying U.S. customer balances as an agent on behalf of its customers, rather than as owner of those funds, means that PayPal cannot treat those funds as liquid assets for purposes of the liquidity rules applicable to California money transmitter licensees. Based on changes to our U.S. PayPal user agreement effective November 1, 2012, PayPal will begin holding U.S. customer balances as direct claims against PayPal, rather than as an agent or custodian on behalf of such PayPal customers. As a result, effective as of November 1, 2012, all U.S. PayPal customer balances, which are currently reported as off-balance sheet, will be prospectively reflected as assets in our consolidated balance sheet with an associated liability.

Indemnification Provisions

In the ordinary course of business, we have included limited indemnification provisions in certain of our agreements with parties with which we have commercial relations, including our standard marketing, promotions and application-programming-interface license agreements. Under these contracts, we generally indemnify, hold harmless and agree to reimburse the indemnified party for losses suffered or incurred by the indemnified party in connection with claims by a third party with respect to our domain names, trademarks, logos and other branding elements to the extent that such marks are applicable to our performance under the subject agreement. In certain cases, we have agreed to provide indemnification for intellectual property infringement. GSI has provided in many of its major ecommerce agreements an indemnity for other types of third-party claims, which are indemnities mainly related to various intellectual property rights, and we have provided similar indemnities in a limited number of agreements for our other businesses. In our PayPal business, we have provided an indemnity to our payment processors in the event of certain third-party claims or card association fines against the processor arising out of conduct by PayPal or PayPal customers. It is not possible to determine the maximum potential loss under these indemnification provisions due to our limited history of prior indemnification claims and the unique facts and circumstances involved in each particular provision. To date, losses recorded in our statement of income in connection with our indemnification provisions have not been significant, either individually or collectively.

Item 3: Quantitative and Qualitative Disclosures About Market Risk

The information in this section should be read in connection with the information on financial market risk related to changes in interest rates and non-U.S. currency exchange rates in Part II, Item 7A, “Quantitative and Qualitative Disclosures About Market Risk,” in our Annual Report on Form 10-K for the year ended December 31, 2011. Our market risk profile has not changed significantly during the first nine months of 2012.

Interest Rate Risk

The primary objective of our investment activities is to preserve principal while at the same time improving yields without significantly increasing risk. To achieve this objective, we maintain our portfolio of cash equivalents and short-term and long-term investments in a variety of available for sale securities, including government and corporate securities and money market funds. As of September 30, 2012, approximately 63% of our total cash and investment portfolio was held in bank deposits and money market funds. As such, changes in interest rates will impact interest income. Fixed rate securities may have their fair market value adversely affected due to a rise in interest rates, and we may suffer losses in principal if we are forced to sell securities that have declined in market value due to changes in interest rates. Additionally, changes in interest rates will impact our interest rate sensitive credit agreement and the interest rate on any commercial paper borrowings, and accordingly will impact interest expense or cost of net revenues.
As of September 30, 2012, we held no direct investments in auction rate securities, collateralized debt obligations, structured investment vehicles or mortgage-backed securities.

Investment Risk

As of September 30, 2012, our cost and equity method investments totaled $180 million, which represented approximately 2% of our total cash and investment portfolio. We review our investments for impairment when events and circumstances indicate a decline in fair value of such assets below carrying value is other-than-temporary. Our analysis includes a review of recent operating results and trends, recent sales/acquisitions of the investee securities and other publicly available data.
Equity Price Risk

We are exposed to equity price risk on marketable equity instruments due to market volatility. At September 30, 2012, the total fair value of our marketable equity instruments (primarily related to our equity holdings in MercadoLibre) was $671 million, which represented approximately 6% of our total cash and investment portfolio.

Foreign Currency Risk

We have significant operations internationally that are denominated in foreign currencies, primarily the Euro, British pound, Korean won and Australian dollar, subjecting us to foreign currency risk which may adversely impact our financial results. We transact business in various foreign currencies and have significant international revenues as well as costs. In addition, we charge our international subsidiaries for their use of intellectual property and technology and for certain corporate services provided by eBay and by PayPal.

We have a foreign exchange exposure management program whose objectives are to identify material foreign currency exposures, manage these exposures and reduce the potential effects of currency fluctuations on our reported consolidated cash flow and results of operations through the purchase of foreign currency exchange contracts. These foreign currency exchange contracts are accounted for as derivative instruments; for additional details related to our derivative instruments, please see "Note 7 – Derivative Instruments" to the condensed consolidated financial statements included in this report.

European Debt Exposures

We actively monitor our exposure to the European markets, including the impact of sovereign debt issues associated with Greece, Ireland, Portugal, Italy and Spain. As of September 30, 2012, we did not have any direct investments in the sovereign debt of these countries or in debt securities issued by corporations or financial institutions organized in these countries. We maintain a small number of operating bank accounts with Spanish and Italian banks that have balances that we do not consider material.

Item 4: Controls and Procedures

(a) Evaluation of disclosure controls and procedures. Based on the evaluation of our disclosure controls and procedures (as defined in Securities Exchange Act of 1934 Rules 13a-15(e) and 15d-15(e)) required by Securities Exchange Act Rules 13a-15(b) or 15d-15(b), our Chief Executive Officer and our Chief Financial Officer have concluded that as of the end of the period covered by this report, our disclosure controls and procedures were effective.

(b) Changes in internal controls. There were no changes in our internal control over financial reporting that occurred during the period covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II: OTHER INFORMATION

Item 1: Legal Proceedings

The information set forth under "Note 9 — Commitments and Contingencies — Litigation and Other Legal Matters" to the condensed consolidated financial statements included in Part I, Item 1 of this report is incorporated herein by reference.

Item 1A: RISK FACTORS

Risk Factors That May Affect Results of Operations and Financial Condition

Our operations and financial results are subject to various risks and uncertainties that could adversely affect our business, financial condition, results of operations and cash flows, as well as the trading price of our common stock.

Our operating results have varied on a quarterly basis during our operating history. Our operating results may fluctuate significantly as a result of a variety of factors, many of which are outside our control. Factors that may affect our operating results include risks described elsewhere in this section and the following:

- general economic conditions, including the possibility of a prolonged period of limited economic growth or possible economic decline in the U.S. and Europe; adverse effects of the ongoing sovereign debt crisis in Europe, including increased Euro currency exchange rate volatility, the negative impact of the crisis and related austerity measures on European economic growth, potential negative spillover effects to the rest of the world, the "contagion" risk of the crisis spreading to additional countries in Europe, the possibility that one or more countries may leave the Euro zone and re-introduce its individual currency, and, in more extreme circumstances, the possible dissolution of the Euro currency; the impact of the "fiscal cliff" in the U.S. and, more generally, the impact of uncertainty regarding the fiscal policy of the U.S. government; disruptions to the credit and financial markets in Europe, the U.S., and elsewhere; contractions or limited growth in consumer spending or consumer credit; and adverse economic conditions that may be specific to the Internet, ecommerce and payments industries;

- the primary and secondary effects of previously announced and possible future changes to our pricing, products and policies, including, among other changes, restrictions or holds on payments made to certain sellers or in connection with certain transactions; changes to our dispute resolution process; upgrades to eBay checkout services, including the introduction of an eBay shopping cart/basket that enables buyers to add items from multiple sellers and pay in a single checkout; changes to our fee structure, including new requirements to qualify for "eBay Trusted Seller" discounts; changes to the design, navigation and functionality of the eBay.com website, including a redesigned homepage, a new "eBay Feed" that allows users to establish a personalized feed of items on their homepage and the display of and larger images and product information ; changes to the checkout process, including the ability for users to connect their eBay and PayPal accounts; and other products and features through which we are intermediating more aspects of transactions between buyers and sellers using our platforms;

- our ability to manage the rapid shift from online commerce and payments to mobile commerce and payments;
- our ability to improve the quality of the user experience on our websites and through mobile devices (including our customer support in the event of a problem) in light of the improved quality generally of the user experience offered by competitive merchants;
- our ability to upgrade and develop our systems (including the migration to GSI's new technology platform and our need to "replatform" our base PayPal technology), infrastructure and customer service capabilities to accommodate growth and to improve the functionality and reliability of our websites and services at a reasonable cost while maintaining 24/7 operations;
- our ability to retain an active user base, attract new users, and encourage existing users to list items for sale, purchase items through our websites and mobile platforms, or use our payment services, especially when consumer spending is weak;
- consumer confidence in the safety and security of transactions using our websites or technology and the effect of any changes in our practices and policies on such confidence;
- our ability to manage the costs of and effectively implement our user protection programs;
- our ability to comply with existing and new laws and regulations as we expand the range and geographical scope of our products and services and as we grow larger, including those laws and regulations discussed below under the caption "If our Payments business is found to be subject to or in violation of any laws or regulations, including those governing money transmission, electronic funds transfers, money laundering, terrorist financing, sanctions, consumer protection, banking and lending, it could be subject to liability, licensure and regulatory approval and may be forced to change its business practices;"
- new laws or regulations (such as those that may stem from the proposed Anti-Counterfeiting Trade Agreement (ACTA) and Trans-Pacific Partnership Agreement (TPP), the European Consumer Rights Directive and the proposed revisions to the European Data Directive) and interpretations of existing laws or regulations, including national court interpretations of the European Court of Justice's decision in the L'Oréal case (see “Item 1: Legal Proceedings” above), that impose liability on us for the actions of our users or otherwise harm our business models, especially as we become more actively involved in various aspects of transactions on our platforms;
- regulatory and legal actions imposing obligations on our businesses or our users, including the injunction related to certain cosmetic and perfume brands (see “Item 1: Legal Proceedings” above);
- the impact on PayPal or Bill Me Later of regulations enacted pursuant to new laws regulating financial institutions, including the Dodd-Frank Wall Street Reform and Consumer Protection Act in the U.S.;
- our ability to manage the costs of compliance with existing and new laws and regulations that affect our businesses;
- the volume, velocity, size, timing, monetization, and completion rates of transactions using our websites or technology;
- our ability to reduce the loss of active buyers and sellers and increase activity of the users of our Marketplaces business, especially with respect to our top buyers and sellers, and increase activity of PayPal account holders, particularly in merchant services business;
- our ability to develop product enhancements, programs, and features on different platforms and mobile devices at a reasonable cost and in a timely manner, including our initiatives to make PayPal solutions available at the retail point of sale;
- changes to our use of advertising on our sites;
- the actions of our competitors, including the introduction of new stores, channels, sites, applications, services, products and functionality;
- the costs and results of litigation or regulatory actions that involve us;

- technical difficulties or service interruptions involving our websites;
- disruptions to services provided to us or our users by third parties;
- our ability to manage the transaction loss rate in our Marketplaces, Payments and GSI ecommerce services businesses;
- our ability to manage funding costs, credit risk and interest-rate risk associated with our Bill Me Later business;
- our ability to successfully and cost-effectively integrate and manage businesses that we acquire;
- the amount and timing of operating costs and capital expenditures relating to the maintenance and expansion of our businesses, operations and infrastructure;

- our ability to comply with the requirements of entities whose services are required for our operations, such as payment card networks and banks;
- the cost and availability of traditional and online advertising, and the success of our brand building and marketing campaigns;
- our ability to attract new personnel in a timely and effective manner and to retain key employees;
- the continued healthy operation of our technology suppliers and other parties with which we have commercial relations;
- continued consumer acceptance of the Internet and of mobile devices as a medium for ecommerce and payments in the face of increasing publicity about data privacy issues, including breaches, fraud, spoofing, phishing, viruses, spyware, malware and other dangers; and
- macroeconomic and geopolitical events affecting commerce generally.

It is difficult for us to forecast the level or source of our revenues or earnings accurately. In view of the rapidly evolving nature of our business, we believe that period-to-period comparisons of our operating results may not be meaningful, and you should not rely upon them as an indication of future performance. We do not have backlog, and substantially all of our net revenues each quarter come from transactions involving sales or payments during that quarter. Due to the inherent difficulty in forecasting revenues, it is also difficult to forecast income statement expenses as a percentage of net revenues. Quarterly and annual income statement expenses as a percentage of net revenues may be significantly different from historical or projected rates. Our operating results in one or more future quarters may fall below the expectations of securities analysts and investors. In that event, the trading price of our common stock would almost certainly decline.

We invest heavily in technology, marketing and promotion, customer support, protection programs and further development of the operating infrastructure for our operations. Some of this investment entails long-term contractual commitments. As a result, we may be unable to adjust our spending rapidly enough to compensate for any unexpected revenue shortfall, which may harm our profitability.

Growth rates of our Marketplaces businesses in some of our most established markets have been slower than that for ecommerce generally and have declined in certain periods. The growth of Internet users is slowing in many countries where we have a significant presence. Despite our efforts to stem our loss of share in these and other markets, we may not be successful. As our growth rates in established markets slow, we will increasingly need to focus on keeping existing Marketplaces users (especially our top buyers and sellers) and PayPal account holders (especially in our merchant services business) active and increasing their activity level on our websites and mobile platforms and their use of our payment services, respectively, in order to continue to grow those respective businesses. The growth of Internet users is accelerating in some countries and regions where we do not have a significant presence (e.g., Brazil/Latin America, Russia, China and certain developing countries in which we do not have a meaningful (or, in some cases, any) domestic business). If we are unable to establish our businesses and drive adoption of our services in such markets, our future growth would be negatively impacted.

Our Marketplaces business continues to face increased competitive pressure online and offline. In particular, the competitive norm for, and the expected level of service from, Internet ecommerce and mobile commerce has significantly increased, due to, for example, improved user experience, greater ease of buying goods, lower (or no) shipping costs, faster shipping times and more favorable return policies. If we are unable to change our services in ways that reflect the changing demands of the ecommerce marketplace, particularly the higher growth of sales of fixed-price items and higher expected service levels (some of which depend on services provided by sellers on our platforms), our business will suffer.

We have announced changes to our Marketplaces business that are intended to drive more sales and improve seller efficiency and buyer experiences and trust. For example, in the U.S., the U.K. and Canada, we may request that PayPal place temporary holds on seller funds in certain instances (e.g., for sellers with a limited selling history or below-standard performance ratings), which is intended to help improve seller performance and increase buyer satisfaction and trust. We may expand the scope of such programs in the future and introduce and implement additional programs with similar aims across different businesses and geographies. Some of the changes that we have announced to date have been controversial with, and led to dissatisfaction among, our sellers, and additional changes that we announce in the future may also be negatively received by some of our sellers. This may not only impact the supply of items listed on our websites, but because many sellers also buy from our sites, it may adversely impact demand as well. Given the number of recent changes that we have made to our policies and pricing, it may take our sellers some time to fully assess and adjust to these changes, and sellers may elect to reduce volume on our sites while making such assessments and adjustments or in response to these changes. If any of these changes cause sellers to move their business (in whole or in part) away from our websites or otherwise fail to improve gross merchandise volume or the number of successful listings, our operating results and profitability will be harmed.

We believe that the mix of sales under our traditional auction-style listing format and fixed-price listing format will continue to shift towards our fixed-price format. Accordingly, we have eliminated some of the features related to our traditional auction-style format and expect others will continue to become less meaningful to, and used less frequently by, our sellers, resulting in a corresponding decrease in revenues from those features. We also expect that the costs associated with our seller discount programs will increase as more sellers become eligible for such discounts. In addition, because a large percentage of PayPal transactions originate on the eBay platform, declines in growth rates in major Marketplaces markets also adversely affect PayPal's growth. The expected future growth of our PayPal, GSI, StubHub and our other lower margin businesses may also cause downward pressure on our profit margins because those businesses have lower gross margins than our Marketplaces platforms.

The sluggish economy and the sovereign debt crisis could harm our business.

Our Marketplaces, Payments and GSI ecommerce services businesses are dependent on consumer purchases, and our GSI business is also impacted by the offline businesses of our GSI clients. The economic downturn resulted in reduced buyer demand and reduced selling prices and the slow recovery (and possible impact of the "fiscal cliff") in the U.S. and the impact of the sovereign debt crisis and resulting austerity measures in Europe may reduce the volume and prices of purchases on our Marketplaces platforms, and the volume and prices of transactions paid for using our Payment services and the online and offline businesses of our GSI clients, any of which would adversely affect our business. These macroeconomic factors could also have a negative and adverse impact on companies with which we do business, which in turn could have an adverse effect on our business.

We are exposed to fluctuations in currency exchange rates and interest rates.

Because we generate substantial revenues outside the U.S. but report our financial results in U.S. dollars, we face exposure to adverse movements in currency exchange rates. In connection with its multi-currency service, PayPal fixes exchange rates twice per day, and may face financial exposure if it incorrectly fixes the exchange rate or if exposure reports are delayed. Given that PayPal also holds some corporate and customer funds in non-U.S. currencies, its financial results are affected by the translation of these non-U.S. currencies into U.S. dollars. In addition, the results of operations of many of our internationally focused websites are exposed to foreign exchange rate fluctuations as the financial results of the applicable subsidiaries are translated from the local currency into U.S. dollars upon consolidation. If the U.S. dollar weakens against foreign currencies, the translation of these foreign currency denominated transactions will result in increased revenues, operating expenses and net income. Similarly, if the U.S. dollar strengthens against foreign currencies, our translation of foreign currency denominated transactions will result in lower net revenues, operating expenses and net income. If the U.S. dollar continues to strengthen against major European currencies (e.g., the Euro and British pound) due to the ongoing sovereign debt crisis in Europe, worsening economic conditions or for any other reasons, our revenues and operating results would be adversely impacted. For the nine months ended September 30, 2012, foreign currency movements relative to the U.S. dollar negatively impacted net revenues of $10.1 billion by approximately $202 million (net of a $42 million positive impact from hedging activities included in PayPal's net revenue) compared to the prior year. As exchange rates vary, net revenues and other operating results, when translated, may differ materially from expectations. In particular, to the extent the U.S. dollar strengthens against the Euro, British pound, Korean won, Australian dollar or Canadian dollar, our foreign revenues and profits will be reduced as a result of these translation adjustments. While from time to time we enter into transactions to hedge portions of our foreign currency translation exposure, it is impossible to predict or completely eliminate the effects of this exposure. In addition, to the extent the U.S. dollar strengthens against the Euro, the British pound, the Australian dollar or other currencies, cross-border trade related to purchases of dollar-denominated goods (or goods from those Asia-Pacific countries whose currencies tend to follow the dollar) by non-U.S. purchasers will likely decrease, and that decrease will likely not be offset by a corresponding increase in cross-border trade involving purchases by U.S. buyers of goods denominated in other currencies, which would adversely affect our business.

In addition, we face exposure to fluctuations in interest rates. Relatively low interest rates have continued to limit our investment income, including income we earn on PayPal customer balances.

Bill Me Later's operations depend on lending services provided by an unaffiliated lender.

In November 2008, we acquired Bill Me Later, a company that facilitates credit services offered by an unaffiliated bank. Bill Me Later is neither a chartered financial institution nor is it licensed to make loans in any state.

Accordingly, Bill Me Later must rely on a bank or licensed lender to issue the Bill Me Later credit products and extend credit to customers to offer the Bill Me Later service. Currently, when a consumer makes a purchase using a Bill Me Later credit product, the chartered financial institution extends credit to the consumer, funds the extension of credit at the point of sale and advances funds to the merchant. We subsequently purchase the receivables related to the extensions of credit made by the chartered financial institution and, as a result of the purchase, bear the risk of loss in the event of loan defaults. Although the chartered financial institution continues to own each customer account, we own the related receivable and Bill Me Later is responsible for all servicing functions related to the account.

In September 2010, WebBank became the issuer of the Bill Me Later credit products. WebBank is an industrial bank chartered by the State of Utah. Any termination or interruption of WebBank's ability to lend could result in our being unable to originate any new transactions for the Bill Me Later service, which would require us to either reach a similar arrangement with another chartered financial institution, which, if possible at all, may not be available on favorable terms, if at all, or to obtain our own bank charter, which would be a time-consuming and costly process and would subject us to a number of additional laws and regulations, compliance with which would likely be burdensome.

A lawsuit was filed against Bill Me Later, PayPal and eBay in the U.S. District Court for the Northern District of California, alleging that in its relationship with the chartered financial institution, Bill Me Later is acting as the true lender to customers in violation of various California laws, including the state's usury law. The court dismissed the usury claims in December 2010, but breach of contract and other claims remain. WebBank requested to intervene in the action and has been added as a party to the action, and in October 2011, the court transferred the case to the U.S. District Court for the District of Utah. The Utah Court allowed plaintiffs the opportunity to amend the complaint, the complaint was amended and plaintiffs re-alleged the usury claims previously dismissed. We and WebBank have filed a motion to dismiss the lawsuit, which was heard by the court in September 2012. We believe that plaintiffs' allegations are without merit and intend to defend ourselves vigorously. However, this area of law is uncertain and if the lawsuit is successful, Bill Me Later may be required to change its methods of operations, pay very substantial damages and reduce some of its charges and fees, which would adversely affect our business.

If our Payments business is found to be subject to or in violation of any laws or regulations, including those governing money transmission, electronic funds transfers, money laundering, terrorist financing, sanctions, consumer protection, banking and lending, it could be subject to liability, licensure and regulatory approval and may be forced to change its business practices.

Our Payments business is subject to various laws and regulations in the U.S. and other countries where it operates, including those governing money transmission, electronic funds transfers, money laundering, terrorist financing, sanctions, consumer protection, banking and lending. The legal and regulatory requirements that apply to our Payments business vary in the markets where we operate. While PayPal has a compliance program focused on compliance with applicable laws and regulations and has significantly increased the resources of that program in the last several years, there can be no assurance that we will not be subject to fines or other enforcement actions in one or more jurisdictions or be required to make changes to our business practices or compliance programs to comply in the future.

While PayPal currently allows its customers with credit cards to send payments from 190 markets, PayPal only allows customers in 110 of those markets (including the U.S.) to receive payments, in some cases with significant restrictions on the manner in which customers can withdraw funds. These limitations may affect PayPal's ability to grow in these markets. Of the 190 markets whose residents can use the PayPal service, 31 (27 countries plus four French overseas departments) are members of the European Union, or EU. Since 2007, PayPal has provided localized versions of its service to customers in the EU through PayPal (Europe) S.à r.l. et Cie, SCA, a wholly-owned subsidiary of PayPal that is licensed and subject to regulation as a bank in Luxembourg by the Commission de Surveillance du Secteur Financier (CSSF). Accordingly, PayPal (Europe) is subject to significant fines or other enforcement action if it violates the disclosure, reporting, anti-money laundering, capitalization, funds management, corporate governance, information security, sanctions or other requirements imposed on Luxembourg banks. Any fines or other enforcement actions imposed by the Luxembourg regulator could adversely affect PayPal's business. PayPal (Europe) implements its localized services in EU countries through a “passport” notification process through the Luxembourg regulator to regulators in other EU member states pursuant to EU Directives, and has completed the “passport” notification process in all EU member countries. The regulators in these countries could notify PayPal (Europe) of local consumer protection laws that apply to its business, in addition to Luxembourg consumer protection law, and could also seek to persuade the Luxembourg regulator to order PayPal (Europe) to conduct its activities in the local country through a branch office. These or similar actions by these regulators could increase the cost of, or delay, PayPal's plans for expanding its business in EU countries. In addition, national interpretations of regulations implementing the EU Payments Service Directive, which established a new regulatory regime for payment services providers, may be inconsistent, which could make compliance more costly and operationally difficult to manage.

In 2011, we began implementing a new payment process in Germany and Austria in which eBay intermediated payments, receiving funds directly from buyers for items purchased from newly registered sellers on the localized eBay websites in those countries and subsequently paying the sellers upon shipment of the items. The German Bundesanstalt für

Finanzdienstleistungsaufsicht (BaFin) and the Austrian Finanzmarktaufsicht (FMA) subsequently determined that eBay was required to obtain a license in order to introduce the new payment method. eBay's payment processing unit is based in Luxembourg and is governed by the CSSF, which had advised that there was no need for such a license. In accordance with the BaFin and FMA positions, eBay has stopped intermediating payments and is working with the CSSF with respect to understanding the requirements associated with obtaining an appropriate license.

In Australia, PayPal serves its customers through PayPal Australia Pty. Ltd., which is licensed by the Australian Prudential Regulatory Authority as a purchased payment facility provider, which is a type of authorized depository institution. Accordingly, PayPal Australia is subject to significant fines or other enforcement action if it violates the disclosure, reporting, anti-money laundering, capitalization, corporate governance or other requirements imposed on Australian depository institutions. In China, PayPal is affiliated with Shanghai Wangfuyi Information Technology Ltd., which is licensed as an Internet Content Provider and operates a payments service only for Chinese customers and only for transactions denominated in Chinese currency. The People's Bank of China (PBOC) has enacted regulations to establish a new type of license, called a Payment Clearing Organization (PCO) license, which will be required for non-bank payment services. The PBOC regulations leave unclear whether a foreign-owned company such as PayPal can control or invest in a Payment Clearing Organization, and whether Wangfuyi or PayPal's wholly-owned subsidiary in China would be eligible to obtain a PCO license. Nonetheless, PayPal has begun the process of applying for such a license.

To date, PayPal has obtained licenses to operate as a money transmitter in 42 U.S. states, the District of Columbia and Puerto Rico. PayPal is also licensed as an escrow agent in one U.S. state. PayPal is applying for money transmitter licenses in five additional states to facilitate its planned offering of payment services at the retail point of sale. The two remaining U.S. states do not currently regulate money transmitters. As a licensed money transmitter, PayPal is subject to restrictions on its investment of customer funds, reporting requirements, bonding requirements, and inspection by state regulatory agencies. If PayPal were found to be in violation of money services laws or regulations, PayPal could be subject to liability and/or additional restrictions, forced to cease doing business with residents of certain states, forced to change its business practices, or required to obtain additional licenses or regulatory approvals that could impose a substantial cost on PayPal. Any change to PayPal's business practices that makes the service less attractive to customers or prohibits its use by residents of a particular jurisdiction could also decrease the velocity of trade on eBay and websites operated by GSI's clients that accept PayPal as a form of payment, which would further harm our business.

PayPal's California regulator, the California Department of Financial Institutions (DFI), recently notified PayPal that PayPal's current practice of holding the funds underlying U.S. customer balances as an agent on behalf of its customers, rather than as owner of those funds, causes PayPal to be in violation of the liquidity rules applicable to California money transmitter licensees. PayPal has established this current practice in part to maintain potential eligibility of those funds for pass-through Federal Deposit Insurance Corporation (FDIC) insurance coverage when those funds are placed in U.S. bank accounts. PayPal has requested the DFI to grant a waiver that would allow PayPal to continue to hold those funds as an agent or custodian on behalf of customers and still qualify those funds as liquid assets. The DFI has indicated that it cannot grant a waiver under its interpretation of current law and that PayPal must become compliant before the end of 2012. As a result of the DFI's ruling, we recently announced changes to our the U.S. PayPal user agreement effective November 1, 2012, pursuant to which all U.S. PayPal customer balances will be held as direct claims against PayPal, rather than as an agent on behalf of its customers. This change to direct ownership will result in these balances, which are currently not reported as assets on our consolidated balance sheet, moving onto our consolidated balance sheet with an offsetting liability. This change will also disqualify the customer balances from pass-through FDIC insurance and result in U.S. PayPal customers becoming general creditors of PayPal, Inc. with respect to such customer balances, and could also result in decreased revenue to PayPal if it decides to shift the funds from interest-bearing bank accounts to securities that bear lower interest rates or non-interest bearing deposit accounts. Any potential decrease in revenue to PayPal resulting from this change is not expected to be material. For additional information, please see “Part I - Item 2: Management's Discussion and Analysis of Financial Condition and Results of Operations” under the caption “Off-Balance Sheet Arrangements,” above. As of September 30, 2012, these funds totaled approximately $3 billion.

In markets other than the U.S., the EU, Australia, the China domestic business and Brazil, PayPal serves its customers through PayPal Private Ltd., a wholly-owned subsidiary of PayPal that is based in Singapore. PayPal Private Ltd. is regulated in Singapore as a stored value issuer. In many of these markets, it is not clear whether PayPal's Singapore-based service is subject only to Singaporean law or, if it were subject to local laws, whether such local law would require a payment processor like PayPal to be licensed as a bank or financial institution or otherwise. In such markets, the business may rely on partnerships with local banks to process payments and conduct foreign exchange in local currency. Local regulators who do not have direct jurisdiction over Singapore-based PayPal Private Ltd. may use their local regulatory power to slow or halt payments to local merchants conducted through the local banking partner. Such regulatory actions impacting local banking partner arrangements could impose substantial costs and involve considerable delay to the provision or development of PayPal services in that market, or could prevent PayPal from providing any services in a given market. For example, in 2010, the Reserve Bank of

India directed the Indian affiliate of PayPal's processing bank to suspend withdrawals to the Indian bank accounts of PayPal customers for both personal and business customers for a period of time. As a result, PayPal ended personal non-commercial payments to and from Indian accounts and the ability of Indian sellers to spend payments they receive, and also stopped offering certain commercial payments between Indian buyers and Indian sellers. In November 2010, the Reserve Bank of India issued guidelines to Indian banks on the requirements for processing export-related transactions for online payment gateway service providers such as PayPal, including a limitation on the amount of individual transactions to no more than $500 (increased in October 2011 to $3,000). The Reserve Bank recently approved an application which would permit PayPal to process domestic Indian transactions, subject to a number of conditions. The Reserve Bank may again impose a suspension if it is not satisfied with PayPal's and its partner bank's actions to comply with these guidelines. In the event of any non-compliance, PayPal could be subject to fines from the Reserve Bank, and PayPal's prospects for future business in India, both cross-border and domestic, could be materially and adversely affected.

Even if PayPal is not currently required to be licensed in some jurisdictions, future localization or targeted marketing of PayPal's service or expansion of the financial products offered by PayPal (whether alone, through a commercial alliance or through an acquisition) in those countries could subject PayPal to additional licensure requirements, laws and regulations and increased regulatory scrutiny, any of which may harm PayPal's business. For example, PayPal will be required to obtain licenses in Japan and Russia to expand its services in those countries, and has applied for such licenses. There can be no assurance that PayPal will be able to obtain such licenses. Even if PayPal were able to obtain such licenses, there would be substantial costs involved in maintaining such licenses, and PayPal would be subject to fines or other enforcement action if it violates disclosure, reporting, anti-money laundering, capitalization, corporate governance or other requirements of such licenses. These factors could impose substantial costs and involve considerable delay to the provision or development of PayPal's products. Delay or failure to receive such a license or regulatory approval could require PayPal to change its business practices or features in ways that would adversely affect PayPal's expansion plans or force PayPal to suspend providing products and services to customers in one or more countries.

PayPal is also subject to various anti-money laundering and counter-terrorist financing laws and regulations around the world that prohibit, among other things, its involvement in transferring the proceeds of criminal activities. PayPal is focused on compliance with these laws and regulations and has programs designed to comply with new and existing legal and regulatory requirements. However, any errors, failures or delays in complying with federal, state or foreign anti-money laundering and counter-terrorist financing laws could result in significant criminal and civil lawsuits, penalties and forfeiture of significant assets or other enforcement actions. In the U.S., PayPal is subject to regulations that require it to report, within required timeframes, suspicious activities involving transactions of $2,000 or more, and may be required to obtain and keep more detailed records on the senders and recipients in certain transfers of $3,000 or more. New regulations on prepaid access programs which took full effect in March 2012 require PayPal to take additional stFONT-WEIGHT: bold; FONT-SIZE: 10pt; FONT-FAMILY: times new roman"> 35% $71,050 39%

Stockholders' equity	$119,576	65%	$111,152	61%
Total capitalization, excluding short-term debt	$182,832	100%	$182,202	100%

As of December 31, 2007, common equity represented 65 percent of total capitalization, compared to 61 percent at December 31, 2006.

The following presents our capitalization as of December 31, 2007 and 2006, if short-term borrowing and the current portion of long-term debt were included in capitalization:

	December 31,					
	2007			2006		
	(In thousands, except percentages)					
Short-term debt	$	45,664	19%	$	27,554	13%
Long-term debt, including current maturities	$	70,912	30%	$	78,706	36%
Stockholders' equity	$	119,576	51%	$	111,152	51%
Total capitalization, including short-term debt	$	236,152	100%	$	217,412	100%

If short-term borrowing and the current portion of long-term debt were included in capitalization, total capitalization increased by $18.7 million in 2007 compared to 2006. The increased capitalization was primarily used to fund a portion of the $31.3 million of net property, plant, and equipment added in 2007 and for other general working capital. In addition, if short-term borrowing and the current portion of long-term debt were included in total capitalization, the equity component of the Company's capitalization would have been 51 percent at both December 31, 2007 and 2006.

Chesapeake remains committed to maintaining a sound capital structure and strong credit ratings to provide the financial flexibility needed to access the capital markets when required. This commitment, along with adequate and timely rate relief for the Company's regulated operations, is intended to ensure that Chesapeake will be able to attract capital from outside sources at a reasonable cost. The Company believes that the achievement of these objectives will provide benefits to customers and creditors, as well as its investors.

Shelf Registration

In July 2006, the Company filed a registration statement on Form S-3 with the SEC to issue up to $40.0 million in new common stock and/or debt securities. The registration statement was declared effective by the SEC in November 2006. In November 2006, we sold 600,300 shares of common stock, including the underwriter's exercise of their over-allotment option of 90,045 shares, under this registration statement, generating net proceeds of $19.7 million. The net proceeds from the sale were used for general corporate purposes, including financing of capital expenditures, repayment of short-term debt, and funding working capital requirements. At December 31, 2007 and 2006, the Company had approximately $20.0 million remaining under this registration statement.

Cash Flows Provided by Operating Activities

Our cash flows provided by (used in) operating activities were as follows:

For the Years Ended December 31,		2007		2006		2005
Net income	$	13,197,710	$	10,506,525	$	10,467,614
Non-cash adjustments to net income		15,554,639		11,186,418		13,059,678
Changes in working capital		(3,070,465)		8,424,055		(9,927,351)
Net cash from operating activties	$	25,681,884	$	30,116,998	$	13,599,941

Period-over-period changes in our cash flows from operating activities are attributable primarily to changes in net income and working capital. Changes in working capital are determined by a variety of factors, including weather, the price of natural gas and propane, the timing of customer collections, payments of natural gas and propane purchases, and deferred gas cost recoveries.

The Company generates a large portion of its annual net income and subsequent increases in our accounts receivable in the first and fourth quarters of each year due to significant volumes of natural gas and propane delivered by our Delmarva natural gas and propane distribution operations to our customers during the peak heating season. In addition, our natural gas and propane inventories, which usually peak in the fall months, are largely drawn down in the heating season and provide a source of cash as the inventory is used to satisfy winter sales demand.

In 2007, our net cash flow provided by operating activities was $25.7 million, a decrease of $4.4 million from 2006. The 2007 operating cash flows reflect the favorable timing of payments for accounts payable and accrued liabilities, which increased operating cash flow by $22.1 million. In addition, increased net income and favorable non-cash adjustments, primarily depreciation expense, contributed to the increase in operating cash flow. Partially offsetting these increases in operating cash flow was an increase in accounts receivable of $28.2 million associated with increased revenues and the timing of invoicing by our propane wholesale and marketing operation.

In 2006, our net cash flow provided by operating activities was $30.1 million, an increase of $16.5 million over 2005. This increase was primarily a result of the recovery during 2006 of working capital that was deployed in 2005 due to significantly higher commodity prices and the amount of working capital required for operations. Also, contributing to this increase was a reduction of $6.1 million in natural gas and propane purchased for inventory as a result of mild weather in the prior heating season and therefore higher inventory balances for the current heating season.

Cash Flows Used in Investing Activities

Net cash flows used in investing activities totaled $31.3 million, $48.9 million and $33.1 million during fiscal years 2007, 2006, and 2005, respectively.

- Cash utilized for capital expenditures was $31.3 million, $48.9 million and $33.3 million for 2007, 2006, and 2005, respectively. Additions to property, plant and equipment in 2007 were primarily for natural gas transmission ($9.2 million), natural gas distribution ($15.2 million), propane distribution ($5.2 million), and other operations ($1.7 million). In both 2007 and 2006, the natural gas distribution expenditures were used primarily to fund expansion and facilities improvements. In both periods, the natural gas transmission capital expenditures related primarily to expanding the Company's transmission system.
  - Sales of property, plant, and equipment generated $205,000 of cash in 2007.
- The Company's environmental expenditures exceeded amounts recovered through rates charged to customers in 2007 and 2006 by $228,000 and $16,000, respectively; in 2005, the Company recovered from its customers $240,000 in excess of its environmental expenditures for the period.

Cash Flows Provided by Financing Activities

Cash flows provided by financing activities totaled $3.7 million during 2007, $20.7 million during 2006, and $20.4 million during 2005. Significant financing activities included the following:

- During 2007 and 2005, net borrowing of short-term debt increased by $18.7 million and $29.6 million, respectively, primarily to support our capital investments. During 2006, the Company reduced it short-term debt by $8.0 million.

- The Company repaid $7.7 million of long-term debt during 2007 compared with $4.9 million during 2006 and $4.8 million during 2005.

- During 2007, the Company paid $7.0 million in cash dividends compared with dividend payments of $6.0 million and $5.8 million for 2006 and 2005, respectively. The increase in dividends paid in 2007 compared to 2006 reflects both growth in the annualized dividend rate, from $1.16 per share during 2006 to $1.18 per share during 2007, and the increase in shares outstanding following the issuance of additional shares of common stock in the fourth quarter of 2006.

- In November 2006, the Company sold 600,300 shares of common stock, including the underwriter's exercise of their over-allotment option of 90,045 shares, pursuant to a shelf registration statement declared effective in November 2006, generating net proceeds of $19.7 million.

- In October 2006, the Company placed $20.0 million of 5.5 percent Senior Notes ("Notes") to three institutional investors (The Prudential Insurance Company of America, Prudential Retirement Insurance and Annuity Company and United Omaha Life Insurance Company).

- In August 2006, the Company paid cash of $435,000, in lieu of issuing shares of the Company's common stock for the 30,000 stock warrants outstanding at December 31, 2005.

Contractual Obligations

We have the following contractual obligations and other commercial commitments as of December 31, 2007:

	Payments Due by Period				
Contractual Obligations	Less than 1 year	1 - 3 years	3 - 5 years	More than 5 years	Total
Long-term debt (1)	$ 7,656,364	$ 13,312,727	$ 14,474,545	$ 35,468,364	$ 70,912,000
Operating leases (2)	790,801	1,211,720	1,166,800	2,252,714	5,422,035
Purchase obligations (3)					
Transmission capacity	9,302,772	20,794,882	6,266,171	21,339,713	57,703,538
Storage — Natural Gas	1,553,175	4,210,670	3,015,217	1,838,948	10,618,010
Commodities	13,907,762	63,515	-	-	13,971,277
Forward purchase contracts — Propane (4)	41,781,709	-	-	-	41,781,709
Unfunded benefits (5)	308,552	628,143	645,350	1,945,895	3,527,940
Funded benefits (6)	73,939	133,864	119,852	1,572,844	1,900,499
Total Contractual Obligations	$ 75,375,074	$ 40,355,521	$ 25,687,935	$ 64,418,478	$ 205,837,008

(1) Principal payments on long-term debt, see Note H, "Long-Term Debt," in the Notes to the Consolidated Financial Statements for additional discussion of this item. The expected interest payments on long-term debt are $5.2 million, $8.8 million, $6.9 million and $10.0 million, respectively, for the periods indicated above. Expected interest payments for all periods total $ 30.9 million.

(2) See Note J, "Lease Obligations," in the Notes to the Consolidated Financial Statements for additional discussion of this item.

(3) See Note N, "Other Commitments and Contingencies," in the Notes to the Consolidated Financial Statements for further information.

(4) The Company has also entered into forward sale contracts. See "Market Risk" of the Management's Discussion and Analysis for further information.

(5) The Company has recorded long-term liabilities of $4.2 million at December 31, 2006 for unfunded post-retirement benefit plans. The amounts specified in the table are based on expected payments to current retirees and assumes a retirement age of 65 for currently active employees. There are many factors that would cause actual payments to differ from these amounts, including early retirement, future health care costs that differ from past experience and discount rates implicit in calculations.

(6) The Company has recorded long-term liabilities of $2.0 million at December 31, 2006 for funded benefits. These liabilities have been funded using a Rabbi Trust and an asset in the same amount is recorded under Investments on the Balance Sheet. The defined benefit pension plan was closed to new participants on January 1, 1999 and participants in the plan on that date were given the option to leave the plan. See Note K, "Employee Benefit Plans," in the Notes to the Consolidated Financial Statements for further information on the plan. Since the plan modification, no additional funding has been required from the Company and none is expected for the next five years, based on factors in effect at December 31, 2006. However, this is subject to change based on the actual return earned by the plan assets and other actuarial assumptions, such as the discount rate and long-term expected rate of return on plan assets.

Off-Balance Sheet Arrangements

The Company has issued corporate guarantees to certain vendors of its propane wholesale marketing subsidiary and its Florida natural gas supply management subsidiary. These corporate guarantees provide for the payment of propane and natural gas purchases in the event either subsidiary's default. Neither of these subsidiaries has ever defaulted in its obligations to pay its suppliers. The liabilities for these purchases are recorded in the Consolidated Financial Statements when incurred. The aggregate amount guaranteed at December 31, 2007 was $24.2 million, with the guarantees expiring on various dates in 2008.

In addition to the corporate guarantees, the Company has issued a letter of credit to its primary insurance company for $775,000, which expires on May 31, 2008. The letter of credit is provided as security to satisfy the deductibles under the Company's various insurance policies. There have been no draws on this letter of credit as of December 31, 2007.

Regulatory Activities

The Company's natural gas distribution operations in Delaware, Maryland and Florida are subject to regulation by their respective PSCs; Eastern Shore, the Company's natural gas transmission operation, is subject to regulation by the FERC.

Delaware. On September 2, 2005, the Delaware division filed an application with the Delaware PSC requesting approval of an alternative rate design and rate structure in order to provide natural gas service to prospective customers in eastern Sussex County ("2005 Proceeding"). While Chesapeake provides natural gas service to residents and businesses in portions of Sussex County under the Company's current tariff, natural gas distribution lines have not been extended to a large portion of eastern Sussex County targeted for growth by the State of Delaware. In April 2002, Governor Ruth Ann Minner established the Delaware Energy Task Force ("Task Force"), whose mission was to address the State's long-term and short-term energy challenges. In September 2003, the Task Force issued its final report to the Governor that included a strategy to enhance the availability of natural gas within the State by evaluating possible incentives for expanding residential and commercial natural gas service. Chesapeake believes its current proposal to implement a rate design that will enable the Company to provide natural gas as a viable energy choice to a broader number of prospective customers within eastern Sussex County supports the Task Force recommendation. As the Delaware division included these proposals in its base rate filing made on July 6, 2007, the Delaware division closed the 2005 Proceeding with the intent to continue discussions in the context of the 2007 base rate proceeding.

On September 1, 2006, the Company filed with the Delaware PSC its annual Gas Sales Service Rates ("GSR") Application, seeking approval to change its GSR rates effective for service rendered on and after November 1, 2006. On October 3, 2006, the Delaware PSC authorized the Company to implement the GSR charges on a temporary basis and subject to refund, pending the completion of full evidentiary hearings and a final decision by the Delaware PSC. The Division of the Public Advocate ("DPA") recommended a cost disallowance of approximately $4.4 million related to the Delaware division's commodity procurement purchases and a disallowance of approximately $275,000 related to pipeline capacity the Delaware division holds in eastern Sussex County, Delaware. The Delaware PSC Staff recommended a cost disallowance of approximately $2.2 million related to the Delaware division's commodity procurement purchases and the deferral of approximately $535,000 related to pipeline capacity the Delaware division holds in eastern Sussex County, Delaware. The Company disagreed with these recommendations and opposed the proposed cost disallowances and deferrals in its rebuttal position submitted on April 19, 2007. Under established Delaware law, gas procurement costs, like other normally accepted operating expenses, cannot be disallowed unless it is shown that the costs were the result of an abuse of discretion, bad faith, or waste. Management believes that the Company's gas procurement practices and pipeline capacity costs were reasonable and that, in no event were the costs at issue incurred as a result of any abuse of discretion, bad faith, or waste on the part of the Company. On July 24, 2007, the Delaware PSC approved a settlement agreement among the parties resulting in a complete recovery of the Delaware division's costs. As a result of the settlement agreement, the Delaware division has agreed to contribute an amount equal to $37,500 per year for the next three years to a program designed to benefit elderly, disabled, and low-income customers of the Delaware division. In addition, with respect to the allowances for recovery of costs associated with pipeline capacity in eastern Sussex County, the settlement provides for the Delaware division to reduce the total amount of GSR charges to be collected from its customers by $275,000, effective beginning with the billing period from November 1, 2007 through October 31, 2008. The settlement also provides for the Delaware division to add $275,000 to the total GSR charges to be collected from customers effective for billings from November 1, 2008 through October 31, 2009.

On November 1, 2006, the Delaware division filed with the Delaware PSC its annual Environmental Rider ("ER") rate application to become effective for service rendered on and after December 1, 2006. The Delaware PSC granted approval of the ER rate at its regularly scheduled meeting on November 21, 2006, subject to full evidentiary hearings and a final decision. On January 23, 2007, the Delaware PSC granted final approval of the ER rate as filed.

On November 9, 2006, the Delaware division filed two applications with the Delaware PSC requesting approval for a Town of Millsboro Franchise Fee Rider and a Town of Georgetown Franchise Fee Rider. These Riders will allow the Delaware division to charge all respective natural gas customers within town limits the franchise fee paid by the Delaware division to the Towns of Millsboro and Georgetown as a condition to providing natural gas service. The Delaware PSC granted approval of both Riders on January 23, 2007.

On July 6, 2007, the Company filed with the Delaware PSC an application seeking approval of the following: (i) participation by the Company's Delaware commercial and industrial customers in transportation buying pools served by third-party natural gas marketers; (ii) a base rate adjustment of $1,896,000 annually that represents approximately a 3.25 percent rate increase on average for the Delaware division's firm customers; (iii) an alternative rate design for residential customers in a defined expansion area in eastern Sussex County, Delaware; and (iv) a revenue normalization mechanism that reduces the impact of natural gas consumption on both customers and the Company. As an incentive for the Delaware division to make the significant capital investments to serve the growing areas of eastern Sussex County and in supporting Delaware's Energy Policy, the Company has proposed as part of the filing that the Delaware division be permitted to earn a return on equity up to 15 percent. This level of return would ensure that the Company's investors are adequately compensated for the increased risk associated with the higher levels of capital investment necessary to provide natural gas in those growing areas. On August 21, 2007, the Delaware PSC authorized the Company to implement charges reflecting the proposed $1,896,000 increase effective September 4, 2007 on a temporary basis and subject to refund, pending the completion of full evidentiary hearings and a final decision by the Delaware PSC. The Delaware PSC Staff filed testimony recommending a rate decrease of $693,245. The DPA recommended a rate decrease of $588,670. Neither party recommended approval of the Delaware division's other proposals mentioned above. The Delaware division strongly disagrees with these positions and is currently in the process of drafting its rebuttal position which was filed on February 7, 2008. The Delaware division anticipates a final decision by the Delaware PSC during the second quarter of 2008.

On September 10, 2007, the Company filed with the Delaware PSC its annual GSR Application, seeking the approval of the Delaware PSC to change its GSR rates effective for service rendered on and after November 1, 2007. On October 2, 2007, the Delaware PSC authorized the Company to implement the GSR charges on a temporary basis and subject to refund, pending the completion of full evidentiary hearings and a final decision by the Delaware PSC. The Delaware division anticipates a final decision by the Delaware PSC during the second or third quarter of 2008.

On November 1, 2007, the Delaware division filed with the Delaware PSC its annual Environmental Rider ("ER") rate application to become effective for service rendered on and after December 1, 2007. The Delaware PSC granted approval of the ER rate at its regularly scheduled meeting on November 20, 2007, subject to full evidentiary hearings and a final decision. The Delaware division anticipates a final decision by the Delaware PSC during the first quarter of 2008.

Maryland. On September 26, 2006, the Maryland PSC approved a base rate increase for the Maryland division of approximately $780,000 annually. In a settlement agreement entered into in that proceeding, the Maryland division was required to file a depreciation study, which was filed on April 9, 2007. The Maryland division filed formal testimony on July 10, 2007, initiating a phase II of this proceeding. In this filing, the Maryland division proposed a rate decrease of approximately $80,000 annually, resulting from a change in depreciation expense. On November 29, 2007 the Maryland PSC approved a settlement agreement for a rate decrease of $132,155, effective December 1, 2007 based on the change in the Company's depreciation rates.

On December 17, 2007, the Maryland PSC held an evidentiary hearing to determine the reasonableness of the Maryland division's four quarterly gas cost recovery filings during the twelve months ended September 30, 2007. No issues were raised at the hearing. The Maryland division anticipates a final decision by the Maryland PSC during the first quarter of 2008.

Florida. On October 10, 2006, the Florida division filed with the Florida PSC a petition for authority to implement phase two of its experimental transitional transportation service ("TTS") pilot program, and for approval of a new tariff to reflect the division's transportation service environment. Phase two of the TTS program for residential and certain small commercial consumers will expand the number of pool managers from one to two and increase the gas supply pricing options available to these consumers. Approved on April 24, 2007 by the Florida PSC, phase two of the TTS program went into effect on July 1, 2007.

On November 29, 2006, the Florida division filed with the Florida PSC a petition for authority to modify its energy conservation programs. In this petition, the Florida division sought approval to increase the cash allowances paid within its Residential Homebuilder Program and the Residential Appliance Replacement Program, and to expand the scope of its Residential Water Heater Retention Program to add natural gas heating systems, cooking and clothes drying appliances. The Florida PSC granted approval of the petition in an order dated March 5, 2007. The modifications and new cash allowances became effective on March 30, 2007.

On May 2, 2007, the Florida division filed its summary of activity and true-up calculation for its 2006 Energy Conservation Cost Recovery Program with the Florida PSC. On September 5, 2007, the Florida PSC issued its audit report in which less than $8,000, or one percent, of the 2006 expenditures were disallowed as non-conservation-related. The results of the audit were incorporated into the calculation of the 2008 Energy Conservation Cost Recovery Factors, which were filed with the Florida PSC on September 13, 2007, approved on November 6, 2007, and became effective on January 1, 2008.

In compliance with the Florida Administrative Code, the Florida division filed its 2007 Depreciation Study ("Study") with the Florida PSC on May 17, 2007. This study provides the Florida PSC with the opportunity to review and address changes in plant and equipment lives, salvage values, reserves and resulting life depreciation rates since the last study performed in 2002. In its filing, the Florida division has requested that any changes to the depreciation rates be made effective January 1, 2008. The Florida division responded to interrogatories concerning the Study on October 15 and December 24, 2007. While the Company cannot predict the outcome of the Florida PSC's review at this time, the Company anticipates a final decision regarding the depreciation rates in the second quarter of 2008.

On July 6, 2007, the Company and Peoples Gas Service ("PGS"), another local gas distribution company in Florida, filed a joint petition for Commission action on a territorial agreement for portions of Pasco County, a Master Territorial Agreement and a Gas Transportation Agreement filed as a special contract. PGS operates a natural gas distribution system in Pasco County but is unable to serve economically certain areas of the county. The Company entered into negotiations with PGS that would allow the Company to serve these areas by connecting to PGS' existing distribution system and to extend its facilities into these specific territories to serve primarily residential and commercial consumers. The negotiations concluded with the execution of a Pasco County Territorial Agreement that provides the Company with two distinct areas as its territory and a Gas Transportation Agreement that specifies the terms, conditions and rates for transportation service across the PGS distribution system. The Company and PGS have also entered into a Master Territorial Agreement that contains terms and conditions which will govern all existing and potential territorial agreements. The Florida PSC approved these agreements at its October 9, 2007 agenda conference.

On August 27, 2007, PIPECO, filed with the Florida PSC its petition for approval of a natural gas transmission pipeline tariff in order to establish its operating rules and regulations. The Florida PSC approved the petition at its December 4, 2007 agenda conference.

Eastern Shore. During 2007, FERC regulatory activity regarding the expansion of Eastern Shore's transmission system included the following:

System Expansion 2006 – 2008 On January 20, 2006, Eastern Shore filed with the FERC an application for a Certificate of Public Convenience and Necessity for its 2006-2008 system expansion project ("the 2006 – 2008 Project").

The application requested authority to construct and operate approximately 55 miles of new pipeline facilities and two new metering and regulating station facilities to provide an additional 47,350 dekatherms per day ("Dt/d") of firm transportation service in accordance with customer requests of 26,200 Dt/d in 2006, 10,300 Dt/d in 2007, and 10,850 Dt/d in 2008, at a total estimated cost of approximately $33.6 million. On June 13, 2006, the FERC issued a certificate authorizing Eastern Shore to construct and operate the 2006 – 2008 Project as proposed. On November 1, 2006, Eastern Shore completed and placed in service the authorized Phase I facilities.

On July 24, 2007, Eastern Shore requested FERC authorization to commence construction of a portion (approximately 4 miles) of the Phase II facilities. Eastern Shore received the requested FERC authorization on August 11, 2007. Facilities have been completed and were placed in service on November 1, 2007. These additional facilities provide for 8,300 Dts of additional firm capacity per day and annualized gross margin contribution of $1.2 million, instead of the amounts included in the original filing of 10,300 Dts of additional firm capacity per day and $1.5 million annualized gross margin contribution.

On November 15, 2007 Eastern Shore requested FERC authorization to commence construction of Phase III facilities (approximately 9.2 miles). The FERC granted this authorization on January 7, 2008. Construction activities are to begin in the first quarter of 2008 and are to be completed and placed in service on November 1, 2008. These Phase III facilities provide for 5,650 Dts of additional firm capacity per day and annualized gross margin contribution of approximately $1.0 million instead of the amounts included in the original filing of 10,850 Dts of additional firm capacity per day and $1.6 million annualized gross margin contribution.

Eastern Shore Energylink Expansion Project (“E3 Project”). In 2006, Eastern Shore proposed to develop, construct and operate approximately 75 miles of new pipeline facilities to transport natural gas from Calvert County, Maryland, crossing under the Chesapeake Bay into Dorchester and Caroline Counties, Maryland, to points on the Delmarva Peninsula where such facilities would interconnect with Eastern Shore’s existing facilities in Sussex County, Delaware.

On May 31, 2006, Eastern Shore entered into Precedent Agreements (the “Precedent Agreements”) with Delmarva Power & Light Company (“Delmarva”) and Chesapeake, through its Delaware and Maryland divisions, to provide additional firm transportation services upon completion of the E3 Project. Both Chesapeake and Delmarva are parties to existing firm natural gas transportation service agreements with Eastern Shore, and each desires additional firm transportation service under the E3 Project, as evidenced by the Precedent Agreements. Pursuant to the Precedent Agreements, the parties agreed to proceed with the required initiatives to obtain the governmental and regulatory authorizations necessary for Eastern Shore to provide, and for Chesapeake and Delmarva to utilize, additional firm transportation service under the E3 Project.

As part of the Precedent Agreements, Eastern Shore, Chesapeake and Delmarva also entered into Letter Agreements which provide that, if the event that the E3 Project is not certificated and placed in service, Chesapeake and Delmarva will each pay their proportionate share of certain pre-certification costs by means of a negotiated surcharge of up to $2 million, over a period of not less than 20 years.

In furtherance of the E3 Project, Eastern Shore submitted a petition to the FERC on June 27, 2006 seeking approval of an uncontested rate-related Settlement Agreement by and between Eastern Shore, Chesapeake and Delmarva (the “Settlement Agreement”). The Settlement Agreement provides Eastern Shore and all customers utilizing Eastern Shore’s system with benefits, including but not limited to the following: (1) advancement of a necessary infrastructure project to meet the growing demand for natural gas on the Delmarva Peninsula; (2) sharing of project development costs by the participating customers in the project; and (3) no development cost risk for non-participating customers. On August 1, 2006, the FERC approved the Settlement Agreement, which was uncontested. On September 6, 2006, Eastern Shore submitted to FERC proposed tariff sheets to implement the provisions of the Settlement Agreement. By Letter Order dated October 6, 2006, the FERC accepted the tariff sheets, effective September 7, 2006.

On April 23, 2007, Eastern Shore submitted to the FERC its request to commence a pre-filing process and on May 15, 2007, the FERC notified Eastern Shore that its request had been approved. The pre-filing process is intended to engage all interested and affected stakeholders early in the process with the intention of resolving all environmental issues prior to the formal certificate application being filed. As part of this process, Eastern Shore has performed environmental, engineering and cultural surveys and studies in the interest of protecting the environment, minimizing any potential impacts to landowners, and cultural resources. Eastern Shore has also held meetings with federal, state and local permitting/regulatory agencies, non-governmental organizations, landowners, and other interested stakeholders.

As part of an updated engineering study, Eastern Shore received additional construction cost estimates for the E3 project, which indicated substantially higher costs than previously estimated. In an effort to optimize the feasibility of the overall project development plan, Eastern Shore explored all potential construction methods, construction cost mitigation strategies, potential design changes and project schedule changes. Eastern Shore also held discussions and meetings with several potential new customers, who have expressed an interest in the project that would expand its size and likely have significant impact on the cost, timeline and in-service date.

On December 20, 2007, Eastern Shore withdrew from the pre-filing process as a result of insufficient customer commitments for capacity to make the project economical. Eastern Shore will continue to explore potential construction methods, construction cost mitigation strategies, additional market requests, and potential design changes in its efforts to improve the overall economics of the project.

If Eastern Shore decides to abandon the E3 Project, it will initiate billing of pre-certification costs surcharge in accordance with the terms of the Precedent Agreements executed with two of its customers, which provide for these customers to reimburse Eastern Shore for pre-certification costs incurred in connection with the E3 Project, up to a maximum amount of $2.0 million each over a period of 20 years. As of December 31, 2007, the Company had incurred $2.97 million of pre-certification costs relating to the E3 Project.

During 2007, Eastern Shore also had developments in the following FERC rate matters:

On October 31, 2006, Eastern Shore filed a base rate proceeding with the FERC in compliance with the settlement approved in its prior base rate proceeding. Eastern Shore's filed rates, proposed to be effective November 1, 2006, reflected an annual increase of $5,589,000 in its annual operating revenues based on increases in operating and maintenance expenses, depreciation expense, taxes other than income taxes, and return on existing gas plant facilities and new facilities placed into service by March 31, 2007.

On November 30, 2006 the FERC issued an order suspending the effectiveness of Eastern Shore's proposed rate increase until May 1, 2007, subject to refund and the outcome of the hearing established in the order. On December 19, 2006, the Presiding Administrative Law Judge ("ALJ") approved a procedural schedule to govern further proceedings in this case.

Settlement conferences were held on April 17, May 30, and June 6, 2007 at the FERC's offices in Washington, D.C. On May 14, 2007, Eastern Shore filed a motion, which the FERC granted, to make its suspended rate increase effective on May 15, 2007, subject to refund, pending the ultimate resolution of the rate case. At the June 6, 2007 conference, the parties reached a settlement agreement in principle, and on June 8, 2007, the Chief ALJ suspended the procedural schedule to allow time for the parties to draft a formal Stipulation and Agreement. The negotiated settlement provides for an annual cost of service of $21,536,000, which reflects a pretax return on equity of 13.6 percent and a rate increase of approximately $1.07 million on an annual basis. On September 10, 2007, Eastern Shore submitted its Settlement Offer to the Commission for the ALJ's review and certification to the full Commission. There were no comments filed objecting to, or in protest of, the Settlement Offer.

Eastern Shore filed concurrently with its Settlement Agreement a Motion to place the settlement rates into effect on September 1, 2007, in order to expedite the implementation of the reduced settlement rates pending final approval of the settlement. The Commission issued an order on September 25, 2007, authorizing Eastern Shore to commence billing its settlement rates effective September 1, 2007.

On October 1, 2007, the Presiding ALJ forwarded to the full Commission an order certifying the uncontested Settlement Agreement as fair, reasonable, and in the public interest. A final Commission Order approving the settlement was issued on January 31, 2008.

Environmental Matters
The Company continues to work with federal and state environmental agencies to assess the environmental impact and explore corrective action at three environmental sites (see Note M to the Consolidated Financial Statements). The Company believes that future costs associated with these sites will be recoverable in rates or through sharing arrangements with, or contributions by, other responsible parties.

Market Risk
Market risk represents the potential loss arising from adverse changes in market rates and prices. Long-term debt is subject to potential losses based on changes in interest rates. The Company's long-term debt consists of first mortgage bonds, fixed-rate senior notes and convertible debentures (see Note H to the Consolidated Financial Statements for annual maturities of consolidated long-term debt). All of the Company's long-term debt is fixed-rate debt and was not entered into for trading purposes. The carrying value of long-term debt, including current maturities, was $70.9 million at December 31, 2007, as compared to a fair value of $75.0 million, based mainly on current market prices or discounted cash flows, using current rates for similar issues with similar terms and remaining maturities. The Company evaluates whether to refinance existing debt or permanently refinance existing short-term borrowing, based in part on the fluctuation in interest rates.

The Company's propane distribution business is exposed to market risk as a result of propane storage activities and entering into fixed price contracts for supply. The Company can store up to approximately four million gallons (including leased storage and rail cars) of propane during the winter season to meet its customers' peak requirements and to serve metered customers. Decreases in the wholesale price of propane may cause the value of stored propane to decline. To mitigate the impact of price fluctuations, the Company has adopted a Risk Management Policy that allows the propane distribution operation to enter into fair value hedges of its inventory. Management reviewed the Company's storage position as of December 31, 2007, and elected not to hedge any of its inventories. At December 31, 2006, the propane distribution operation had entered into a swap agreement to protect the Company from the impact of price increases on the price-cap plan that we offer to customers. The Company considered this agreement to be an economic hedge that did not qualify for hedge accounting as described in SFAS 133. At the end of 2006, the market price of propane dropped below the unit price within the swap agreement. As a result of the price drop, the Company marked the agreement to market, which resulted in an unrealized loss of $84,000. The Company did not enter into a similar agreement in 2007.

The Company's propane wholesale marketing operation is a party to natural gas liquids ("NGL") forward contracts, primarily propane contracts, with various third parties. These contracts require that the propane wholesale marketing operation purchase or sell NGL at a fixed price at fixed future dates. At expiration, the contracts are settled by the delivery of NGL to the Company or the counter-party or "booking out" the transaction. Booking out is a procedure for financially settling a contract in lieu of the physical delivery of energy. The propane wholesale marketing operation also enters into futures contracts that are traded on the New York Mercantile Exchange. In certain cases, the futures contracts are settled by the payment or receipt of a net amount equal to the difference between the current market price of the futures contract and the original contract price; however, they may also be settled by physical receipt or delivery of propane.

The forward and futures contracts are entered into for trading and wholesale marketing purposes. The propane wholesale marketing business is subject to commodity price risk on its open positions to the extent that market prices for NGL deviate from fixed contract settlement prices. Market risk associated with the trading of futures and forward contracts is monitored daily for compliance with the Company's Risk Management Policy, which includes volumetric limits for open positions. To manage exposures to changing market prices, open positions are marked up or down to market prices and reviewed by the Company's oversight officials daily. In addition, the Risk Management Committee reviews periodic reports on market and the credit risk of counter-parties, approves any exceptions to the Risk Management Policy (within limits established by the Board of Directors) and authorizes the use of any new types of contracts. Quantitative information on forward and futures contracts at December 31, 2007 and 2006 is presented in the following tables.

At December 31, 2007	Quantity in gallons	Estimated Market Prices	Weighted Average Contract Prices
Forward Contracts			
Sale	30,941,400	$0.8925 — $1.6025	$1.3555
Purchase	30,954,000	$0.8700 — $1.6000	$1.3498

Estimated market prices and weighted average contract prices are in dollars per gallon.
All contracts expire in 2008.

At December 31, 2006	Quantity in gallons	Estimated Market Prices	Weighted Average Contract Prices
Forward Contracts			
Sale	13,797,000	$0.9250 — $1.2100	$1.0107
Purchase	13,733,800	$0.9250 — $1.2200	$1.0098

Estimated market prices and weighted average contract prices are in dollars per gallon.
All contracts expired in 2007.

The Company's natural gas distribution and marketing operations have entered into agreements with natural gas suppliers to purchase natural gas for resale to their customers. Purchases under these contracts either do not meet the definition of derivatives in SFAS No. 133 or are considered "normal purchases and sales" under SFAS No. 138 and are not marked to market.

Competition

The Company’s natural gas operations compete with other forms of energy including electricity, oil and propane. The principal competitive factors are price and, to a lesser extent, accessibility. The Company’s natural gas distribution operations have several large volume industrial customers that can use fuel oil as an alternative to natural gas. When oil prices decline, these interruptible customers may convert to oil to satisfy their fuel requirements. Lower levels of interruptible sales may occur when oil prices are lower than the price of natural gas. Oil prices, as well as the prices of electricity and other fuels, are subject to fluctuation for a variety of reasons; therefore, future competitive conditions are not predictable. To address this uncertainty, the Company uses flexible pricing arrangements on both the supply and sales sides of this business to compete with the fluctuations in its customers’ alternative fuel prices. As a result of the transmission operation’s conversion to open access and the Florida gas distribution division’s restructuring of its services, their businesses have shifted from providing bundled transportation and sales service to providing only transportation and contract storage services.

The Company’s natural gas distribution operations in Delaware, Maryland and Florida offer unbundled transportation services to certain commercial and industrial customers. In 2002, the Florida operation extended such service to residential customers. With such transportation service available on the Company’s distribution systems, the Company is competing with third-party suppliers to sell gas to industrial customers. With respect to unbundled transportation services, the Company’s competitors include interstate transmission companies, if the distribution customers are located close enough to a transmission company’s pipeline to make connections economically feasible. The customers at risk are usually large volume commercial and industrial customers with the financial resources and capability to bypass the Company’s distribution operations in this manner. In certain situations, the Company’s distribution operations may adjust services and rates for these customers to retain their business. The Company expects to continue to expand the availability of transportation service to additional classes of distribution customers in the future. The Company established a natural gas sales and supply operation in Florida to compete for customers eligible for transportation services. The Company also provides such sales service in Delaware.

The Company’s propane distribution operations compete with several other propane distributors in their service territories, primarily on the basis of service and price, emphasizing reliability of service and responsiveness. Competition is generally from local outlets of national distribution companies and local businesses because distributors located in close proximity to customers incur lower costs of providing service. Propane competes with electricity as an energy source, because it is typically less expensive than electricity, based on equivalent BTU value. Propane also competes with home heating oil as an energy source. Since natural gas has historically been less expensive than propane, propane is generally not distributed in geographic areas served by natural gas pipeline or distribution systems.

The propane wholesale marketing operation competes against various regional and national marketers, many of which have significantly greater resources and are able to obtain price or volumetric advantages.

The advanced information services business faces significant competition from a number of larger competitors having substantially greater resources available to them than does the Company. In addition, changes in the advanced information services business are occurring rapidly, which could adversely affect the markets for the products and services offered by these businesses. This segment competes on the basis of technological expertise, reputation and price.

Inflation

Inflation affects the cost of supply, labor, products and services required for operations, maintenance and capital improvements. While the impact of inflation has remained low in recent years, natural gas and propane prices are subject to rapid fluctuations. In the Company’s regulated natural gas distribution operations, fluctuations in natural gas prices are passed on to customers through the gas cost recovery mechanism in the Company’s tariffs. To help cope with the effects of inflation on its capital investments and returns, the Company seeks rate relief from regulatory commissions for its regulated operations and closely monitors the returns of its unregulated business operations. To compensate for fluctuations in propane gas prices, the Company adjusts its propane selling prices to the extent allowed by the market.

Cautionary Statement

Chesapeake Utilities Corporation has made statements in this Form 10-K that are considered to be "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. These statements are not matters of historical fact and are typically identified by words such as, but not limited to, "believes," "expects," "intends," "plans," and similar expressions, or future or conditional verbs such as "may," "will," "should," "would," and "could." T statements relate to matters such as customer growth, changes in revenues or gross margins, capital expenditures, environmental remediation costs, regulatory trends and decisions, market risks associated with our propane operations, the competitive position of the Company, inflation, and other matters. It is important to understand that these forward-looking statements are not guarantees, but are subject to certain risks and uncertainties and other important factors that could cause actual results to differ materially from those in the forward-looking statements. The factors that could cause actual results to differ materially from the Company's expectations include, but are not limited to:

- the temperature sensitivity of the natural gas and propane businesses;
- the effects of spot, forward, futures market prices, and the Company's use of derivative instruments on the Company's distribution, wholesale marketing and energy trading businesses;
- the amount and availability of natural gas and propane supplies;
- the access to interstate pipelines' transportation and storage capacity and the construction of new facilities to support future growth;
- the effects of natural gas and propane commodity price changes on the operating costs and competitive positions of our natural gas and propane distribution operations;
- third-party competition for the Company's unregulated and regulated businesses;
- changes in federal, state or local regulation and tax requirements, including deregulation;
- changes in technology affecting the Company's advanced information services segment;
- changes in credit risk and credit requirements affecting the Company's energy marketing subsidiaries;
- the effects of accounting changes;
- changes in benefit plan assumptions;
- cost of compliance with environmental regulations or the remediation of environmental damage;
- the effects of general economic conditions, including interest rates, on the Company and its customers;
- the ability of the Company's new and planned facilities and acquisitions to generate expected revenues;
- the ability of the Company to construct facilities at or below estimated costs;
- the Company's ability to obtain the rate relief and cost recovery requested from utility regulators and the timing of the requested regulatory actions;
- the Company's ability to obtain necessary approvals and permits from regulatory agencies on a timely basis;

- impact of inflation on the results of operations, cash flows, financial position and on the Company's planned capital expenditures;
- inability to access the financial markets to a degree that may impair future growth; and
- operating and litigation risks that may not be covered by insurance.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk.

Information concerning quantitative and qualitative disclosure about market risk is included in Item 7 under the heading "Management's Discussion and Analysis — Market Risk."

Item 8. Financial Statements and Supplementary Data.

Management's Report on Internal Control Over Financial Reporting
Management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rules 13a-15(f). A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Under the supervision and with the participation of management, including the principal executive officer and principal financial officer, Chesapeake's management conducted an evaluation of the effectiveness of its internal control over financial reporting based on the criteria established in a report entitled "Internal Control — Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate. Chesapeake's management has evaluated and concluded that Chesapeake's internal control over financial reporting was effective as of December 31, 2007.

Report of Independent Registered Public Accounting Firm

To the Board of Directors and

Stockholders of Chesapeake Utilities Corporation

We have audited the accompanying consolidated balance sheet of Chesapeake Utilities Corporation as of December 31, 2007, and the related consolidated statements of income, stockholders' equity, comprehensive income, cash flows and income taxes for the year then ended. Chesapeake Utilities Corporation's management is responsible for these consolidated financial statements. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Chesapeake Utilities Corporation and subsidiaries as of December 31, 2007 and the results of their operations and their cash flows for the year ended in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Chesapeake Utilities Corporation's internal control over financial reporting as of December 31, 2007, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 10, 2008 expressed an unqualified opinion.

/s/ Beard Miller Company LLP

Beard Miller Company LLP
Reading, Pennsylvania
March 10, 2008

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders
of Chesapeake Utilities Corporation

In our opinion, the consolidated balance sheet as of December 31, 2006, and the related consolidated statements of income, comprehensive income, cash flows, stockholders' equity and income taxes for each of the two years in the period ended December 31, 2006, before the effects of the adjustments to retrospectively reflect the discontinued operations described in Note B, present fairly, in all material respects, the financial position of Chesapeake Utilities Corporation and its subsidiaries at December 31, 2006, and the results of their operations and their cash flows for each of the two years in the period ended December 31, 2006, in conformity with accounting principles generally accepted in the United States of America (the 2006 financial statements before the effects of the adjustments discussed in Note B are not presented herein). In addition, in our opinion, the financial statement schedule for the each of the two years in the period ended December 31, 2006, presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements before the effects of the adjustments described above. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits. We conducted our audits, before the effects of the adjustments described above, of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note K to the consolidated financial statements, the Company changed the manner in which it accounts for defined benefit pension and other postretirement plans, effective December 31, 2006.

We were not engaged to audit, review, or apply any procedures to the adjustments to retrospectively reflect the discontinued operations described in Note B and accordingly, we do not express an opinion or any other form of assurance about whether such adjustments are appropriate and have properly applied. Those adjustments were audited by other auditors.

/s/ PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP
Boston, MA
March 10, 2007

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Consolidated Statements of Income

For the Twelve Months Ended December 31,		2007		2006		2005
Operating Revenues	$	258,286,495	$	231,199,565	$	229,485,352
Operating Expenses						
Cost of sales, excluding costs below		170,848,211		155,809,747	$	153,398,723
Operations		42,274,023		36,670,302		39,778,597
Maintenance		2,203,800		2,103,558		1,818,981
Depreciation and amortization		9,060,185		8,243,715	$	7,568,209
Other taxes		5,786,694		5,040,306	$	4,999,963
Total operating expenses		230,172,913		207,867,628		207,564,473
Operating Income		28,113,582		23,331,937		21,920,879
Other income, net of other expenses		291,305		189,093	$	382,610
Interest charges		6,589,639		5,773,993	$	5,132,458
Income Before Income Taxes		21,815,248		17,747,037		17,171,031
Income taxes		8,597,461		6,999,072		6,472,220
Income from Continuing Operations		13,217,787		10,747,965		10,698,811
Loss from discontinued operations, net of tax benefit of $10,898, $162,510 and $160,204		(20,077)		(241,440)		(231,197)
Net Income	$	13,197,710	$	10,506,525	$	10,467,614
Weighted Average Common Shares Outstanding:						
Basic		6,743,041		6,032,462		5,836,463
Diluted		6,854,716		6,155,131		5,992,552
Earnings (Loss) Per Share of Common Stock:						
Basic						
From continuing operations	$	1.96	$	1.78	$	1.83
From discontinued operations		-	$	(0.04)		(0.04)
Net Income	$	1.96	$	1.74	$	1.79
Diluted						
From continuing operations	$	1.94	$	1.76	$	1.81
From discontinued operations		-	$	(0.04)		(0.04)
Net Income	$	1.94	$	1.72	$	1.77

The accompanying notes are an integral part of the financial statements.

Consolidated Statements of Cash Flows

For the Years Ended December 31,	2007	2006	2005
Operating Activities			
Net Income	$ 13,197,710	$ 10,506,525	$ 10,467,614
Adjustments to reconcile net income to net operating cash:			
Depreciation and amortization	9,060,185	8,243,715	7,568,209
Depreciation and accretion included in other costs	3,336,506	3,102,066	2,705,620
Deferred income taxes, net	1,831,030	(408,533)	1,510,777
Gain on sale of assets	(204,882)	-	-
Unrealized gain (loss) on commodity contracts	(170,465)	37,110	(227,193)
Unrealized loss on investments	(122,819)	(151,952)	(56,650)
Employee benefits and compensation	1,825,028	382,608	1,621,607
Other, net	56	(18,596)	(62,692)
Changes in assets and liabilities:			
Sale (purchase) of investments	229,125	(177,990)	(1,242,563)
Accounts receivable and accrued revenue	(28,189,132)	9,705,860	(16,831,751)
Propane inventory, storage gas and other inventory	1,193,336	354,764	(5,704,040)
Regulatory assets	(344,680)	2,498,954	(1,719,184)
Prepaid expenses and other current assets	(1,188,481)	(271,438)	36,704
Other deferred charges	(2,477,879)	(231,822)	(102,561)
Long-term receivables	83,653	137,101	247,600
Accounts payable and other accrued liabilities	22,130,049	(11,434,370)	15,569,924
Income taxes receivable (payable)	(158,556)	1,800,913	(2,006,762)
Accrued interest	33,112	273,672	(42,376)
Customer deposits and refunds	2,534,655	2,361,265	462,781
Accrued compensation	1,117,941	(542,512)	875,342
Regulatory liabilities	2,124,091	2,824,068	144,501
Other liabilities	(157,699)	1,125,590	385,034
Net cash provided by operating activities	25,681,884	30,116,998	13,599,941
Investing Activities			
Property, plant and equipment expenditures	(31,277,390)	(48,845,828)	(33,319,613)
Proceeds from sale of assets	204,882	-	-
Environmental recoveries (expenditures)	(227,979)	(15,549)	240,336
	(31,300,487)	(48,861,377)	(33,079,277)

Net cash used by investing activities			
Financing Activities			
Common stock dividends	(7,029,821)	(5,982,531)	(5,789,180)
Issuance of stock for Dividend Reinvestment Plan	299,436	321,865	458,757
Stock issuance	-	19,698,509	-
Cash settlement of warrants	-	(434,782)	-
Change in cash overdrafts due to outstanding checks	(541,052)	49,047	874,083
Net borrowing (repayment) under line of credit agreements	18,651,055	(7,977,347)	29,606,400
Proceeds from issuance of long-term debt	-	20,000,000	-
Repayment of long-term debt	(7,656,580)	(4,929,674)	(4,794,827)
Net cash provided by financing activities	3,723,038	20,745,087	20,355,233
Net Increase (Decrease) in Cash and Cash Equivalents	(1,895,565)	2,000,708	875,897
Cash and Cash Equivalents — Beginning of Period	4,488,366	2,487,658	1,611,761
Cash and Cash Equivalents — End of Period	$ 2,592,801	$ 4,488,366	$ 2,487,658
Supplemental Disclosures of Non-Cash Investing Activities:			
Capital property and equipment acquired on account, but not paid as of December 31	$ 365,890	$ 1,490,890	$ 1,367,348
Supplemental Disclosure of Cash Flow information			
Cash paid for interest	$ 5,592,279	$ 5,334,477	$ 5,052,013
Cash paid for income taxes	$ 7,009,206	$ 6,285,272	$ 6,342,476

The accompanying notes are an integral part of the financial statements.

Consolidated Balance Sheets

Assets		December 31, 2007		December 31, 2006
Property, Plant and Equipment				
Natural gas	$	289,706,066	$	269,012,516
Propane		48,506,231		44,791,552
Advanced information services		1,157,808		1,054,368
Other plant		8,567,833		9,147,500
Total property, plant and equipment		347,937,938		324,005,936
Less: Accumulated depreciation and amortization		(92,414,289)		(85,010,472)
Plus: Construction work in progress		4,899,608		1,829,948
Net property, plant and equipment		260,423,257		240,825,412
Investments		1,909,271		2,015,577
Current Assets				
Cash and cash equivalents		2,592,801		4,488,366
Accounts receivable (less allowance for uncollectible accounts of $952,075 and $661,597, respectively)		72,218,191		44,969,182
Accrued revenue		5,265,474		4,325,351
Propane inventory, at average cost		7,629,295		7,187,035
Other inventory, at average cost		1,280,506		1,564,937
Regulatory assets		1,575,072		1,275,653
Storage gas prepayments		6,042,169		7,393,335
Income taxes receivable		1,237,438		1,078,882
Deferred income taxes		2,155,393		1,365,316
Prepaid expenses		3,496,517		2,280,900
Mark-to-market energy assets		7,812,456		1,379,896
Other current assets		146,253		173,388
Total current assets		111,451,565		77,482,241
Deferred Charges and Other Assets				
Goodwill		674,451		674,451
Other intangible assets, net		178,073		191,878
Long-term receivables		740,680		824,333
Regulatory assets		2,539,235		1,765,088
Other deferred charges		3,640,480		1,215,004
Total deferred charges and other assets		7,772,919		4,670,754

Total Assets	$	381,557,012	$	324,993,984

The accompanying notes are an integral part of the financial statements.

Consolidated Balance Sheets

Capitalization and Liabilities	December 31, 2007	December 31, 2006
Capitalization		
Stockholders' equity		
Common Stock, par value $0.4867 per share (authorized 12,000,000 shares)	$ 3,298,473	$ 3,254,998
Additional paid-in capital	65,591,552	61,960,220
Retained earnings	51,538,194	46,270,884
Accumulated other comprehensive loss	(851,674)	(334,550)
Deferred compensation obligation	1,403,922	1,118,509
Treasury stock	(1,403,922)	(1,118,509)
Total stockholders' equity	119,576,545	111,151,552
Long-term debt, net of current maturities	63,255,636	71,050,000
Total capitalization	182,832,181	182,201,552
Current Liabilities		
Current portion of long-term debt	7,656,364	7,656,364
Short-term borrowing	45,663,944	27,553,941
Accounts payable	54,893,071	33,870,552
Customer deposits and refunds	10,036,920	7,502,265
Accrued interest	865,504	832,392
Dividends payable	1,999,343	1,939,482
Accrued compensation	3,400,112	2,901,053
Regulatory liabilities	6,300,766	4,199,147
Mark-to-market energy liabilities	7,739,261	1,371,379
Other accrued liabilities	2,500,542	2,634,416
Total current liabilities	141,055,827	90,460,991
Deferred Credits and Other Liabilities		
Deferred income taxes	28,795,885	26,517,098
Deferred investment tax credits	277,698	328,277
Regulatory liabilities	1,136,071	1,236,254
Environmental liabilities	835,143	211,581
Other pension and benefit costs	2,513,030	1,608,311
Accrued asset removal cost	20,249,948	18,410,992
Other liabilities	3,861,229	4,018,928

Total deferred credits and other liabilities		57,669,004		52,331,441
Other Commitments and Contingencies (Note N)				
Total Capitalization and Liabilities	$	381,557,012	$	324,993,984

The accompanying notes are an integral part of the financial statements.

Consolidated Statements of Stockholders' Equity

For the Years Ended December 31,	2007	2006	2005
Common Stock			
Balance — beginning of year	$ 3,254,998	$ 2,863,212	$ 2,812,538
Dividend Reinvestment Plan	17,197	18,685	20,038
Retirement Savings Plan	14,388	14,457	10,255
Conversion of debentures	3,945	8,117	11,004
Performance shares and options exercised (1)	7,945	14,536	9,377
Stock issuance	-	335,991	-
Balance — end of year	3,298,473	3,254,998	2,863,212
Additional Paid-in Capital			
Balance — beginning of year	61,960,220	39,619,849	36,854,717
Dividend Reinvestment Plan	1,121,190	1,148,100	1,224,874
Retirement Savings Plan	934,295	900,354	682,829
Conversion of debentures	133,839	275,300	373,259
Performance shares and options exercised (1)	498,674	887,426	484,170
Stock-based compensation	943,334	-	-
Stock issuance	-	19,362,518	-
Exercise warrants, net of tax	-	(233,327)	-
Balance — end of year	65,591,552	61,960,220	39,619,849
Retained Earnings			
Balance — beginning of year	46,270,884	42,854,894	39,015,087
Net income	13,197,710	10,506,525	10,467,614
Cash dividends (2)	(7,930,400)	(7,090,535)	(6,627,807)
Balance — end of year	51,538,194	46,270,884	42,854,894

Accumulated Other Comprehensive Income (Loss)			
Balance — beginning of year	(334,550)	(578,151)	(527,246)
Minimum pension liability adjustment, net of tax	28,106	74,036	(50,905)
Gain (Loss) on funded status of Employee Benefit Plans, net of tax	(545,230)	169,565	-
Balance — end of year	(851,674)	(334,550)	(578,151)
Deferred Compensation Obligation			
Balance — beginning of year	1,118,509	794,535	816,044
New deferrals	285,413	323,974	130,426
Payout of deferred compensation	-	-	(151,935)
Balance — end of year	1,403,922	1,118,509	794,535
Treasury Stock			
Balance — beginning of year	(1,118,509)	(797,156)	(1,008,696)
New deferrals related to compensation obligation	(285,413)	(323,974)	(130,426)
Purchase of treasury stock	(29,771)	(51,572)	(182,292)
Sale and distribution of treasury stock	29,771	54,193	524,258
Balance — end of year	(1,403,922)	(1,118,509)	(797,156)
Total Stockholders' Equity	$ 119,576,545	$ 111,151,552	$ 84,757,183

(1) Includes amounts for shares issued for Directors' compensation.

(2) Cash dividends declared per share for 2007, 2006 and 2005 were $1.18, $1.16 and $1.14, respectively.

Consolidated Statements of Comprehensive Income						
Net income	$	13,197,710	$	10,506,525	$	10,467,614
Pension adjustments, net of tax of						
$342,320, ($48,889) and $33,615, respectively		(517,124)		74,036		(50,905)
Comprehensive Income	$	12,680,586	$	10,580,561	$	10,416,709

The accompanying notes are an integral part of the financial statements.

Consolidated Statements of Income Taxes

For the Years Ended December 31,	2007	2006	2005
Current Income Tax Expense			
Federal	$ 5,512,071	$ 5,994,296	$ 3,687,800
State	1,223,145	1,424,485	789,233
Investment tax credit adjustments, net	(50,579)	(54,816)	(54,816)
Total current income tax expense	6,684,637	7,363,965	4,422,217
Deferred Income Tax Expense (1)			
Property, plant and equipment	2,958,758	1,697,024	1,380,628
Deferred gas costs	(629,228)	(2,085,066)	1,064,310
Pensions and other employee benefits	(9,154)	(97,436)	(340,987)
Environmental expenditures	45,872	(5,580)	(98,229)
Other	(464,322)	(36,345)	(115,923)
Total deferred income tax expense (benefit)	1,901,926	(527,403)	1,889,799
Total Income Tax Expense	$ 8,586,563	$ 6,836,562	$ 6,312,016
Reconciliation of Effective Income Tax Rates			
Continuing Operations			
Federal income tax expense (2)	$ 7,635,336	$ 6,212,237	$ 6,009,861
State income taxes, net of federal benefit	1,086,680	$ 829,630	$ 732,046
Other	(124,555)	$ (42,795)	$ (269,687)
Total continuing operations	$ 8,597,461	$ 6,999,072	$ 6,472,220
Discontinued operations	$ (10,898)	$ (162,510)	$ (160,204)
Total income tax expense	$ 8,586,563	$ 6,836,562	$ 6,312,016
Effective income tax rate	39.4%	39.4%	37.6%
At December 31,	2007	2006	

Deferred Income Taxes		
Deferred income tax liabilities:		
Property, plant and equipment	$ 31,058,050	$ 27,997,744
Environmental costs	250,021	204,149
Other	860,993	870,424
Total deferred income tax liabilities	32,169,064	29,072,317
Deferred income tax assets:		
Pension and other employee benefits	2,581,853	2,225,944
Self insurance	384,009	468,922
Deferred gas costs	1,146,133	528,814
Other	1,416,577	696,855
Total deferred income tax assets	5,528,572	3,920,535
Deferred Income Taxes Per Consolidated Balance Sheet	$ 26,640,492	$ 25,151,782

(1) Includes $260,000, ($60,000), and $146,000 of deferred state income taxes for the years 2007, 2006, and 2005, respectively.
(2) Federal income taxes were recorded at 35% for each year represented.

The accompanying notes are an integral part of the financial statements.

A. Summary of Accounting Policies

Nature of Business

Chesapeake is engaged in natural gas distribution to 62,852 customers located in central and southern Delaware, Maryland's Eastern Shore and Florida. The Company's natural gas transmission subsidiary operates an interstate pipeline from various points in Pennsylvania and northern Delaware to the Company's Delaware and Maryland distribution divisions as well as other utility and industrial customers in Pennsylvania, Delaware and the Eastern Shore of Maryland. The Company's propane distribution and wholesale marketing segment provides distribution service to 34,143 customers in central and southern Delaware, the Eastern Shore of Maryland, southeastern Pennsylvania, central Florida and the Eastern Shore of Virginia and markets propane to wholesale customers including large independent oil and petrochemical companies, resellers and propane distribution companies in the southeastern United States. The advanced information services segment provides domestic and international clients with information-technology-related business services and solutions for both enterprise and e-business applications.

Principles of Consolidation

The Consolidated Financial Statements include the accounts of the Company and its wholly owned subsidiaries. The Company does not have any ownership interests in investments accounted for using the equity method or any variable interests in a variable interest entity. All intercompany transactions have been eliminated in consolidation.

System of Accounts

The natural gas distribution divisions of the Company located in Delaware, Maryland and Florida are subject to regulation by their respective PSCs with respect to their rates for service, maintenance of their accounting records and various other matters. Eastern Shore is an open access pipeline and is subject to regulation by the FERC. Our financial statements are prepared in accordance with GAAP, which give appropriate recognition to the ratemaking and accounting practices and policies of the various commissions. The propane, advanced information services and other business segments are not subject to regulation with respect to rates or maintenance of accounting records.

Property, Plant, Equipment and Depreciation

Utility and non-utility property is stated at original cost. Costs include direct labor, materials and third-party construction contractor costs, allowance for capitalized interest and certain indirect costs related to equipment and employees engaged in construction. The costs of repairs and minor replacements are charged against income as incurred, and the costs of major renewals and betterments are capitalized. Upon retirement or disposition of non-utility property, the gain or loss, net of salvage value, is charged to income. Upon retirement or disposition of utility property, the gain or loss, net of salvage value, is charged to accumulated depreciation. The provision for depreciation is computed using the straight-line method at rates that amortize the unrecovered cost of depreciable property over the estimated remaining useful life of the asset. Depreciation and amortization expenses are provided at an annual rate for each segment. The three-year average rates were three percent for natural gas distribution and transmission, five percent for propane, eleven percent for advanced information services and six percent for general plant.

At December 31,	2007	2006	Useful Life (1)
Plant in service			
Mains	$166,202,413	$151,890,304	27-41 years
Services — utility	35,127,633	32,334,145	14-33 years
Compressor station equipment	24,959,330	24,921,976	28 years
Liquefied petroleum gas equipment	25,575,213	24,627,398	30-33 years
	18,111,466	16,093,737	

Meters and meter installations			Propane 10-33 years, Natural gas 26-44 years
Measuring and regulating station equipment	14,067,262	13,272,201	27-54 years
Office furniture and equipment	9,947,881	10,114,101	Non-regulated 3-10 years, Regulated 14-28 years
Transportation equipment	11,194,916	10,686,259	3-11 years
Structures and improvements	10,024,105	9,538,345	10-44 years (2)
Land and land rights	7,404,679	7,386,268	Not depreciable, except certain regulated assets
Propane bulk plants and tanks	5,313,061	5,301,457	15 - 40 years
Various	20,009,979	17,839,745	Various
Total plant in service	347,937,938	324,005,936	
Plus construction work in progress	4,899,608	1,829,948	
Less accumulated depreciation	(92,414,289)	(85,010,472)	
Net property, plant and equipment	$260,423,257	$240,825,412	

(1) Certain immaterial account balances may fall outside this range.

The regulated operations compute depreciation in accordance with rates approved by either the state Public Service Commission or the FERC. These rates are based on depreciation studies and may change periodically upon receiving approval from the appropriate regulatory body. The depreciation rates shown above are based on the remaining useful lives of the assets at the time of the depreciation study, rather than their original lives. The depreciation rates are composite, straight-line rates applied to the average investment for each class of depreciable property and are adjusted for anticipated cost of removal less salvage value.

The non-regulated operations compute depreciation using the straight-line method over the estimated useful life of the asset.

(2) Includes buildings, structures used in connection with natural gas and propane operations, improvements to those facilities and leasehold improvements.

Cash and Cash Equivalents

The Company's policy is to invest cash in excess of operating requirements in overnight income-producing accounts. Such amounts are stated at cost, which approximates market value. Investments with an original maturity of three months or less when purchased are considered cash equivalents.

Inventories

The Company uses the average cost method to value propane and materials and supplies inventory. If market prices drop below cost, inventory balances that are subject to price risk are adjusted to market values.

Regulatory Assets, Liabilities and Expenditures

The Company accounts for its regulated operations in accordance with SFAS No. 71, "Accounting for the Effects of Certain Types of Regulation." This standard includes accounting principles for companies whose rates are determined by independent third-party regulators. When setting rates, regulators often make decisions, the economics of which require companies to defer costs or revenues in different periods than may be appropriate for unregulated enterprises. When this situation occurs, the regulated utility defers the associated costs as assets (regulatory assets) on the balance sheet and records them as expense on the income statement as it collects revenues. Further, regulators can also impose liabilities upon a company for amounts previously collected from customers, and for recovery of costs that are expected to be incurred in the future (regulatory liabilities).

At December 31, 2007 and 2006, the regulated utility operations had recorded the following regulatory assets and liabilities on the Balance Sheets. These assets and liabilities will be recognized as revenues and expenses in future periods as they are reflected in customers' rates.

At December 31,	2007	2006
Regulatory Assets		
Current		
Underrecovered purchased gas costs	$ 1,389,454	$ 1,076,921
Conservation cost recovery	-	51,408
PSC Assessment	22,290	22,290
Flex rate asset	107,394	81,926
Other	55,934	43,108
Total current	1,575,072	1,275,653
Non-Current		
Income tax related amounts due from customers	1,115,638	1,300,544
Deferred regulatory and other expenses	446,642	188,686
Deferred gas supply	15,201	15,201
Deferred post retirement benefits	111,159	138,949
Environmental regulatory assets and expenditures	850,594	121,708
Total non-current	2,539,234	1,765,088
Total Regulatory Assets	$ 4,114,306	$ 3,040,741
Regulatory Liabilities		
Current		
Self insurance — current	$ 191,004	$ 568,897
Overrecovered purchased gas costs	4,225,845	2,351,553
Shared interruptible margins	11,202	100,355
Conservation cost recovery	395,379	-

Operational flow order penalties	-	7,831
Swing transportation imbalances	1,477,336	1,170,511
Total current	6,300,766	4,199,147
Non-Current		
Self insurance — long-term	757,557	600,787
Income tax related amounts due to customers	151,521	285,819
Environmental overcollections	226,993	349,648
Total non-current	1,136,071	1,236,254
Accrued asset removal cost	20,249,948	18,410,992
Total Regulatory Liabilities	$ 27,686,785	$ 23,846,393

Included in the regulatory assets listed above are $107,000 of which is accruing interest. Of the remaining regulatory assets, $2.6 million will be collected in approximately one to two years, $293,000 will be collected within approximately 3 to 10 years, and $721,000 will be collected within approximately 11 to 15 years. In addition, there is approximately $466,000 for which the Company is awaiting regulatory approval for recovery, but once approved is expected to be collected within 12 months.

As required by SFAS No. 71, the Company monitors its regulatory and competitive environment to determine whether the recovery of its regulatory assets continues to be probable. If the Company were to determine that recovery of these assets is no longer probable, it would write off the assets against earnings. The Company believes that SFAS No. 71 continues to apply to its regulated operations, and that the recovery of its regulatory assets is probable.

Goodwill and Other Intangible Assets
The Company accounts for its goodwill and other intangibles under SFAS No. 142, "Goodwill and Other Intangible Assets." Under SFAS No. 142, goodwill is not amortized but is tested for impairment at least annually. In addition, goodwill of a reporting unit is tested for impairment between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying value. Other intangible assets are amortized on a straight-line basis over their estimated economic useful lives. Please refer to Note F "Goodwill and Other Intangible Assets" for additional discussions of this subject.

Other Deferred Charges
Other deferred charges include discount, premium and issuance costs associated with long-term debt. Debt costs are deferred and then are amortized to interest expense over the original lives of the respective debt issuances.

Income Taxes and Investment Tax Credit Adjustments
The Company files a consolidated federal income tax return. Income tax expense allocated to the Company's subsidiaries is based upon their respective taxable incomes and tax credits.

Deferred tax assets and liabilities are recorded for the tax effect of temporary differences between the financial statements bases and tax bases of assets and liabilities and are measured using the enacted tax rates in effect in the years in which the differences are expected to reverse. The portions of the Company's deferred tax liabilities applicable to utility operations, which have not been reflected in current service rates, represent income taxes recoverable through future rates. Deferred tax assets are recorded net of any valuation allowance when it is more likely than not that such tax benefits will be realized. Investment tax credits on utility property have been deferred and are allocated to income ratably over the lives of the subject property.

The Company adopted the provisions of FIN 48 "Accounting for Uncertainty in Income Taxes," effective January 1, 2007. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in a Company's financial statements in accordance with SFAS 109 "Accounting for Income Taxes." FIN 48 requires that an uncertain tax position should be recognized only if it is "more likely than not" that the position is sustainable based on technical merits. Recognizable tax positions should then be measured to determine the amount of benefit recognized in the financial statements. The Company's adoption of FIN 48 did not have an impact on its financial condition or results of operations.

Financial Instruments
Xeron, Inc. ("Xeron"), the Company's propane wholesale marketing operation, engages in trading activities using forward and futures contracts, which have been accounted for using the mark-to-market method of accounting. Under mark-to-market accounting, the Company's trading contracts are recorded at fair value, net of future servicing costs. The changes in market price are recognized as gains or losses in revenues on the income statement in the period of change. The resulting unrealized gains and losses are recorded as assets or liabilities, respectively. There were unrealized gains of $179,000 and $8,500 at December 31, 2007 and 2006, respectively. Trading liabilities are recorded in mark-to-market energy liabilities. Trading assets are recorded in mark-to-market energy assets.

The Company's natural gas and propane distribution operations have entered into agreements with natural gas and propane suppliers to purchase gas for resale to their customers. Purchases under these contracts either do not meet the definition of derivatives of SFAS No. 133 or are considered "normal purchases and sales" under SFAS No. 138 and are accounted for on an accrual basis.

The propane distribution operation may enter into a fair value hedge of its inventory in order to mitigate the impact of wholesale price fluctuations. At December 31, 2007, the Company decided not to hedge any of its propane inventories. At December 31, 2006, the propane distribution operation had entered into a swap agreement to protect the Company from the impact of price increases on the price-cap plan that we offer to customers. The Company considered this agreement to be an economic hedge that did not qualify for hedge accounting as described in SFAS 133. At the end of the 2006, the market price of propane dropped below the unit price within the swap agreement. As a result of the price drop, the Company marked the agreement to market, which resulted in an unrealized loss of $84,000.

Earnings Per Share

Chesapeake calculates earnings per share in accordance with SFAS 128 "Earnings per Share." The calculations of both basic and diluted earnings per share are presented in the following chart.

For the Periods Ended December 31,	2007	2006	2005
Calculation of Basic Earnings Per Share:			
Net Income	$ 13,197,710	$ 10,506,525	$ 10,467,614
Weighted average shares outstanding	6,743,041	6,032,462	5,836,463
Basic Earnings Per Share	$ 1.96	$ 1.74	$ 1.79
Calculation of Diluted Earnings Per Share:			
Reconciliation of Numerator:			
Net Income	$ 13,197,710	$ 10,506,525	$ 10,467,614
Effect of 8.25% Convertible debentures	95,611	105,024	123,559
Adjusted numerator — Diluted	$ 13,293,321	$ 10,611,549	$ 10,591,173
Reconciliation of Denominator:			
Weighted shares outstanding — Basic	6,743,041	6,032,462	5,836,463
Effect of dilutive securities			
Warrants	-	-	11,711
8.25% Convertible debentures	111,675	122,669	144,378
Adjusted denominator — Diluted	6,854,716	6,155,131	5,992,552
Diluted Earnings Per Share	$ 1.94	$ 1.72	$ 1.77

Operating Revenues

Revenues for the natural gas distribution operations of the Company are based on rates approved by the PSCs of the jurisdictions in which we operate. The natural gas transmission operation's revenues are based on rates approved by the FERC. Customers' base rates may not be changed without formal approval by these commissions. However, the regulatory authorities have granted the Company's regulated natural gas distribution operations the ability to negotiate rates, based on approved methodologies, with customers that have competitive alternatives. In addition, the natural gas transmission operation can negotiate rates above or below the FERC-approved tariff rates.

For regulated deliveries of natural gas, Chesapeake reads meters and bills customers on monthly cycles that do not coincide with the accounting periods used for financial reporting purposes. Chesapeake accrues unbilled revenues for gas that has been delivered, but not yet billed at the end of an accounting period to the extent that they do not coincide. In connection with this accrual, Chesapeake must estimate the amount of gas that has not been accounted for on its delivery system and must estimate the amount of the unbilled revenue by jurisdiction and customer class. A similar computation is made to accrue unbilled revenues for propane customers with meters, such as community gas system customers.

The propane wholesale marketing operation records trading activity, on a net mark-to-market basis in the Company's income statement, for open contracts. The propane distribution, advanced information services and other segments record revenue in the period the products are delivered and/or services are rendered.

Chesapeake's natural gas distribution operations in Delaware and Maryland each have a purchased gas cost recovery mechanism. This mechanism provides the Company with a method of adjusting the billing rates with its customers for changes in the cost of purchased gas included in base rates. The difference between the current cost of gas purchased and the cost of gas recovered in billed rates is deferred and accounted for as either unrecovered purchased gas costs or amounts payable to customers. Generally, these deferred amounts are recovered or refunded within one year.

The Company charges flexible rates to the natural gas distribution's industrial interruptible customers to make them competitive with alternative types of fuel. Based on pricing, these customers can choose natural gas or alternative fuels. Neither the Company nor the interruptible customer is contractually obligated to deliver or receive natural gas.

Allowance for Doubtful Accounts

An allowance for doubtful accounts is recorded against amounts due to reduce the net receivable balance to the amount we reasonably expect to collect based upon our collections experiences and our assessment of our customers' inability or reluctance to pay. If circumstances change, however, our estimate of the recoverability of accounts receivable may also change. Circumstances which could affect our estimates include, but are not limited to, customer credit issues, the level of natural gas prices and general economic conditions. Accounts are written off once they are deemed to be uncollectible.

Certain Risks and Uncertainties

The Company's financial statements are prepared in conformity with generally accepted accounting principles that require management to make estimates in measuring assets and liabilities and related revenues and expenses (see Notes M and N to the Consolidated Financial Statements for significant estimates). These estimates involve judgments with respect to, among other things, various future economic factors that are difficult to predict and are beyond the control of the Company; therefore, actual results could differ from those estimates.

The Company records certain assets and liabilities in accordance with SFAS No. 71. If the Company were required to terminate application of SFAS No. 71 for its regulated operations, all such deferred amounts would be recognized in the income statement at that time. This could result in a charge to earnings, net of applicable income taxes, which could be material.

FASB Statements and Other Authoritative Pronouncements
In June 2006, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation ("FIN") No. 48, "Employers' Accounting for Uncertainty in Income Taxes." This interpretation: (i) clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS No. 109, "Accounting for Income Taxes;" (ii) prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return; and (iii) provides guidance on derecognition and classification of uncertain tax positions, reporting of interest and penalties, accounting in interim periods, disclosure, and transition. FIN No.48 is effective for fiscal years beginning after December 15, 2006, and Chesapeake's adoption of it in the first quarter of 2007 did not have any impact on the Company's Consolidated Financial Statements.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements." This statement defines fair value, establishes a framework for measuring fair value in GAAP, and expands disclosures about fair value measurements. This statement applies under other accounting pronouncements that require or permit fair value measurements, the FASB having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, this statement does not require any new fair value measurements. Since SFAS No. 157 is effective for financial statements issued within fiscal years beginning after November 15, 2007, Chesapeake will be required to adopt this statement in the first quarter of 2008. The Company does not expect SFAS No. 157 will have a material impact on its Consolidated Financial Statements.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities-including an amendment of FASB Statement No. 115." SFAS No. 159 permits entities to measure at fair value many financial instruments and certain other items that are not currently required to be measured at fair value, with unrealized gains and losses related to these financial instruments reported in earnings at each subsequent reporting date. This Statement is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007.   The Company does not expect SFAS No. 159 will have a material impact on its Consolidated Financial Statements.

In April 2007, the FASB directed the FASB Staff to issue FSP No. FIN 39-1, "Amendment of FASB Interpretation No. 39" ("FSP FIN 39-1"). FSP FIN 39-1 modifies FIN No. 39, "Offsetting of Amounts Related to Certain Contracts," and permits companies to offset cash collateral receivables or payables with net derivative positions under certain circumstances. FSP FIN 39-1 is effective for fiscal years beginning after November 15, 2007, with early adoption permitted. The Company does not expect FSP FIN 39-1 will have a material impact its Consolidated Financial Statements.

Reclassification of Prior Years' Amounts
The Company reclassified some previously reported amounts to conform to current period classifications.

B. Business Dispositions and Discontinued Operations

During the quarter ended September 30, 2007, Chesapeake decided to close its distributed energy services subsidiary, Chesapeake OnSight Services, LLC ("OnSight"), which has experienced operating losses since its inception in 2004. OnSight was previously reported as part of the Company's Other business segment. At December 31, 2007, the results of operations for OnSight have been reclassified to discontinued operations and shown net of tax for all periods presented. For 2007, the discontinued operations experienced a net loss of $20,000, compared to a net loss of $241,000 for 2006 and a net loss of $231,000 for 2005.

C. Segment Information

The following table presents information about the Company's reportable segments. The table excludes financial data related to our distributed energy company, which was reclassed to discontinued operations for each year presented.

For the Years Ended December 31,	2007	2006	2005
Operating Revenues, Unaffiliated Customers			
Natural gas distribution, transmission and marketing	$ 180,842,699	$ 170,114,512	$ 166,388,562
Propane	62,837,696	48,575,976	48,975,349
Advanced information services	14,606,100	12,509,077	14,121,441
Other	-	-	-
Total operating revenues, unaffiliated customers	$ 258,286,495	$ 231,199,565	$ 229,485,352
Intersegment Revenues (1)			
Natural gas distribution, transmission and marketing	$ 359,235	$ 259,970	$ 193,404
Propane	406	-	668
Advanced information services	492,840	58,532	18,123
Other	622,272	618,492	618,492
Total intersegment revenues	$ 1,474,753	$ 936,994	$ 830,687
Operating Income			
Natural gas distribution, transmission and marketing	$ 22,485,266	$ 19,733,487	$ 17,235,810
Propane	4,497,843	2,534,035	3,209,388
Advanced information services	835,981	767,160	1,196,545
Other and eliminations	294,492	297,255	279,136
Operating Income	28,113,582	23,331,937	21,920,879
Other income	291,305	189,093	382,610
Interest charges	6,589,639	5,773,993	5,132,458
Income taxes	8,597,461	6,999,072	6,472,220
Net income from continuing operations	$ 13,217,787	$ 10,747,965	$ 10,698,811

Depreciation and Amortization			
Natural gas distribution, transmission and marketing	$ 6,917,609	$ 6,312,277	$ 5,682,137
Propane	1,842,047	1,658,554	1,574,357
Advanced information services	143,706	112,729	122,569
Other and eliminations	156,823	160,155	189,146
Total depreciation and amortization	$ 9,060,185	$ 8,243,715	$ 7,568,209
Capital Expenditures			
Natural gas distribution, transmission and marketing	$ 23,086,713	$ 43,894,614	$ 28,433,671
Propane	5,290,215	4,778,891	3,955,799
Advanced information services	174,184	159,402	294,792
Other	1,591,272	321,204	739,079
Total capital expenditures	$ 30,142,384	$ 49,154,111	$ 33,423,341

(1) All significant intersegment revenues are billed at market rates and have been eliminated from consolidated revenues.

At December 31,	2007	2006	2005
Identifiable Assets			
Natural gas distribution, transmission and marketing	$ 273,500,890	$ 252,292,600	$ 225,667,049
Propane	94,966,212	60,170,200	57,344,859
Advanced information services	2,507,910	2,573,810	2,062,902
Other	10,533,511	10,503,804	10,911,229
Total identifiable assets	$ 381,508,523	$ 325,540,414	$ 295,986,039

Chesapeake uses the management approach to identify operating segments. Chesapeake organizes its business around differences in products or services, and the operating results of each segment are regularly reviewed by the Company's chief operating decision maker in order to make decisions about resources and to assess performance. The segments are evaluated based on their pre-tax operating income.

The Company's operations are primarily domestic. The advanced information services segment has infrequent transactions with foreign companies, located primarily in Canada, which are denominated and paid in U.S. dollars. These transactions are immaterial to the consolidated revenues.

D. Fair Value of Financial Instruments

Various items within the balance sheet are considered to be financial instruments, because they are cash or are to be settled in cash. The carrying values of these items generally approximate their fair value (see Note E to the Consolidated Financial Statements for disclosure of fair value of investments). The Company's open forward and futures contracts at December 31, 2007 had a gain of $179,000 and at December 31, 2006 had a gain in fair value of $8,500, based on market rates at the respective dates. The fair value of the Company's long-term debt is estimated using a discounted cash flow methodology. The Company's long-term debt at December 31, 2007, including current maturities, had an estimated fair value of $75.0 million as compared to a carrying value of $70.9 million. At December 31, 2006, the estimated fair value was approximately $81.4 million as compared to a carrying value of $78.7 million. These estimates are based on published corporate borrowing rates for debt instruments with similar terms and average maturities.

E. Investments

The investment balances at December 31, 2007 and 2006 represent a Rabbi Trust associated with the Company's Supplemental Executive Retirement Savings Plan. In accordance with SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities," the Company classifies these investments as trading securities. As a result of classifying them as trading securities, the Company is required to report the securities at their fair value, with any unrealized gains and losses included in other income. The Company also has an associated liability that is recorded and adjusted each month for the gains and losses incurred by the Trust. At December 31, 2007 and 2006, total investments had a fair value of $1.9 million and $2.0 million, respectively.

F. Goodwill and Other Intangible Assets

In accordance with SFAS No. 142, goodwill is tested for impairment at least annually. In addition, goodwill of a reporting unit is tested for impairment between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying value. The propane unit had $674,000 in goodwill for the two years ended December 31, 2007 and 2006. Testing for 2007 and 2006 has indicated that no impairment of the goodwill has occurred.

The carrying value and accumulated amortization of intangible assets subject to amortization for the years ended December 31, 2007 and 2006 are as follow:

	December 31, 2007		December 31, 2006	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization

Customer lists	$ 115,333	$ 82,269	$ 115,333	$ 75,057
Acquisition costs	263,659	118,649	263,659	112,057
Total	$ 378,992	$ 200,918	$ 378,992	$ 187,114

Amortization of intangible assets was $14,000 for the years ended December 31, 2007 and 2006. The estimated annual amortization of intangibles is $14,000 per year for each of the years 2008 through 2012.

G. Stockholders' Equity

Changes in common stock shares issued and outstanding are shown in the table below:

For the Years Ended December 31,	2007	2006	2005
Common Stock shares issued and outstanding (1)			
Shares issued — beginning of period balance	6,688,084	5,883,099	5,778,976
Dividend Reinvestment Plan (2)	35,333	38,392	41,175
Retirement Savings Plan	29,563	29,705	21,071
Conversion of debentures	8,106	16,677	22,609
Employee award plan	350	350	-
Performance shares and options exercised (3)	15,974	29,516	19,268
Public offering	-	690,345	-
Shares issued — end of period balance (4)	6,777,410	6,688,084	5,883,099
Treasury shares — beginning of period balance	-	(97)	(9,418)
Purchases	-	-	(4,852)
Dividend Reinvestment Plan	-	-	2,142
Retirement Savings Plan	-	-	12,031
Other issuances	-	97	-
Treasury Shares — end of period balance	-	-	(97)
Total Shares Outstanding	6,777,410	6,688,084	5,883,002

(1) 12,000,000 shares are authorized at a par value of $0.4867 per share.
(2) Includes shares purchased with reinvested dividends and optional cash payments.
(3) Includes shares issued for Directors' compensation.
(4) Includes 57,309, 48,187, and 37,528 shares at December 31, 2007, 2006 and 2005, respectively, held in a Rabbi Trust established by the Company relating to the Deferred Compensation Plan.

In 2000 and 2001, the Company entered into agreements with an investment banker to assist in identifying acquisition candidates. Under the agreements, the Company issued warrants to the investment banker to purchase 15,000 shares of Chesapeake stock in 2000, at an exercise price of $18.00 per share and 15,000 in 2001 at an exercise price of $18.25 per share. In August 2006, the investment banker exercised the 30,000 warrants pursuant to the terms of the agreement at $33.3657 per share. At the request of the investment banker, Chesapeake settled the warrants with a cash payment of $435,000, in lieu of issuing shares of the Company's common stock. At December 31, 2007 and 2006, Chesapeake did not have any stock warrants outstanding.

On November 21, 2006, the Company completed a public offering of 600,300 shares of its common stock at a price per share of $30.10. On November 30, 2006, the Company completed the sale of 90,045 additional shares of its common stock, pursuant to the over-allotment option granted to the Underwriters by the Company. The net proceeds from the sale of common stock, after deducting underwriting commissions and expenses, were approximately $19.8 million, which were added to the Company's general funds and used primarily to repay a portion of the Company's short-term debt under unsecured lines of credit.

H. Long-term Debt

The Company's outstanding long-term debt, net of current maturities, is as shown below.

At December 31,	2007	2006
Uncollateralized senior notes:		
7.97% note, due February 1, 2008	$0	$1,000,000
6.91% note, due October 1, 2010	1,818,182	2,727,273
6.85% note, due January 1, 2012	3,000,000	4,000,000
7.83% note, due January 1, 2015	12,000,000	14,000,000
6.64% note, due October 31, 2017	24,545,454	27,272,727
5.50% note, due October 12, 2020	20,000,000	20,000,000
Convertible debentures:		
8.25% due March 1, 2014	1,832,000	1,970,000
Promissory note	60,000	80,000
Total Long-Term Debt	$63,255,636	$71,050,000

Annual maturities of consolidated long-term debt for the next five years are as follows: $7,656,364 for 2008;
$6,656,364 for 2009,$6,656,364 for 2010, $7,747,273 for 2011, $6,727,273 for 2012.

The convertible debentures may be converted, at the option of the holder, into shares of the Company's common stock at a conversion price of $17.01 per share. During 2007 and 2006, debentures totaling $138,000 and $284,000, respectively, were converted to stock. The debentures are also redeemable for cash at the option of the holder, subject to an annual non-cumulative maximum limitation of $200,000. In 2007 and 2006, no debentures were redeemed for cash. During 2005, debentures totaling $5,000 were redeemed for cash. At the Company's option, the debentures may be redeemed at stated amounts.

On October 12, 2006, the Company issued $20 million of 5.5 percent Senior Notes to three institutional investors (The Prudential Insurance Company of America, Prudential Retirement Insurance and Annuity Company and United Omaha Life Insurance Company). The original note agreement was executed on October 18, 2005 and provided for the Company to sell the Notes at any time prior to January 15, 2007. The terms of the Notes require annual principal repayments of $2 million beginning on the fifth anniversary of the issuance of the Notes. The Notes will mature on October 12, 2020. The proceeds from this issuance were used to reduce a portion of the Company's outstanding short-term debt.

Indentures to the long-term debt of the Company and its subsidiaries contain various restrictions. The most stringent restrictions state that the Company must maintain equity of at least 40 percent of total capitalization, and the pro-forma fixed charge coverage ratio must be 1.5 times. The Company is in compliance with all of its debt covenants.

I. Short-term Borrowing

The Board of Directors has authorized the Company to borrow up to $55.0 million of short-term debt, as required, from various banks and trust companies under short-term lines of credit. As of December 31, 2007, Chesapeake had five unsecured bank lines of credit with three financial institutions, totaling $90.0 million, none of which requires compensating balances. These bank lines are available to provide funds for the Company's short-term cash needs to meet seasonal working capital requirements and to fund temporarily portions of its capital expenditures. Three of the bank lines, totaling $25.0 million, are committed. Advances offered under the uncommitted lines of credit are subject to the discretion of the banks. The outstanding balance of short-term borrowing at December 31, 2007 and 2006 was $45.7 million and $27.6 million, respectively. The annual weighted average interest rates on short-term debt were 5.46 percent and 5.47 percent for 2007 and 2006, respectively.

The Company also had a letter of credit outstanding with its primary insurance company in the amount of $775,000 as security to satisfy the deductibles under the Company's various insurance policies. This letter of credit reduced the amounts available under the lines of credit and is scheduled to expire on May 31, 2008. The Company does not anticipate that this letter of credit will be drawn upon by the counterparty, and the Company expects that it will be renewed as necessary.

J. Lease Obligations

The Company has entered into several operating lease arrangements for office space at various locations, equipment and pipeline facilities. Rent expense related to these leases was $736,000, $680,000, and $837,000 for 2007, 2006, and 2005, respectively. Future minimum payments under the Company's current lease agreements are $791,000, $668,000, $544,000, $531,000 and $636,000 for the years 2008 through 2012, respectively; and $2.3 million thereafter, with an aggregate total of $5.4 million.

K. Employee Benefit Plans

Retirement Plans

Before 1999, Company employees generally participated in both a defined benefit pension plan ("Defined Pension Plan") and a Retirement Savings Plan. Effective January 1, 1999, the Company restructured its retirement program to compete more effectively with similar businesses. As part of this restructuring, the Company closed the Defined Pension Plan to new participants. Employees who participated in the Defined Pension Plan at that time were given the option of remaining in (and continuing to accrue benefits under) the Defined Pension Plan or receiving an enhanced matching contribution in the Retirement Savings Plan.

Because the Defined Pension Plan was not open to new participants, the number of active participants in that plan decreased and is approaching the minimum number needed for the Defined Pension Plan to maintain its tax-qualified status. To avoid jeopardizing the tax-qualified status of the Defined Pension Plan, the Company's Board of Directors amended the Defined Pension Plan on September 24, 2004. To ensure that the Company continues to provide appropriate levels of benefits to the Company's employees, the Board amended the Defined Pension Plan and the Retirement Savings Plan, effective January 1, 2005, so that Defined Pension Plan participants who were actively employed by the Company on that date: (1) receive two additional years of benefit service credit to be used in calculating their Defined Pension Plan benefit (subject to the Defined Pension Plan’s limit of 35 years of benefit service credit), (2) have the option to receive their Defined Pension Plan benefit in the form of a lump sum at the time they retire, and (3) are eligible to receive the enhanced matching contribution in the Retirement Savings Plan. In addition, effective January 1, 2005, the Board amended the Defined Pension Plan so that participants will not accrue any additional benefits under that plan. These changes were communicated to the Company’s employees during the first week of November 2004.

In September 2006, the FASB issued SFAS No. 158, “Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans” (SFAS 158). The Company adopted SFAS 158 prospectively on December 31, 2006. SFAS 158 requires that we recognize all obligations related to defined benefit pensions and other postretirement benefits. This statement requires that we quantify the plans’ funded status as an asset or a liability on our consolidated balance sheets.

SFAS 158 requires that we measure the plans’ assets and obligations that determine our funded status as of the end of the fiscal year. The Company is also required to recognize as a component of accumulated other comprehensive income (“AOCI”) the changes in funded status that occurred during the year that are not recognized as part of net periodic benefit cost, as explained in SFAS No. 87, “Employers’ Accounting for Pensions,” or SFAS No. 106, “Employers’ Accounting for Postretirement Benefits Other Than Pensions.”

At December 31, 2007, the funded status of the Company’s Defined Pension Plan was a liability of $274,739; at December 31, 2006 it was an asset of $590,560. In order to account for the liability and decrease in the funded status in accordance with FAS 158, the Company took a charge of $568,316, net of tax, to Comprehensive Income. In addition, the funded status of the postretirement health and life insurance plan was a liability of $1.756 million at December 31, 2007 compared to $1.763 million at December 31, 2006. To adjust for the reduced liability for the postretirement health and life insurance plan, as required by FAS 158, the Company recorded income of $23,086, net of tax, to Comprehensive Income.

The amounts in AOCI for the respective retirement plans that are expected to be recognized as a component of net benefit cost in 2008 are set forth in the following table.

	Defined Benefit Pension	Executive Excess Defined Benefit Pension	Other Postretirement Benefit
Prior service cost (credit)	$(4,699)	-	-
Loss (gain)	-	$46,444	$130,973

Defined Benefit Pension Plan

As described above, effective January 1, 2005, the Defined Pension Plan was frozen with respect to additional years of service or additional compensation. Benefits under the plan were based on each participant’s years of service and highest average compensation, prior to the freeze. The Company’s funding policy provides that payments to the trustee shall be equal to the minimum funding requirements of the Employee Retirement Income Security Act of 1974. The Company does not expect to be required to make any funding payments to the Defined Pension Plan in 2008. The measurement dates for the Pension Plan were December 31, 2007 and 2006.

The following schedule summarizes the assets of the Defined Pension Plan, by investment type, at December 31, 2007, 2006 and 2005:

At December 31,	2007	2006	2005
Asset Category			
Equity securities	49.03%	77.34%	76.12%
Debt securities	50.26%	18.59%	23.28%
Other	0.71%	4.07%	0.60%
Total	100.00%	100.00%	100.00%

The asset listed as “Other” in the above table represents monies temporarily held in money market funds. The money market fund invests at least 80 percent of its total assets in:

- United States Government obligations; and
- Repurchase agreements that are fully collateralized by such obligations.

The investment policy of the Plan calls for an allocation of assets between equity and debt instruments with equity being 60 percent and debt at 40 percent, but allowing for a variance of 20 percent in either direction. In addition, as changes are made to holdings, cash, money market funds or United States Treasury Bills may be held temporarily by the fund. Investments in the following are prohibited: options, guaranteed investment contracts, real estate, venture capital, private placements, futures, commodities, limited partnerships and Chesapeake stock; short selling and margin transactions are prohibited as well. During 2004, Chesapeake modified its investment policy to allow the Employee Benefits Committee to reallocate investments to better match the expected life of the plan.

The following schedule sets forth the funded status of the Defined Pension Plan at December 31, 2007, 2006 and 2005:

At December 31,	2007	2006	2005
Change in benefit obligation:			
Benefit obligation — beginning of year	$ 11,449,725	$ 12,399,621	$ 12,053,063
Interest cost	622,057	635,877	645,740
Change in assumptions	-	(301,851)	388,979
Actuarial loss	282,684	607	28,895
Benefits paid	(1,280,946)	(1,284,529)	(717,056)
Benefit obligation — end of year	11,073,520	11,449,725	12,399,621
Change in plan assets:			
Fair value of plan assets — beginning of year	12,040,287	11,780,866	12,097,248
Actual return on plan assets	39,440	1,543,950	400,674
Benefits paid	(1,280,946)	(1,284,529)	(717,056)
Fair value of plan assets — end of year	10,798,781	12,040,287	11,780,866
Reconciliation of funded status: (1)			
Plan assets in excess (less than) benefit obligation at year-end	(274,739)	590,560	(618,755)
Unrecognized prior service cost	-	-	(34,259)
Unrecognized net actuarial gain	-	-	(129,739)
Net amount accrued	$ (274,739)	$ 590,560	$ (782,753)
Assumptions:			
Discount rate	5.50%	5.50%	5.25%
Expected return on plan assets	6.00%	6.00%	6.00%

(1) After the adoption of SFAS 158 on December 31, 2006, these amounts are recorded and this reconciliation is no longer required.

The Company reviewed the assumptions used for the discount rate to calculate the benefit obligation of the plan and has elected to maintain the rate at 5.50 percent, reflecting relatively no change in the interest rates of high quality bonds and reflecting the expected life of the plan, in light of the lump sum payment option. In addition, the average expected return on plan assets for the Defined Pension Plan remained constant at six percent due to the adoption of a change in the investment policy that allows for a higher level of investment in bonds and a lower level of equity investments. Since the Plan is frozen in regard additional years of service and compensation, the rate of assumed compensation rate increases is not applicable. The accumulated benefit obligation was $11.1 million and $11.4 million at December 31, 2007 and 2006, respectively.

Net periodic pension benefit for the Defined Pension Plan for 2007, 2006, and 2005 include the components as shown below:

For the Years Ended December 31,	2007	2006	2005
Components of net periodic pension cost:			
Interest cost	$622,057	$635,877	$645,740
Expected return on assets	(696,398)	(690,533)	(703,285)
Amortization of:			
Prior service cost	(4,699)	(4,699)	(4,699)
Net periodic pension benefit	($79,040)	($59,355)	($62,244)
Assumptions:			
Discount rate	5.50%	5.25%	5.50%
Expected return on plan assets	6.00%	6.00%	6.00%

Executive Excess Defined Benefit Pension Plan

The Company also provides an unfunded executive excess defined benefit pension plan (“Pension SERP”). As noted above, this plan was frozen with respect to additional years of service and additional compensation as of December 31, 2004. Benefits under the plan were based on each participant’s years of service and highest average compensation, prior to the freeze. The accumulated benefit obligation was $2.32 million and $2.29 million at December 31, 2007 and 2006, respectively.

The following schedule sets forth the status of the Pension SERP:

At December 31,	2007	2006	2005
Change in benefit obligation:			
Benefit obligation — beginning of year	$ 2,286,970	$ 2,322,471	$ 2,162,952
Interest cost	123,361	119,588	119,658
Actuarial (gain) loss	5,123	(65,886)	133,839
Benefits paid	(89,204)	(89,203)	(93,978)
Benefit obligation — end of year	2,326,250	2,286,970	2,322,471
Change in plan assets:			
Fair value of plan assets — beginning of year	-	-	-
Employer contributions	89,204	89,203	93,978
Benefits paid	(89,204)	(89,203)	(93,978)
Fair value of plan assets — end of year	-	-	-
Funded status	(2,326,250)	(2,286,970)	(2,322,471)
Unrecognized net actuarial loss	-	-	959,492
Net amount accrued (1)	$ (2,326,250)	$ (2,286,970)	$ (1,362,979)
Assumptions:			
Discount rate	5.50%	5.50%	5.25%

(1) After the adoption of SFAS 158 on December 31, 2006, these amounts are recorded and this reconciliation is no longer required.

The Company reviewed the assumptions used for the discount rate of the plan to calculate the benefit obligation and has elected to maintain the rate at 5.50 percent, reflecting relatively no change in the interest rates of high quality bonds and a reduction in the expected life of the plan. Since the Plan is frozen in regard to additional years of service and compensation, the rate of assumed pay rate increases is not applicable. The measurement dates for the Pension SERP were December 31, 2007 and 2006.

Net periodic pension costs for the Pension SERP for 2007, 2006, and 2005 include the components as shown below:

For the Years Ended December 31,	2007	2006	2005
Components of net periodic pension cost:			
Service cost	$ 0	$ 0	$ 0
Interest cost	123,361	119,588	119,658
Amortization of:			
Actuarial loss	51,734	57,039	49,319

Net periodic pension cost	$ 175,095	$ 176,627	$ 168,977
Assumptions:			
Discount rate	5.50%	5.25%	5.50%

Other Postretirement Benefits

The Company sponsors a defined benefit postretirement health care and life insurance plan that covers substantially all employees. The following schedule sets forth the status of the postretirement health care and life insurance plan:

At December 31,	2007	2006	2005
Change in benefit obligation:			
Benefit obligation — beginning of year	$ 1,763,108	$ 1,534,684	$ 1,599,280
Retirees	56,123	264,470	(59,152)
Fully-eligible active employees	21,012	(114,082)	(31,761)
Other active	(84,679)	78,036	26,317
Benefit obligation — end of year	$ 1,755,564	$ 1,763,108	$ 1,534,684
Change in plan assets:			
Fair value of plan assets — beginning of year	-	-	-
Employer contributions	243,660	300,360	89,238
Plan participant's contributions	100,863	94,914	72,866
Benefits paid	(344,523)	(395,274)	(162,104)
Fair value of plan assets — end of year	-	-	-
Funded status	$ (1,755,564)	$ (1,763,108)	$ (1,534,684)
Unrecognized transition obligation	-	-	22,282
Unrecognized net actuarial loss	-	-	751,450
Net amount accrued (1)	$ (1,755,564)	$ (1,763,108)	$ (760,952)
Assumptions:			
Discount rate	5.50%	5.50%	5.25%

(1) After the adoption of SFAS 158 on December 31, 2006, these amounts are recorded and this reconciliation is no longer required.

Net periodic postretirement costs for 2007, 2006 and 2005 include the following components:

For the Years Ended December 31,	2007	2006	2005
Components of net periodic postretirement cost:			
Service cost	$ 6,203	$ 9,194	$ 6,257
Interest cost	101,776	93,924	77,872
Amortization of:			
Transition obligation	-	22,282	27,859
Actuarial loss	166,423	144,694	88,291
Net periodic postretirement cost	$ 274,402	$ 270,094	$ 200,279

The health care inflation rate for 2007 to calculate the benefit obligation is assumed to be 5.5 percent for medical and 7 percent for prescription drugs. These rates are projected to decrease to ultimate rates of five and six percent, respectively, by the year 2009. A one percentage point increase in the health care inflation rate from the assumed rate would increase the accumulated postretirement benefit obligation by approximately $242,000 as of January 1, 2008, and would increase the aggregate of the service cost and interest cost components of the net periodic postretirement benefit cost for 2008 by approximately $15,000. A one percentage point decrease in the health care inflation rate from the assumed rate would decrease the accumulated postretirement benefit obligation by approximately $200,000 as of January 1, 2008, and would decrease the aggregate of the service cost and interest cost components of the net periodic postretirement benefit cost for 2008 by approximately $12,000. The measurement dates were December 31, 2007 and 2006.

Estimated Future Benefit Payments

The schedule below shows the estimated future benefit payments for each of the years 2008 through 2012 and the aggregate of the next five years for each of the plans previously described.

	Defined Benefit Pension Plan (1)	Executive Excess Defined Benefit Pension Plan (2)	Other Post-Retirement Benefits (2)
2008	$ 734,940	$ 87,959	$ 196,449
2009	1,363,074	86,586	199,250
2010	921,490	85,081	208,938
2011	437,213	83,444	195,679
2012	1,332,896	113,415	204,524
Years 2013 through 2017	3,755,455	835,415	1,081,460

(1) The pension plan is funded; therefore, benefit payments are expected to be paid out of the plan assets.

(2) Benefit payments are expected to be paid out of the general funds of the Company.

Retirement Savings Plan

The Company sponsors a 401(k) Retirement Savings Plan, which provides participants a mechanism for making contributions for retirement savings. Each participant may make pre-tax contributions of up to 15 percent of eligible base compensation, subject to Internal Revenue Service limitations. These participants were eligible for the enhanced matching described below, effective January 1, 2005.

Effective January 1, 1999, the Company began offering an enhanced 401(k) Plan to all new employees, as well as existing employees who elected to no longer participate in the Defined Pension Plan. The Company makes matching contributions of up to six percent of each employee's pre-tax compensation for the year, except for the employees of our Advanced Information Services segment. The match is between 100 percent and 200 percent of the employee’s contribution, based on the employee’s age and years of service. The first 100 percent is matched with Chesapeake common stock. The remaining match is invested in the Company’s 401(k) Plan according to each employee’s election options.

Effective July 1, 2006, the Company’s contribution made on behalf of Advanced Information Services segment employees, is a 50 percent matching contribution, up to six percent of the employee’s annual compensation. The matching contribution is funded in Chesapeake common stock. The Plan was also amended at the same time to enable it to receive discretionary profit-sharing contributions in the form of employee pre-tax deferrals. The extent to which the Advanced Information Services segment has any dollars available for profit-sharing is dependent upon the extent to which actual earnings exceed budgeted earnings. Any profit-sharing dollars made available to employees can be deferred into the Plan and/or paid out in the form of a bonus.

On December 1, 2001, the Company converted the 401(k) fund holding Chesapeake stock to an Employee Stock Ownership Plan (“ESOP”).

Effective January 1, 1999, the Company began offering a non-qualified supplemental employee retirement savings plan (“401(k) SERP”) open to Company executives over a specific income threshold. Participants receive cash only matching contribution percentage equivalent to their 401(k) match level. All contributions and matched funds can be invested among the twenty-one mutual funds available for investment. These same funds are available for investment of employee contributions within the Retirement Savings Plan. All obligations arising under the 401(k) SERP are payable from the general assets of Chesapeake, although Chesapeake has established a Rabbi Trust to help pay benefits under the 401(k) SERP. As discussed further in Note E – “Investments,” to the Consolidated Financial Statements, the assets held in the Rabbi Trust had a fair value of $1.9 million and $2.0 million at December 31, 2007 and 2006, respectively. The assets of the Rabbi Trust are at all times subject to the claims of Chesapeake’s general creditors.

The Company’s contributions to the 401(k) plans totaled $1.48 million, $1.61 million, and $1.68 million for the years ended December 31, 2007, 2006, and 2005, respectively. As of December 31, 2007, there are 47,916 shares reserved to fund future contributions to the Retirement Savings Plan.

Deferred Compensation Plan

On December 7, 2006, the Board of Directors approved the Chesapeake Utilities Corporation Deferred Compensation Plan (“Deferred Compensation Plan”), as amended, effective January 1, 2007. The Deferred Compensation Plan is a non-qualified, deferred compensation arrangement under which certain executives and members of the Board of Directors are able to defer payment of part or all of certain specified types of compensation, including executive cash bonuses, executive performance shares, and directors' fees. At December 31, 2007, the Deferred Compensation Plan consists solely of shares of common stock related to the deferral of executive performance shares and directors’ stock retainers.

Participants in the Deferred Compensation Plan are able to elect the payment of benefits to begin on a specified future date after the election is made in the form of a lump sum or annual installments. Deferrals of executive cash bonuses and directors' cash retainers and fees shall be paid in cash. All deferrals of executive performance shares and directors' stock retainers shall be paid in shares of the Company's common stock, except that cash shall be paid in lieu of fractional shares.

The Company established a Rabbi Trust in connection with the Deferred Compensation Plan. The value of the Company's stock held in the Rabbi Trust is classified within the stockholders' equity section of the Balance Sheet and has been accounted for in a manner similar to treasury stock. The amounts recorded under the Deferred Compensation Plan totaled $1.4 million and $1.1 million at December 31, 2007 and 2006, respectively.

L. Share-Based Compensation Plans

The Company accounts for its share-based compensation arrangements under SFAS No. 123 (revised 2004), "Share Based Payments" ("SFAS 123R"), which requires companies to record compensation costs for all share-based awards over the respective service period for employee services received in exchange for an award of equity or equity-based compensation. The compensation cost is based on the fair value of the grant on the date it was awarded. The Company currently has two share-based compensation plans, the Directors Stock Compensation Plan ("DSCP") and the Performance Incentive Plan ("PIP"), that require accounting under SFAS 123R.

The table below presents the amounts included in net income, after tax, related to share-based compensation expense, for the restricted stock awards issued under the DSCP and the PIP.

For the year ended December 31,	2007	2006	2005
Directors Stock Compensation Plan	$ 110,360	$ 100,860	$ 83,980
Performance Incentive Plan	493,510	332,110	439,580
Amounts included in net income, after tax	$ 603,870	$ 432,970	$ 523,560

Stock Options
The Company did not have any stock options outstanding at December 31, 2007 or December 31, 2006, nor were any stock options issued during 2007 and 2006.

Directors Stock Compensation Plan
Under the DSCP, each non-employee director of the Company received in 2007 an annual retainer of 600 shares of common stock and an additional 150 shares of common stock for services as a committee chairman. Shares issued under the DSCP are fully vested as of the date of the grant. The Company records a prepaid expense as of the date of the grant equal to the fair value of the shares issued and amortizes the expense equally over a service period of one year.

A summary of restricted stock activity under the DSCP for the three years of 2007, 2006, and 2005 is presented below:

	Number of Restricted Shares	Weighted Average Grant Date Fair Value
Outstanding — December 31, 2004	-	
Issued — May 5, 2005	5,850	$ 24.68
Vested	5,850	
Outstanding — December 31, 2005	-	
Issued — May 2, 2006	5,850	$ 30.02

Vested	5,850		
Outstanding — December 31, 2006	-		
Issued — May 2, 2007	5,850	$	31.38
Vested	5,850		
Outstanding — December 31, 2007	-		

Compensation expense related to DSCP awards recorded by the Company for the years 2007, 2006, and 2005 is presented in the following table:

For the year ended December 31,		2007		2006		2005
Compensation expense for DSCP	$	180,920	$	165,340	$	137,670

As of December 31, 2007, there were 57,450 shares reserved for issuance under the terms of the Company's DSCP.

Performance Incentive Plan ("PIP")
The Company's Compensation Committee of the Board of Directors is authorized to grant key employees of the Company the right to receive awards of shares of the Company's common stock, contingent upon the achievement of established performance goals. These awards are subject to certain post-vesting transfer restrictions. The shares granted under the PIP are fully vested, and the fair value of each share is equal to the market price of the Company's common stock on the date of grant.

A summary of restricted stock activity under the PIP for the three years of 2007, 2006, and 2005 is presented below:

	Number of Restricted Shares	Weighted Average Grant Date Fair Value
Outstanding — December 31, 2004	-	
Issued — February 24, 2005	10,130	$ 27.00
Vested	10,130	
Outstanding — December 31, 2005	-	
Issued — February 23, 2006	23,666	$ 30.40
Vested	23,666	
Outstanding — December 31, 2006	-	
Issued — March 1, 2007	10,124	$ 30.89
Vested	10,124	
Outstanding — December 31, 2007	-	

Compensation expense related to the PIP recorded by the Company during the three years of 2007, 2006, and 2005 is presented in the following table:

For the year ended December 31,	2007	2006	2005
Compensation expense for PIP	$ 809,030	$ 544,450	$ 720,630

As of December 31, 2007, there were 389,876 shares reserved for issuance under the terms of the Company’s PIP.

M. Environmental Commitments and Contingencies

Chesapeake is subject to federal, state and local laws and regulations governing environmental quality and pollution control. These laws and regulations require the Company to remove or remedy the effect on the environment of the disposal or release of specified substances at current and former operating sites.

In 2004, Chesapeake received a Certificate of Completion for the remedial work performed at a former manufactured gas plant site located in Dover, Delaware. Chesapeake is also currently participating in the investigation, assessment or remediation of two additional former manufactured gas plant sites located in Maryland and Florida. The Company has accrued liabilities for the three sites referred to, respectively, as the Dover Gas Light, Salisbury Town Gas Light and the Winter Haven Coal Gas sites. The Company has been in discussions with the Maryland Department of the Environment (“MDE”) regarding a fourth former manufactured gas plant site located in Cambridge, Maryland. The following discussion provides details of each site.

Dover Gas Light Site

The Dover Gas Light site is a former manufactured gas plant site located in Dover, Delaware. On January 15, 2004, the Company received a Certificate of Completion of Work from the United States Environmental Protection Agency (“EPA”) regarding this site. This concluded Chesapeake’s remedial action obligation related to this site and relieves Chesapeake from liability for future remediation at the site, unless previously unknown conditions are discovered at the site, or information previously unknown to the EPA is received that indicates the remedial action that has been taken is not sufficiently protective. These contingencies are standard and are required by the EPA in all liability settlements.

The Company has reviewed its remediation costs incurred to date for the Dover Gas Light site and has concluded that all costs incurred have been paid. The Company does not expect any future environmental expenditure for this site. Through December 31, 2007, the Company has incurred approximately $9.67 million in costs related to environmental testing and remedial action studies at the site. Approximately $9.96 million has been recovered through December 2007 from other parties or through rates. As of December 31, 2007, a regulatory liability of approximately $294,500, representing the over-recovery portion of the clean-up costs, has been recorded. The over-recovery is temporary and will be refunded by the Company to customers in future rates.

Salisbury Town Gas Light Site
In cooperation with the MDE, the Company has completed remediation of the Salisbury Town Gas Light site, located in Salisbury, Maryland, where it was determined that a former manufactured gas plant had caused localized ground-water contamination. During 1996, the Company completed construction and began Air Sparging and Soil-Vapor Extraction ("AS/SVE") remediation procedures. Chesapeake has been reporting the remediation and monitoring results to the MDE on an ongoing basis since 1996. In February 2002, the MDE granted permission to decommission permanently the AS/SVE system and to discontinue all on-site and off-site well monitoring, except for one well that is being maintained for continued product monitoring and recovery. Chesapeake has requested a No Further Action determination and is awaiting such a determination from the MDE.

Through December 31, 2007, the Company has incurred approximately $2.9 million for remedial actions and environmental studies at the Salisbury Town Gas Light site. Of this amount, approximately $1.88 million has been recovered through insurance proceeds or in rates. On September 26, 2006, the Company received approval from the Maryland Public Service Commission to recover, through its rates charged to customers, the remaining $1.02 million of the incurred environmental remediation costs.

Winter Haven Coal Gas Site
The Winter Haven Coal Gas site is located in Winter Haven, Florida. Chesapeake has been working with the Florida Department of Environmental Protection ("FDEP") in assessing this coal gas site. In May 1996, the Company filed with the FDEP an AS/SVE Pilot Study Work Plan (the "Work Plan") for the Winter Haven Coal Gas site. After discussions with the FDEP, the Company filed a modified Work Plan, which contained a description of the scope of work to complete the site assessment activities and a report describing a limited sediment investigation performed in 1997. In December 1998, the FDEP approved the modified Work Plan, which the Company completed during the third quarter of 1999. In February 2001, the Company filed a Remedial Action Plan ("RAP") with the FDEP to address the contamination of the subsurface soil and ground-water in a portion of the site. The FDEP approved the RAP on May 4, 2001. Construction of the AS/SVE system was completed in the fourth quarter of 2002, and the system remains fully operational.

In the third quarter of 2007, the Company performed an updated environmental review of this site, including a review of any potential liabilities related to the investigation and remediation actions. Based on this review, the Company increased its liability by approximately $700,000 for the updated estimate of costs to remediate this site. Through December 31, 2007, the Company has incurred approximately $1.8 million of environmental costs associated with this site. At December 31, 2007, the Company had accrued a liability of $835,000 related to this site, offsetting (a) $15,000 collected through rates in excess of costs incurred and (b) a regulatory asset of approximately $851,000, representing the uncollected portion of the estimated clean-up costs. The Company expects to recover the remaining clean-up costs through rates.

The FDEP has indicated that the Company may be required to remediate sediments along the shoreline of Lake Shipp, immediately west of the Winter Haven Coal Gas site. Based on studies performed to date, the Company objects to the

FDEP's suggestion that the sediments have been contaminated and will require remediation. The Company's early estimates indicate that some of the corrective measures discussed by the FDEP may cost as much as $1 million. Given the Company's view as to the absence of ecological effects, the Company believes that cost expenditures of this magnitude are unwarranted and plans to oppose any requirement that it undertake corrective measures in the offshore sediments. Chesapeake anticipates that it will be several years before this issue is resolved. At this time, the Company has not recorded a liability for sediment remediation. The outcome of this matter cannot be predicted at this time.

Other

The Company is in discussions with the MDE regarding a manufactured gas plant site located in Cambridge, Maryland. The outcome of this matter cannot be determined at this time; therefore, the Company has not recorded an environmental liability for this location.

N. Other Commitments and Contingencies

Natural Gas and Propane Supply
The Company's natural gas and propane distribution operations have entered into contractual commitments to purchase gas from various suppliers. The contracts have various expiration dates. In April 2007, the Company renewed its contract with an energy marketing and risk management company to manage a portion of the Company's natural gas transportation and storage capacity. This new contract expires on March 31, 2008. PESCO is currently in the process of obtaining and reviewing supply proposals from suppliers and anticipates executing agreements prior to the existing contracts.

Corporate Guarantees
The Company has issued corporate guarantees to certain vendors of its propane wholesale marketing subsidiary and its Florida natural gas supply management subsidiary. These corporate guarantees provide for the payment of propane and natural gas purchases in the event of either subsidiary's default. The liabilities for these purchases are recorded in the Consolidated Financial Statements when incurred. The aggregate amount guaranteed at December 31, 2007 totaled $24.2 million, with the guarantees expiring on various dates in 2008. No guarantees were recorded by the Company in 2007.

In addition to the corporate guarantees, the Company has issued a letter of credit to its primary insurance company for $775,000, which expires on May 31, 2008. The letter of credit is provided as security to satisfy the deductibles under the Company's various insurance policies. There have been no draws on this letter of credit as of December 31, 2007.

Internal Revenue Service Audit
In November 2007, the Company was notified by the Internal Revenue Service ("IRS") that its consolidated federal income tax return for the year ended December 31, 2005 has been selected for examination. The IRS audit is ongoing and is expected to be completed in the second quarter of 2008. The outcome of this audit cannot be determined at this time; therefore, the Company has not recorded any reserves for potential assessments that may result from the examination.

Other
The Company is involved in certain legal actions and claims arising in the normal course of business. The Company is also involved in certain legal and administrative proceedings before various governmental agencies concerning rates. In the opinion of management, the ultimate disposition of these proceedings will not have a material effect on the consolidated financial position, results of operations or cash flows of the Company.

O. Quarterly Financial Data (Unaudited)

In the opinion of the Company, the quarterly financial information shown below includes all adjustments necessary for a fair presentation of the operations for such periods and to disclose OnSight as a discontinued operation. The quarterly information shown has been adjusted to reflect the reclassification of OnSight's operations for all periods presented. Due to the seasonal nature of the Company's business, there are substantial variations in operations reported on a quarterly basis.

For the Quarters Ended	March 31	June 30	September 30	December 31
2007				
Operating Revenue	$ 93,526,891	$ 52,501,920	$ 41,418,718	$ 70,838,968
Operating Income	$ 14,613,572	$ 3,698,066	$ 985,634	$ 8,816,310

Net Income (Loss)	$	7,991,088	$	1,481,791	$	(355,898)	$	4,080,730
Earnings per share:								
Basic	$	1.19	$	0.22	$	(0.05)	$	0.60
Diluted	$	1.18	$	0.22	$	(0.05)	$	0.60
2006								
Operating Revenue	$	90,950,160	$	44,303,239	$	35,141,531	$	60,804,636
Operating Income	$	11,535,195	$	3,303,448	$	322,672	$	8,170,621
Net Income (Loss)	$	6,096,416	$	1,132,509	$	(656,579)	$	3,934,179
Earnings per share:								
Basic	$	1.03	$	0.19	$	(0.11)	$	0.63
Diluted	$	1.01	$	0.19	$	(0.11)	$	0.62

Item 9. Changes In and Disagreements With Accountants on Accounting and Financial Disclosure.

On March 20, 2007, the Audit Committee of the Board of Directors of Chesapeake Utilities Corporation (the “Company”) dismissed PricewaterhouseCoopers LLP (“PwC”) as the Company's independent registered public accounting firm.

The reports of PwC on the consolidated financial statements of the Company for the years ended December 31, 2006 and 2005 did not contain an adverse opinion or a disclaimer of opinion, nor were they qualified or modified as to uncertainty, audit scope, or accounting principle.

During the years ended December 31, 2006 and 2005 and through March 20, 2007, there have been no (a) disagreements, as described under Item 304(a)(1)(iv) of Regulation S-K, with PwC on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure, which disagreements, if not resolved to the satisfaction of PwC, would have caused PwC to make reference thereto in their reports on the Company’s consolidated financial statements for such years, or (b) reportable events, as described under Item 304(a)(1)(v) of Regulation S-K.

The Company engaged Beard Miller Company LLP as its new independent registered public accounting firm. During the years ended December 31, 2006 and 2005 and through March 20, 2007, the Company had not consulted with Beard Miller Company LLP on any matters or events described in Item 304(a)(2) (i) and (ii) of Regulation S-K.

Item 9A. Controls and Procedures.

Evaluation of Disclosure Controls and Procedures

The Chief Executive Officer and Chief Financial Officer of the Company, with the participation of other Company officials, have evaluated the Company’s “disclosure controls and procedures” (as such term is defined under Rule 13a-15(e) and 15d – 15(e) promulgated under the Securities Exchange Act of 1934, as amended) as of December 31, 2007. Based upon their evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company’s disclosure controls and procedures were effective as of December 31, 2007.

Changes in Internal Controls

There has been no change in internal control over financial reporting (as such term is defined in Exchange Act Rule 13a-15(f)) that occurred during the quarter ended December 31, 2007, that materially affected, or is reasonably likely to materially affect, internal control over financial reporting.

CEO and CFO Certifications

The Company's Chief Executive Officer as well as the Senior Vice President and Chief Financial Officer have filed with the Securities and Exchange Commission the certifications required by Section 302 of the Sarbanes-Oxley Act of 2002 as Exhibits 31.1 and 31.2 to the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2007. In addition, on May 27, 2007, the Company's CEO certified to the New York Stock Exchange that he was not aware of any violation by the Company of the NYSE corporate governance listing standards.

Management's Report on Internal Control Over Financial Reporting

The report of management required under this Item 9A is contained in Item 8 of this Form 10-K under the caption "Management's Report on Internal Control over Financial Reporting."

Our independent auditors, Beard Miller Company LLP, have audited and issued their report on effectiveness of the Company's internal control over financial reporting. That report appears below.

Report of Independent Registered Public Accounting Firm

To the Board of Directors and

Stockholders of Chesapeake Utilities Corporation

We have audited Chesapeake Utilities Corporation's internal control over financial reporting as of December 31, 2007, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Chesapeake Utilities Corporation's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Report on Internal Control Over Financial Reporting appearing under Item 8. Our responsibility is to express an opinion on the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Chesapeake Utilities Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Chesapeake Utilities Corporation as of December 31, 2007, and the related consolidated statements of income, stockholders' equity, comprehensive income, cash flows and income taxes for the year then ended, and our report dated March 10, 2008 expressed an unqualified opinion.

/s/ Beard Miller Company LLP

Beard Miller Company LLP
Reading, Pennsylvania
March 10, 2008

Item 9B. Other Information.

None

Part III

Item 10. Directors, Executive Officers of the Registrant and Corporate Governanace.

The information required by this Item is incorporated herein by reference to the portions of the Proxy Statement, captioned “Proposal I – Election of Directors,” “Information Regarding the Board of Directors and Nominees,” “Corporate Governance Practices and Stockholder Communications – Nomination of Directors,” “Committees of the Board – Audit Committee” and “Section 16(a) Beneficial Ownership Reporting Compliance” to be filed not later than March 31, 2008 in connection with the Company’s Annual Meeting to be held on May 1, 2008.

The information required by this Item with respect to executive officers is, pursuant to instruction 3 of paragraph (b) of Item 401 of Regulation S-K, set forth in this report following Item 4, as Item 4A, under the caption “Executive Officers of the Company.”

The Company has adopted a Code of Ethics for Financial Officers, which applies to its principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions. The information set forth under Item 1 hereof concerning the Code of Ethics for Financial Officers is incorporated herein by reference.

Item 11. Executive Compensation.

The information required by this Item is incorporated herein by reference to the portion of the Proxy Statement captioned “Director Compensation,” “Executive Compensation” and “Compensation Discussion and Analysis” in the Proxy Statement to be filed not later than March 31, 2008, in connection with the Company’s Annual Meeting to be held on May 1, 2008.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.

The information required by this Item is incorporated herein by reference to the portion of the Proxy Statement captioned “Beneficial Ownership of Chesapeake’s Securities” to be filed not later than March 31, 2008 in connection with the Company’s Annual Meeting to be held on May 1, 2008.

The following table sets forth information, as of December 31, 2007, with respect to compensation plans of Chesapeake and its subsidiaries, under which shares of Chesapeake common stock are authorized for issuance:

	(a)	(b)	(c)
	Number of securities to be issued upon exercise of outstanding options, warrants and rights	Weighted-average exercise price of outstanding options, warrants and rights	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column

				(a)
Equity compensation plans approved by security holders	0	(1)	471,626	(2)
Equity compensation plans not approved by security holders	0	(3)		
Total	0			

(1) All options to purchase shares under the 1992 Performance Incentive Plan, as amended, were exercised as of 12/31/05.

(2) Includes 389,876 shares under the 2005 Performance Incentive Plan, 57,450 shares available under the 2005 Directors Stock Compensation Plan, and 24,300 shares available under the 2005 Employee Stock Awards Plan.

(3) All warrants were exercised in 2006.

Item 13. Certain Relationships and Related Transactions, and Director Independence.

None

Item 14. Principal Accounting Fees and Services.

The information required by this Item is incorporated herein by reference to the portion of the Proxy Statement captioned "Fees and Services of the Independent Public Accounting Firm" to be filed not later than March 31, 2008, in connection with the Company's Annual Meeting to be held on May 1, 2008.

Part IV

Item 15. Exhibits, Financial Statement Schedules.

(a) The following documents are filed as part of this report:

1. Financial Statements:

- Report of Independent Registered Public Accounting Firm;
- Consolidated Statements of Income for each of the three years ended December 31, 2007, 2006 and 2005;
- Consolidated Balance Sheets at December 31, 2007 and December 31, 2006;
- Consolidated Statements of Cash Flows for each of the three years ended December 31, 2007, 2006, and 2005;
- Consolidated Statements of Common Stockholders' Equity for each of the three years ended December 31, 2007, 2006, and 2005;
- Consolidated Statements of Comprehensive Income for each of the three years ended December 31, 2007, 2006, and 2005;
- Consolidated Statements of Income Taxes for each of the three years ended December 31,2007, 2006, and 2005;
- Notes to the Consolidated Financial Statements.

2. Financial Statement Schedule:

- Report of Independent Registered Public Accounting Firm; and
- Schedule II - Valuation and Qualifying Accounts.

All other schedules are omitted, because they are not required, are inapplicable or the information is otherwise shown in the financial statements or notes thereto.

3. Exhibits

- Εξηιβιτ 1.1 Underwriting Agreement entered into by Chesapeake Utilities Corporation and Robert W. Baird & Co. Incorporated and A.G. Edwards & Sons, Inc., on November 15, 2007, relating to the sale and issuance of 600,300 shares of the Company's common stock, is incorporated herein by reference to Exhibit 1.1 of the Company's Current Report on Form 8-K, filed November 16, 2007, File No. 001-11590.
- Εξηιβιτ 3.1 Restated Certificate of Incorporation of Chesapeake Utilities Corporation is incorporated herein by reference to Exhibit 3.1 of the Company's Quarterly Report on Form 10-Q for the period ended June 30, 1998, File No. 001-11590.

- Εξηιβιτ 3.2 Amended and Restated Bylaws of Chesapeake Utilities Corporation, effective December 12, 2007, is filed herewith.

- Εξηιβιτ 4.1 Form of Indenture between the Company and Boatmen's Trust Company, Trustee, with respect to the 8 1/4% Convertible Debentures is incorporated herein by reference to Exhibit 4.2 of the Company's Registration Statement on Form S-2, Reg. No. 33-26582, filed on January 13, 1989.

- Εξηιβιτ 4.2 Note Agreement dated February 9, 1993, by and between the Company and Massachusetts Mutual Life Insurance Company and MML Pension Insurance Company, with respect to $10 million of 7.97% Unsecured Senior Notes due February 1, 2008, is incorporated herein by reference to Exhibit 4 to the Company's Annual Report on Form 10-K for the year ended December 31, 1992, File No. 0-593.

- Εξηιβιτ 4.3 Note Purchase Agreement, entered into by the Company on October 2, 1995, pursuant to which the Company privately placed $10 million of its 6.91% Senior Notes, due in 2010, is not being filed herewith, in accordance with Item 601(b)(4)(iii) of Regulation S-K. The Company hereby agrees to furnish a copy of that agreement to the SEC upon request.

- Εξηιβιτ 4.4 Note Purchase Agreement, entered into by the Company on December 15, 1997, pursuant to which the Company privately placed $10 million of its 6.85% Senior Notes due in 2012, is not being filed herewith, in accordance with Item 601(b)(4)(iii) of Regulation S-K. The Company hereby agrees to furnish a copy of that agreement to the SEC upon request.

- Εξηιβιτ 4.5 Note Purchase Agreement entered into by the Company on December 27, 2000, pursuant to which the Company privately placed $20 million of its 7.83% Senior Notes, due in 2015, is not being filed herewith, in accordance with Item 601(b)(4)(iii) of Regulation S-K. The Company hereby agrees to furnish a copy of that agreement to the SEC upon request.

- Εξηιβιτ 4.6 Note Agreement entered into by the Company on October 31, 2002, pursuant to which the Company privately placed $30 million of its 6.64% Senior Notes, due in 2017, is incorporated herein by reference to Exhibit 2 of the Company's Current Report on Form 8-K, filed November 6, 2002, File No. 001-11590.

- Εξηιβιτ 4.7 Note Agreement entered into by the Company on October 18, 2005, pursuant to which the Company, on October 12, 2006, privately placed $20 million of its 5.5% Senior Notes, due in 2020, with Prudential Investment Management, Inc., is incorporated herein by reference to Exhibit 4.1 of the Company's Annual Report on Form 10-K for the year ended December 31, 2005, File No. 001-11590.

- Εξηιβιτ 4.8 Form of Senior Debt Trust Indenture between Chesapeake Utilities Corporation and the trustee for the debt securities is incorporated herein by reference to Exhibit 4.3.1 of the Company's Registration Statement on Form S-3A, Reg. No. 333-135602, dated November 6, 2006.

- Εξηιβιτ 4.9 Form of Subordinated Debt Trust Indenture between Chesapeake Utilities Corporation and the trustee for the debt securities is incorporated herein by reference to Exhibit 4.3.2 of the Company's Registration Statement on Form S-3A, Reg. No. 333-135602, dated November 6, 2006.

- Εξηιβιτ 4.10 Form of debt securities is incorporated herein by reference to Exhibit 4.4 of the Company's Registration Statement on Form S-3A, Reg. No. 333-135602, dated November 6, 2006.

- Εξηιβιτ 10.1* Chesapeake Utilities Corporation Cash Bonus Incentive Plan, dated January 1, 2005, is incorporated herein by reference to Exhibit 10.3 of the Company's Annual Report on Form 10-K for the year ended December 31, 2004, File No. 001-11590.

- Εξηιβιτ 10.2* Chesapeake Utilities Corporation Directors Stock Compensation Plan, adopted in 2005, is incorporated herein by reference to the Company's Proxy Statement dated March 28, 2005, in connection with the Company's Annual Meeting held on May 5, 2005, File No. 001-11590.

- Εξηιβιτ 10.3* Chesapeake Utilities Corporation Employee Stock Award Plan, adopted in 2005, is incorporated herein by reference to the Company's Proxy Statement dated March 28, 2005, in connection with the Company's Annual Meeting held on May 5, 2005, File No. 001-11590.

- Εξηιβιτ 10.4* Chesapeake Utilities Corporation Performance Incentive Plan, adopted in 2005, is incorporated herein by reference to the Company's Proxy Statement dated March 28, 2005, in connection with the Company's Annual Meeting held on May 5, 2005, File No. 001-11590.

- Εξηιβιτ 10.5* Deferred Compensation Program (amended and restated as of December 7, 2006) is incorporated herein by reference to Exhibit 10 of the Company's Current Report on Form 8-K, filed December 13, 2006, File No. 001-11590.

- Εξηιβιτ 10.6* Executive Employment Agreement dated December 29, 2006, by and between Chesapeake Utilities Corporation and S. Robert Zola, is incorporated herein by reference to Exhibit 10.7 of the Company's Annual Report on Form 10-K for the year ended December 31, 2006, File No. 001-11590.

- Εξηιβιτ 10.7* Executive Employment Agreement dated December 29, 2006, by and between Chesapeake Utilities Corporation and Stephen C. Thompson, is incorporated herein by reference to Exhibit 10.8 of the Company's Annual Report on Form 10-K for the year ended December 31, 2006, File No. 001-11590.

- Εξηιβιτ 10.8* Executive Employment Agreement dated December 29, 2006, by and between Chesapeake Utilities Corporation and Beth W. Cooper, is incorporated herein by reference to Exhibit 10.9 of the Company's Annual Report on Form 10-K for the year ended December 31, 2006, File No. 001-11590.

- Εξηιβιτ 10.9* Executive Employment Agreement dated December 29, 2006, by and between Chesapeake Utilities Corporation and Michael P. McMasters, is incorporated herein by reference to Exhibit 10.10 of the Company's Annual Report on Form 10-K for the year ended December 31, 2006, File No. 001-11590.

- Εξηιβιτ 10.10* *Executive Employment Agreement dated December 29, 2006, by and between Chesapeake Utilities Corporation and John R. Schimkaitis, is incorporated herein by reference to Exhibit 10.11 of the Company's Annual Report on Form 10-K for the year ended December 31, 2006, File No. 001-11590.

- Εξηιβιτ 10.11* Performance Share Agreement dated January 23, 2008 for the period 2008 to 2009, pursuant to Chesapeake Utilities Corporation Performance Incentive Plan by and between Chesapeake Utilities Corporation and John R. Schimkaitis, filed herewith.

- Εξηιβιτ 10.12* Performance Share Agreement dated January 23, 2008 for the period 2008 to 2010, pursuant to Chesapeake Utilities Corporation Performance Incentive Plan by and between Chesapeake Utilities Corporation and John R. Schimkaitis, is filed herewith.

- Εξηιβιτ 10.13* Performance Share Agreement dated January 23, 2008 for the period 2008 to 2009, pursuant to Chesapeake Utilities Corporation Performance Incentive Plan by and between Chesapeake Utilities Corporation and Michael P. McMasters, is filed herewith.
- Εξηιβιτ 10.14* Performance Share Agreement dated January 23, 2008 for the period 2008 to 2010, pursuant to Chesapeake Utilities Corporation Performance Incentive Plan by and between Chesapeake Utilities Corporation and Michael P. McMasters, is filed herewith.
- Εξηιβιτ 10.15* Performance Share Agreement dated January 23, 2008 for the period 2008 to 2009, pursuant to Chesapeake Utilities Corporation Performance Incentive Plan by and between Chesapeake Utilities Corporation and Stephen C. Thompson, is filed herewith.
- Εξηιβιτ 10.16* Performance Share Agreement dated January 23, 2008 for the period 2008 to 2010, pursuant to Chesapeake Utilities Corporation Performance Incentive Plan by and between Chesapeake Utilities Corporation and Stephen C. Thompson, is filed herewith.
- Εξηιβιτ 10.17* Performance Share Agreement dated January 23, 2008 for the period 2008 to 2009, pursuant to Chesapeake Utilities Corporation Performance Incentive Plan by and between Chesapeake Utilities Corporation and Beth W. Cooper, is filed herewith.
- Εξηιβιτ 10.18* Performance Share Agreement dated January 23, 2008 for the period 2008 to 2010, pursuant to Chesapeake Utilities Corporation Performance Incentive Plan by and between Chesapeake Utilities Corporation and Beth W. Cooper, is filed herewith.
- Εξηιβιτ 10.19* Performance Share Agreement dated January 23, 2008 for the period 2008 to 2009, pursuant to Chesapeake Utilities Corporation Performance Incentive Plan by and between Chesapeake Utilities Corporation and S. Robert Zola, is filed herewith.
- Εξηιβιτ 10.20* Performance Share Agreement dated January 23, 2008 for the period 2008 to 2010, pursuant to Chesapeake Utilities Corporation Performance Incentive Plan by and between Chesapeake Utilities Corporation and S. Robert Zola, is filed herewith.

- Εξηιβιτ 12 Computation of Ratio of Earning to Fixed Charges is filed herewith.

- Εξηιβιτ 14.1 Code of Ethics for Financial Officers is incorporated herein by reference to Exhibit 14 of the Company's Annual Report on Form 10-K for the year ended December 31, 2006, File No. 001-11590.

- Εξηιβιτ 14.2 Business Code of Ethics and Conduct is filed herewith.

- Εξηιβιτ 16 Letter Regarding Change in Certifying Accountant is filed herewith.

- Εξηιβιτ 21 Subsidiaries of the Registrant is filed herewith.

- Εξηιβιτ 22 Published Report Regarding Matters Submitted to Vote of Security Holders is incorporated herein by reference to Part II, Item 4 of the Company's Quarterly Report on Form 10-Q for the period ended June 30, 2006, File No. 001-11590.

- Εξηιβιτ 23.1 Consent of Independent Registered Public Accounting Firm is filed herewith.

- Εξηιβιτ 23.2 Consent of Preceding Independent Registered Public Accounting Firm for years 2006 and 2005 is filed herewith.

- Εξηιβιτ 31.1 Certificate of Chief Executive Office of Chesapeake Utilities Corporation pursuant to Exchange Act Rule 13a-14(a), dated March 10, 2008, is filed herewith.

- Εξηιβιτ 31.2 Certificate of Chief Financial Officer of Chesapeake Utilities Corporation pursuant to Exchange Act Rule 13a-14(a), dated March 10, 2008, is filed herewith.

- Εξηιβιτ 32.1 Certificate of Chief Executive Office of Chesapeake Utilities Corporation pursuant to 18 U.S.C. Section 1350, dated March 10, 2008, is filed herewith.

- Εξηιβιτ 32.2 Certificate of Chief Financial Officer of Chesapeake Utilities Corporation pursuant to 18 U.S.C. Section 1350, dated March 10, 2008, is filed herewith.

* Management contract or compensatory plan or agreement.

Signatures

Pursuant to the requirements of Section 13 or 15 (d) of the Securities Exchange Act of 1934, Chesapeake Utilities Corporation has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Chesapeake Utilities Corporation

By: /s/ John R. Schimkaitis
John R. Schimkaitis
President and Chief Executive Officer
Date: March 10, 2008

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

/s/ Ralph J. Adkins
Ralph J. Adkins, Chairman of the Board
and Director
Date: February 20, 2008

/s/ John R. Schimkaitis
John R. Schimkaitis, President,
Chief Executive Officer and Director
Date: March 10, 2008

/s/ Michael P. McMasters
Michael P. McMasters, Senior Vice President
and Chief Financial Officer
(Principal Financial and Accounting Officer)
Date: March 10, 2008

/s/ Richard Bernstein
Richard Bernstein, Director
Date: February 20, 2008

/s/ Eugene H. Bayard
Eugene H. Bayard, Director
Date: February 20, 2008

/s/ Thomas J. Bresnan
Thomas J. Bresnan, Director
Date: March 10, 2008

/s/ Thomas P. Hill, Jr.
Thomas P. Hill, Jr., Director
Date: February 20, 2008

/s/ Walter J. Coleman
Walter J. Coleman, Director
Date: February 20, 2008

/s/ J. Peter Martin
J. Peter Martin, Director
Date: February 20, 2008

/s/ Joseph E. Moore, Esq.
Joseph E. Moore, Esq., Director
Date: February 20, 2008

/s/ Calvert A. Morgan, Jr.
Calvert A. Morgan, Jr., Director
Date: February 20, 2008

Report of Independent Registered Public Accounting Firm

To the Board of Directors and

Stockholders of Chesapeake Utilities Corporation

The audit referred to in our report dated March 10, 2008 relating to the consolidated financial statements of Chesapeake Utilities Corporation as of December 31, 2007 and for the year then ended, which is contained in Item 8 of this Form 10-K also included the audit of the financial statement schedules listed in Item 15. These financial statement schedules are the responsibility of the Chesapeake Utilities Corporation's management. Our responsibility is to express an opinion on these financial statement schedules based on our audit.

In our opinion such financial statement schedules, when considered in relation to the basic consolidated financial statements taken as a whole, present fairly, in all material respects, the information set forth therein.

/s/ Beard Miller Company LLP

Beard Miller Company LLP
Reading, Pennsylvania
March 10, 2008

Chesapeake Utilities Corporation and Subsidiaries
Schedule II
Valuation and Qualifying Accounts

		Additions			
For the Year Ended December 31,	Balance at Beginning of Year	Charged to Income	Other Accounts (1)	Deductions (2)	Balance at End of Year
Reserve Deducted From Related Assets					
Reserve for Uncollectible Accounts					
2007	$ 661,597	$ 818,561	$ 26,190	$ (554,273)	$ 952,075
2006	$ 861,378	$ 381,424	$ 65,519	$ (646,724)	$ 661,597
2005	$ 610,819	$ 632,644	$ 158,409	$ (540,494)	$ 861,378

(1) Recoveries.
(2) Uncollectible accounts charged off.

Upon written request, Chesapeake will provide, free of charge, a copy of any exhibit to the 2007 Annual Report on Form 10-K not included in this document.